SYNBIOTICS CORP
Form 10-Q
August 16, 2004
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U.S. SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT UNDER SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2004

OR

¨ TRANSITION REPORT UNDER SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

Commission file number 0-11303

SYNBIOTICS CORPORATION

(Exact name of registrant as specified in its charter)

California	**95-3737816**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

11011 Via Frontera

San Diego, California **92127**
(Address of principal executive offices) (Zip Code)

Registrant s telephone number, including area code: (858) 451-3771

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

As of August 16, 2004, there were 20,378,479 shares of our common stock outstanding.

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements

Synbiotics Corporation

Condensed Consolidated Balance Sheet

	June 30, 2004	December 31, 2003
	(unaudited)	(audited)
Assets		
Current assets:		
Cash and equivalents	$ 808,000	$ 1,045,000
Accounts receivable	2,527,000	2,686,000
Inventories	5,931,000	5,266,000
Other current assets	1,442,000	878,000
	10,708,000	9,875,000
Property and equipment, net	1,029,000	1,232,000
Goodwill	1,397,000	1,397,000
Intangibles, net	1,979,000	2,358,000
Other assets	354,000	479,000
	$ 15,467,000	$ 15,341,000
Liabilities and Shareholders Equity:		
Current liabilities:		
Accounts payable and accrued expenses	$ 4,549,000	$ 4,005,000
Current portion of long-term debt	4,549,000	4,804,000
	9,098,000	8,809,000
Other liabilities	2,219,000	2,134,000
Shareholders equity:		
Series C preferred stock, $1,000 liquidation preference per share (aggregating $2,800,000 at June 30, 2004 and December 31, 2003), 4,000 shares authorized, 2,800 shares issued and outstanding at June 30, 2004 and December 31, 2003	2,604,000	2,604,000
Common stock, no par value, 70,000,000 shares authorized, 20,379,000 and 20,025,000 shares issued and outstanding at June 30, 2004 and December 31, 2003	46,473,000	46,316,000
Common stock warrants	1,035,000	1,035,000
Accumulated other comprehensive loss	(521,000)	(411,000)
Accumulated deficit	(45,441,000)	(45,146,000)

Total shareholders equity	4,150,000	4,398,000
	$ 15,467,000	$ 15,341,000

See accompanying notes to condensed consolidated financial statements.

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Synbiotics Corporation

Condensed Consolidated Statement of Operations and Comprehensive Income (Loss) (unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Revenues:				
Net sales	$ 4,560,000	$ 4,774,000	$ 9,691,000	$ 10,922,000
Royalties	168,000	97,000	215,000	99,000
	4,728,000	4,871,000	9,906,000	11,021,000
Operating expenses:				
Cost of sales	2,006,000	2,340,000	4,454,000	5,303,000
Research and development	316,000	291,000	739,000	556,000
Selling and marketing	1,025,000	988,000	2,138,000	2,052,000
General and administrative	1,727,000	897,000	3,304,000	1,715,000
Patent litigation settlement	(850,000)		(850,000)	(515,000)
	4,224,000	4,516,000	9,785,000	9,111,000
Income from operations	504,000	355,000	121,000	1,910,000
Other income (expense):				
Interest, net	(147,000)	(139,000)	(257,000)	(274,000)
Income (loss) before income taxes	357,000	216,000	(136,000)	1,636,000
Provision for (benefit from) income taxes		(8,000)	2,000	13,000
Net income (loss)	357,000	224,000	(138,000)	1,623,000
Translation adjustment	(23,000)	191,000	(110,000)	389,000
Comprehensive income (loss)	$ 334,000	$ 415,000	$ (248,000)	$ 2,012,000
Net income (loss) available to common shareholders	$ 304,000	$ 171,000	$ (243,000)	$ 1,518,000
Basic net income (loss) per share	$ 0.01	$ 0.01	$ (0.01)	$ 0.08
Diluted net income (loss) per share	$ 0.01	$ 0.01	$ (0.01)	$ 0.04

See accompanying notes to condensed consolidated financial statements.

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Synbiotics Corporation

Condensed Consolidated Statement of Cash Flows (unaudited)

	Six Months Ended June 30,	
	2004	2003
Cash flows from operating activities:		
Net income (loss)	$ (138,000)	$ 1,623,000
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	576,000	546,000
Receivable from patent litigation settlement	(425,000)	(265,000)
Changes in assets and liabilities:		
Accounts receivable	102,000	247,000
Inventories	(705,000)	571,000
Other assets	(131,000)	10,000
Accounts payable and accrued expenses	645,000	(1,782,000)
Other liabilities	87,000	80,000
Net cash provided by operating activities	11,000	1,030,000
Cash flows from investing activities:		
Acquisition of property and equipment	(83,000)	(115,000)
Receipts from notes receivable	116,000	
Net cash provided by (used for) investing activities	33,000	(115,000)
Cash flows from financing activities:		
Payments of long-term debt	(256,000)	(786,000)
Net cash (used for) provided by financing activities	(256,000)	(786,000)
Net (decrease) increase in cash and equivalents	(212,000)	129,000
Effect of exchange rates on cash	(25,000)	37,000
Cash and equivalents beginning of period	1,045,000	869,000
Cash and equivalents end of period	$ 808,000	$ 1,035,000

See accompanying notes to condensed consolidated financial statements.

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Notes to Condensed Consolidated Financial Statements (unaudited)

Note 1 - Interim Financial Statements:

The accompanying condensed consolidated balance sheet as of June 30, 2004 and the condensed consolidated statements of operations and comprehensive income (loss) and of cash flows for the three and six months ended June 30, 2004 and 2003 have been prepared by Synbiotics Corporation (the Company) and have not been audited. The condensed consolidated financial statements of the Company include the accounts of its wholly-owned subsidiary Synbiotics Europe SAS (SBIO-E). All significant intercompany transactions and accounts have been eliminated in consolidation. These financial statements, in the opinion of management, include all adjustments (consisting only of normal recurring accruals) necessary for a fair presentation of the financial position, results of operations and cash flows for all periods presented. The financial statements should be read in conjunction with the financial statements and notes thereto included in the Company s Annual Report on Form 10-K filed for the year ended December 31, 2003. Interim operating results are not necessarily indicative of operating results for the full year.

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Note 2 Going Concern:

The accompanying consolidated condensed financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. Although the Company was profitable in 2003, during the six months ended June 30, 2004, the Company incurred a net loss of $138,000, and had an accumulated deficit of $45,441,000 as of June 30, 2004.

As of June 30, 2004, the Company had an outstanding principal balance under its bank debt totaling $4,549,000 (Note 5), all of which was due and payable in January 2004. The bank had informally reduced the monthly principal payments to $30,000 for the payments due February 1, 2004, and March 1, 2004. On March 29, 2004, the Company entered into a forbearance agreement with the bank whereby the bank agreed not to exercise any of its rights under the credit agreement through May 5, 2004, and agreed to formally reduce the monthly principal payments to $30,000 for the payments due April 1, 2004, and May 1, 2004; the forbearance agreement has now expired. The Company believes it will be able to restructure or refinance the bank debt. However, no assurance can be given that the Company will be successful in this effort to restructure or refinance the bank debt. The Company s resources do not enable it to repay the note in its entirety immediately.

These factors raise substantial doubt about the Company s ability to continue as a going concern for a reasonable period of time. The consolidated condensed financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or the amounts and classification of liabilities that might be necessary should the Company be unable to continue as a going concern.

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Notes to Condensed Consolidated Financial Statements (unaudited)

Note 3 - Inventories:

Inventories consist of the following:

	June 30, 2004	December 31, 2003
	(unaudited)	(audited)
Raw materials	$ 3,422,000	$ 2,532,000
Work in process	416,000	477,000
Finished goods	2,093,000	2,257,000
	$ 5,931,000	$ 5,266,000

Note 4 Goodwill and Other Intangible Assets:

The Company has allocated all of its goodwill to its only reporting unit, which is also its only reportable segment (Note 10). There were no changes in the carrying amount of goodwill from December 31, 2002 to June 30, 2004.

Other intangible assets were as follows:

	June 30, 2004		December 31, 2003	
	Gross Carrying Value	Accumulated Amortization	Gross Carrying Value	Accumulated Amortization
Patents	$ 4,972,000	$ 3,136,000	$ 5,108,000	$ 2,922,000
Licenses	618,000	475,000	618,000	446,000
	$ 5,590,000	$ 3,611,000	$ 5,726,000	$ 3,368,000

The weighted-average amortization periods for patents and licenses are 9 years and 10 years, respectively, and the weighted-average amortization period for total intangible assets is 9 years. Annual pretax amortization for other intangibles over the next five years (including the remaining six months of 2004) is estimated to be as follows:

2004	$ 334,000
2005	638,000
2006	629,000
2007	369,000
2008	13,000
	$ 1,983,000

Note 5 Note Payable:

As of June 30, 2004, the Company had an outstanding principal balance under its bank debt totaling $4,549,000, all of which was due and payable in January 2004. The bank had informally reduced the monthly principal payments to $30,000 for the payments due February 1, 2004, and March 1, 2004. On March 29, 2004, the Company entered into a forbearance agreement with the bank whereby the bank agreed not to exercise any of its rights under the credit agreement through May 5, 2004, and agreed to formally reduce the monthly principal payments to $30,000 for the payments due April 1, 2004, and May 1, 2004; the forbearance agreement has now expired. In June 2004, the bank notified the Company that it was increasing the interest rate on the debt from prime plus 2%

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SYNBIOTICS CORPORATION

Notes to Condensed Consolidated Financial Statements (unaudited)

to prime plus 7%. The Company believes it will be able to restructure or refinance the bank debt. However, no assurance can be given that the Company will be successful in this effort to restructure or refinance the bank debt.

Note 6 Preferred Stock Dividends:

On March 11, 2004, the Company declared a dividend on the Series C preferred stock, in the form of common stock with a value totaling $158,000, for dividends accrued and payable as of January 31, 2004. Redwood West Coast, LLC (Redwood), the holder of the Series C preferred stock, as permitted by the Certificate of Determination of the Series C preferred stock, had elected to receive a dividend in the form of shares of the Company s common stock in lieu of overdue cash dividends. As a result, the Company issued 354,000 shares of the Company s common stock to Redwood s distributees on March 11, 2004.

Note 7 Patent Litigation Settlement:

In September 2003, the Company filed a lawsuit against Agen Biomedical, Ltd. (Agen) in the United States District Court for the Southern District of California alleging that Agen infringed a patent owned by the Company relating to heartworm diagnostic technology. In June 2004, the Company and Agen entered into a settlement agreement which has resolved all outstanding claims in the lawsuit. As part of the agreement, each party has licensed certain intellectual property rights from the other party, including Agen licensing from the Company the patent relating to the heartworm diagnostic technology. In addition, the Company received $425,000 in June 2004, and will receive $425,000 in June 2005. In addition, the Company will supply certain biologicals to Agen at specified prices, and the Company will receive a percentage of Agen s sales of Agen products containing the supplied biologicals. As a result the settlement, the Company has recorded a one-time credit to operating expenses totaling $850,000 during the three months ended June 30, 2004.

Note 8 Income (Loss) per Share:

The following is a reconciliation of net income (loss) and share amounts used in the computations of income (loss) per share:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003

	(unaudited)	(unaudited)	(unaudited)	(unaudited)
Basic net income (loss) used:				
Net income (loss)	$ 357,000	$ 224,000	$ (138,000)	$ 1,623,000
Less cumulative preferred stock dividends	(53,000)	(53,000)	(105,000)	(105,000)
Net income (loss) used in computing basic net income (loss) per share	$ 304,000	$ 171,000	$ (243,000)	$ 1,518,000
Diluted net income (loss) used:				
Net income (loss) used in computing basic income (loss	$ 304,000	$ 171,000	$ (243,000)	$ 1,518,000
Add cumulative preferred stock dividends	53,000	53,000		105,000
Net income (loss) used in computing diluted net income (loss) per share	$ 357,000	$ 224,000	$ (243,000)	$ 1,623,000

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Notes to Condensed Consolidated Financial Statements (unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
	(unaudited)	(unaudited)	(unaudited)	(unaudited)
Shares used:				
Weighted average common shares outstanding used in computing basic income (loss) per share	20,378,000	19,821,000	20,261,000	19,198,000
Weighted average options and warrants to purchase common stock as determined by the treasury method	1,054,000	665,000		500,000
Weighted average common shares issuable upon conversion of preferred stock as determined by the if-converted method	21,797,000	21,797,000		21,797,000
Shares used in computing diluted income (loss) per share	43,229,000	42,283,000	20,261,000	41,495,000

Weighted average options and warrants to purchase common stock as determined by the application of the treasury method and weighted average shares of common stock issuable upon conversion of the Series C preferred stock as determined by the if-converted method totaling 996,000 and 583,000 shares for the three months ended June 30, 2004 and 2003, respectively, and totaling 23,664,000 and 583,000 shares for the six months ended June 30, 2004 and 2003, respectively, have been excluded from the shares used in computing diluted net income (loss) per share as their effect is anti-dilutive.

Note 9 Income Taxes:

The Company s provision for income taxes for the six months ended June 30, 2004, is less than the amount expected by applying the Federal statutory rate to income before income taxes, resulting from the Company s net operating loss for the period, and the corresponding change in the Company s valuation allowance for deferred tax assets.

Note 10 Segment Information and Significant Customers:

The Company has determined that it has only one reportable segment based on the fact that all of its net sales are from its animal health products. Although the Company sells diagnostic and instrument products, it does not base its business decision making on a product category basis.

The following are revenues for the Company s diagnostic and instrument products:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
	(unaudited)	(unaudited)	(unaudited)	(unaudited)
Diagnostics	$ 4,156,000	$ 4,456,000	$ 8,872,000	$ 10,347,000
Instruments	404,000	318,000	819,000	575,000
Other revenues	168,000	97,000	215,000	99,000
	$ 4,728,000	$ 4,871,000	$ 9,906,000	$ 11,021,000

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Notes to Condensed Consolidated Financial Statements (unaudited)

The following are revenues and long-lived assets information by geographic area:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
	(unaudited)	(unaudited)	(unaudited)	(unaudited)
Revenues:				
United States	$ 2,788,000	$ 2,991,000	$ 5,735,000	$ 6,914,000
France	511,000	500,000	1,224,000	1,088,000
Other foreign countries	1,429,000	1,380,000	2,947,000	3,019,000
	$ 4,728,000	$ 4,871,000	$ 9,906,000	$ 11,021,000

	June 30, 2004	December 31, 2003
	(unaudited)	(audited)
Long-lived assets:		
United States	$ 2,768,000	$ 3,078,000
France	1,991,000	2,388,000
	$ 4,759,000	$ 5,466,000

There were no sales to any one customer that totaled 10% or more of total revenues during the three and six months ended June 30, 2004 and 2003.

Note 11 Stock-Based Compensation:

The Company measures its stock-based employee compensation using the intrinsic value method. The following disclosures present as reported amounts, utilizing the intrinsic value method, and pro forma amounts, after applying the fair value method, related to stock-based awards made to employees that were outstanding as of June 30, 2004 and 2003:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
	(unaudited)	(unaudited)	(unaudited)	(unaudited)
Net income (loss):				
As reported	$ 357,000	$ 224,000	$ (138,000)	$ 1,623,000
Pro forma	$ 342,000	$ 191,000	$ (169,000)	$ 1,557,000
Basic net income (loss) per share:				
As reported	$ 0.01	$ 0.01	$ (0.01)	$ 0.08
Pro forma	$ 0.01	$ 0.01	$ (0.01)	$ 0.08
Diluted net income (loss) per share:				
As reported	$ 0.01	$ 0.01	$ (0.01)	$ 0.04
Pro forma	$ 0.01	$	$ (0.01)	$ 0.04
Stock-based employee compensation:				
As reported	$	$	$	$
Pro forma	$ 15,000	$ 33,000	$ 31,000	$ 66,000

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

The information contained in this Management s Discussion and Analysis of Financial Condition and Results of Operations and elsewhere in this Quarterly Report on Form 10-Q contains both historical financial information and forward-looking statements. Forward-looking statements are characterized by words such as intend , plan , believe , will , would , etc. Historical financial information may not be indicative of future financial performance. In fact, future financial performance may be materially different than the historical financial information presented herein. Moreover, the forward-looking statements about future business or future results of operations are subject to significant uncertainties and risks, including those detailed under the caption Certain Risk Factors , which could cause actual future results to differ materially from what is suggested by the forward-looking information.

Results of Operations

Our net sales for the second quarter 2004 decreased by $214,000 or 4% from the second quarter of 2003. The decrease reflects a decrease in our diagnostic product sales of $300,000, offset by an increase in our instrument product sales of $86,000. Our net sales for the six months ended June 30, 2004 decreased by $1,231,000 or 11% from the six months ended June 30, 2003. The decrease reflects a decrease in our diagnostic product sales of $1,475,000 offset by an increase in our instrument product sales of $244,000. Sales of our diagnostic products decreased primarily due to additional competition in the canine heartworm diagnostic market from Agen Biomedical Ltd. (Agen). Agen s canine heartworm diagnostic product is essentially identical to our Witness® canine heartworm diagnostic test kit, including biological components which incorporate our patented technology.

Agen is currently distributing its products in the U.S. through Vedco, a co-operative buying group. Several of the members/owners of this buying group distribute our canine heartworm and other products, and have decided to promote Agen s canine heartworm product instead of ours. Additionally, Agen s distributors marketed the canine heartworm product with a price which is significantly less than previously established prices in this market. As a result, we have been forced to compete on price and our average selling price for our Witness® canine heartworm product during the first six months of 2004 was 22% less than that during the first six months of 2003. We do not believe that this price erosion will be easily reversed, especially after our patent expires in late 2005. Our instrument product sales increased primarily due to increased placements of our SCA 2000™ blood coagulation timing instrument and the resulting sales of the related consumables.

In April 2003, Agen terminated its supply agreement with us. Agen contract manufactured certain of our Witness® in-clinic diagnostic products including canine heartworm, feline leukemia, feline heartworm and canine parvovirus, using key biological components which we manufacture at our facilities and had provided to Agen. We then identified a U.S.-based alternate contract manufacturer of the same Witness® products previously manufactured for us by Agen. We licensed the alternate-source Witness® canine heartworm product with the USDA, and we began selling this product in January 2004; we believe our first-quarter sales of this product would have been higher if we had been able to re-launch it before the quarter began. We also anticipate having the alternate-source Witness® feline leukemia and canine parvovirus products available for sale by the end of the third quarter of 2004. In addition to the material impact during the first quarter of 2004, we also believe that our results of operations and financial condition could be materially adversely affected for the remainder of 2004 and beyond if we are unable to fully succeed in reintroducing the alternate-source products into the market.

We recognize revenue from product sales when title and risk of loss transfers to our customer, which is generally upon shipment. Amounts we charge to our customers for shipping and handling are included in our net sales. We provide promotional discounts and rebates to certain of our distributors. Based upon the structure of these rebate programs and our past history, we are able to accurately estimate the amount of rebates at the time of sale. These rebates are recorded as a reduction of our net sales. We

recognize license fee revenue ratably over the license term when we have further performance obligations to our licensee. In the event that we have no further performance obligations to our licensee, we recognize license fee revenue upon receipt.

Our cost of sales as a percentage of our net sales was 44% and 49% during the second quarter of 2004 and 2003, respectively, and was 46% and 49% during the six months ended June 30, 2004 and 2003, respectively. The decreases are due to improved margins on our Witness® canine heartworm diagnostic products due to a change in contract manufacturers, and on our SCA 2000™ consumables due to increased selling prices. A significant portion of our manufacturing costs are fixed. Among our major products, our DiroCHEK® canine heartworm diagnostic products are manufactured at our facilities, whereas our WITNESS® in-clinic canine heartworm, feline leukemia, and canine parvovirus diagnostic products and our SCA 2000™ instrument products are manufactured by third parties. We manufacture the key biological materials contained in our WITNESS® canine heartworm,

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feline leukemia and canine parvovirus diagnostic products. In addition to affecting our gross margins, outsourcing of manufacturing renders us relatively more dependent on the third-party manufacturers. Agen, the previous contract manufacturer of certain of our Witness® products, ceased to supply us with those products In April 2003. We then identified a U.S.-based alternate contract manufacturer of the same Witness® products previously contract manufactured for us by Agen, and the cost of these products to us is lower than the cost of those contract manufactured for us by Agen. In 2004 we are incurring costs to re-license the feline leukemia and canine parvovirus diagnostic products with the USDA.

Our research and development expenses increased by $25,000 or 9% during the second quarter of 2004 as compared to the second quarter of 2003, and increased by $183,000 or 33% during the six months ended June 30, 2004 as compared to the six months ended June 30, 2003. The increase is a result of increased research and development expenses contracted by us from a third party and an increase in foreign currency exchange rates over the second quarter of 2003 and the six months ended June 30, 2003 of 6% and 11%, respectively. The increase in the foreign currency exchange rates affects the consolidation of Synbiotics Europe, SAS (SBIO-E), our wholly-owned subsidiary located in Lyon, France. Our research and development expenses as a percentage of our net sales were 7% and 6% during the second quarter of 2004 and 2003, respectively, and were 8% and 5% during the six months ended June 30, 2004 and 2003, respectively.

Our selling and marketing expenses increased by $37,000 or 4% during the second quarter of 2004 as compared to the second quarter of 2003, and increased by $86,000 or 4% during the six months ended June 30, 2004 as compared to the six months ended June 30, 2003. The increases are a result of advertising and promotional costs associated with the re-launch of our Witness® canine heartworm product and an increase in foreign currency exchange rates over the second quarter of 2003 and the six months ended June 30, 2003 of 6% and 11%, respectively. The increase in the foreign currency exchange rates affects the consolidation of SBIO-E. Our selling and marketing expenses as a percentage of our net sales were 22% and 21% during the second quarter of 2004 and 2003, respectively, and were 22% and 19% during the six months ended June 30, 2004 and 2003, respectively.

Our general and administrative expenses during the second quarter of 2004 increased by $830,000 or 93% as compared to the second quarter of 2003, and increased by $1,589,000 or 93% during the six months ended June 30, 2004 as compared to the six months ended June 30, 2003. The increases are primarily due to legal expenses associated with our lawsuit with Agen. In addition, our general and administrative expenses were higher due to an increase in foreign currency exchange rates over the second quarter of 2003 and the six months ended June 30, 2003 of 6% and 11%, respectively. The increase in the foreign currency exchange rates affects the consolidation of SBIO-E. Our general and administrative expenses as a percentage of our net sales were 38% and 19% during the second quarter of 2004 and 2003, respectively, and were 34% and 16% during the six months ended June 30, 2004 and 2003, respectively. Because we settled the Agen litigation in late June 2004, we expect our legal expenses to decline significantly beginning in the third quarter of 2004.

In September 2003, we filed a lawsuit against Agen in the United States District Court for the Southern District of California alleging that Agen infringed a patent owned by us relating to heartworm diagnostic technology. In June 2004, we entered into a settlement agreement with Agen which has resolved all outstanding claims in the lawsuit. As part of the agreement, each party has licensed certain intellectual property rights from the other party, including Agen licensing from us the patent relating to the canine heartworm diagnostic technology. In addition, we received $425,000 in June 2004, and we will receive $425,000 in June 2005. In addition, we will supply certain biologicals to Agen at specified prices, and we will receive a percentage of Agen s sales of Agen products containing the supplied biologicals. As a result of the settlement, we have recorded a one-time credit to operating expenses totaling $850,000 during the three months ended June 30, 2004.

In November 1998, we filed a lawsuit against Heska Corporation in the United States District Court for the Southern District of California alleging that Heska infringed a patent owned by us relating to heartworm diagnostic technology. In March 2003, we entered into settlement and license agreements with Heska which resolved all outstanding claims in the lawsuit. As part of those

agreements, each party has licensed certain intellectual property rights from the other party, including Heska licensing from us the patent relating to the heartworm diagnostic technology. In addition, we received $250,000 in April, 2003, and we will receive $265,000 in 24 monthly installments of $11,000 beginning in January 2004. As a result, we recorded a one-time credit to operating expenses totalling $515,000 during the first quarter of 2003. In addition, Heska agreed to make royalty payments to us on its sales of licensed canine heartworm diagnostic products beginning April 2003.

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As a result of these settlement agreements, our royalty income during the second quarter of 2004 increased by $71,000 or 73% as compared to the first quarter of 2003, and increased by $116,000 or 117% during the six months ended June 30, 2004 as compared to the six months ended June 30, 2003. Any future royalty income will, of course, depend on the other companies net sales, which tend to be at the expense of our own product sales; also, depressed pricing in the market will tend to reduce the other companies net sales and thus reduce our future royalty income.

Our net interest expense increased by $8,000 or 6% during the second quarter of 2004 as compared to the second quarter of 2003, and decreased by $17,000 or 6% during the six months ended June 30, 2004 as compared to the six months ended June 30, 2003. The changes are due to decreases in the outstanding principal balance of our bank debt, offset by an increase in the interest rate on our bank debt. In June 2004, the bank notified us that it was increasing the interest rate on our bank debt from prime plus 2% to prime plus 7%.

We recognized a provision for income taxes of $2,000 during the six months ended June 30, 2004 as compared to a provision for income taxes of $13,000 during the six months ended June 30, 2003. The change is due to the net operating loss during the six months ended June 30, 2004, and the provision for income taxes for the six months ended June 30, 2004 represents minimum state income taxes.

Financial Condition and Liquidity

The following table summarizes the future cash payments related to our contractual obligations (other than trade payables) as of June 30, 2004 (amounts are in thousands):

	Total	2004	2005	2006	2007	2008	Thereafter
Long-term debt	$ 4,549	$ 4,549					
Operating leases	5,042	452	$ 923	$ 737	$ 523	$ 385	$ 2,022
Other long-term obligations	2,500		1,000	1,500			

Our bank loan came due in January 2004; we did not pay it when it came due, and as of July 31, 2004, we had an outstanding principal balance on the note of $4,549,000. We will have to extend or restructure the note with the bank or refinance it with another lending source. The bank had informally reduced the monthly principal payments to $30,000 for the payments due February 1, 2004, and March 1, 2004. On March 29, 2004, we entered into a forbearance agreement with the bank whereby the bank agreed not to exercise any of its rights under the credit agreement through May 5, 2004, and agreed to formally reduce the monthly principal payments to $30,000 for the payments due April 1, 2004, and May 1, 2004; the forbearance agreement has now expired. In June 2004, the bank notified us that it was increasing the interest rate on our bank debt from prime plus 2% to prime plus 7%. We believe we will be able to restructure or refinance the bank debt, and it is absolutely essential to us that we do so. However, no assurance can be given that we will be successful in this effort to restructure or refinance the bank debt. Our bank has given us no commitment that it will refinance the loan.

Our loan has been handled by the bank s workout department since 2001. We have, however, with the exception of the January 25, 2004, balloon payment, always made our monthly payments of principal and interest, which we hope will weigh in our favor. In each of the past three years we have repaid approximately $1,200,000 of principal on the note.

We have had positive cash flow from operations, although a large portion was from patent litigation settlements.. Nonetheless, our cash and working capital positions are uncomfortably thin and we may well require additional financing in the future, even if our bank loan situation is resolved. There can be no assurance that such financing would be available to us on favorable terms, or at all. Because our stock price is low, any equity financing would significantly dilute current shareholders.

Our operations are seasonal due to the sales of our canine heartworm diagnostic products. Our sales and profits tend to be concentrated in the first half of the year, as our distributors prepare for the heartworm season by purchasing diagnostic products for resale to veterinarians. The operations of SBIO-E have reduced our seasonality as sales of their large animal diagnostic products tend to occur evenly throughout the year. In addition, sales of our SCA 2000™ instruments and supplies and our poultry diagnostic products reduce our seasonality.

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Certain Risk Factors

Our future operating results are subject to a number of factors, including:

In addition to the necessity of extending or refinancing our bank loan which matured in January 2004, we may need additional capital in the future

Our bank loan came due in January 2004; we did not pay it when it came due, and as of June 30, 2004, we had an outstanding principal balance on the note of $4,549,000. We will have to restructure the note with the bank or refinance it with another lending source. The bank had informally reduced the monthly principal payments to $30,000 for the payments due February 1, 2004, and March 1, 2004. On March 29, 2004, we entered into a forbearance agreement with the bank whereby the bank agreed not to exercise any of its rights under the credit agreement through May 5, 2004, and agreed to formally reduce the monthly principal payments to $30,000 for the payments due April 1, 2004, and May 1, 2004; the forbearance agreement has now expired. In June 2004, the bank notified us that it was increasing the interest rate on our bank debt from prime plus 2% to prime plus 7%. No assurance can be given that we will be successful in this effort to restructure or refinance the bank debt. Our cash and working capital positions are uncomfortably thin. We may also need to raise additional funds if our estimates of revenues, working capital and/or capital expenditure requirements change or prove inaccurate or in order for us to respond to unforeseen technological or marketing hurdles or to take advantage of unanticipated opportunities.

Further, our future capital requirements will depend on many factors beyond our control or ability to accurately estimate, including continued scientific progress in our product development programs, the cost of manufacturing scale-up, the costs involved in preparing, filing, prosecuting, maintaining and enforcing patent claims, the cost involved in patent infringement litigation, competing technological and market developments, and the cost of establishing effective sales and marketing arrangements. Such funds may not be available at the time or times needed, or available on terms acceptable to us. If adequate funds are not available, or are not available on acceptable terms, we may not be able to take advantage of market opportunities, to develop new products, or to otherwise respond to competitive pressures. This inability could materially harm our business.

If we are unable to fully succeed in responding to competition in the canine heartworm market and in reintroducing to the market the Witness® products which were previously manufactured by Agen, it could also hinder our ability to restructure or refinance our bank loan, or obtain any other necessary additional capital.

We may be unable to fully succeed in reintroducing our key Witness® products

Agen was the contract manufacturer of certain of our Witness® in-clinic diagnostic products, and Agen ceased supplying these products in April 2003. We have licensed the alternate-source Witness® canine heartworm product with the USDA (now to be supplied by another contract manufacturer), and we began selling this product in January 2004. We also anticipate having the alternate-source Witness® feline leukemia and canine parvovirus products available for sale by the end of the third quarter of 2004. In addition to the risks that the alternate-source products will be delayed, will experience quality issues, cannot be supplied reliably, etc., we cannot ensure that after our products have been off the market for several months we will necessarily be able to regain our previous market share and our previous price points.

The market in which we operate is intensely competitive, even with regard to our key canine heartworm diagnostic products, and many of our competitors are larger and more established

The market for animal health care products is extremely competitive. Companies in the animal health care market compete to develop new products, to market and manufacture products efficiently, to implement effective research strategies, and to obtain regulatory approval. Our current competitors include IDEXX Laboratories, a significantly larger company, Heska Corporation and Agen. These companies have greater financial, manufacturing, marketing, and research resources than we do. In addition, IDEXX Laboratories prohibits its distributors from selling competitors products, including ours. Further, additional competition could come from new entrants to the animal health care market. We cannot assure you that we will be able to compete successfully in the future or that competition will not harm our business.

Our canine heartworm diagnostic products constituted 24% of our sales for the year ended December 31, 2003. In addition to our historic competition with IDEXX Laboratories, the sales leader in this product category, our sales have been substantially affected by Heska entering the market in 1999, and their benefiting from us being out of the market after Agen terminated our

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supply agreement. Since October 2003, Agen has also entered the market. Additional competition, including erosion of the average selling price, from Agen in this key market with this product has seriously damaged us. We could face renewed competition from other new competitors when our U.S. heartworm patent expires in December 2005.

Under our settlement with Agen in June 2004, we licensed Agen our U.S. heartworm patent. In addition we agreed to sell to Agen the same biological components as are used in our own Witness® in-clinic canine heartworm diagnostic products. Agen is therefore able to manufacture and sell canine heartworm diagnostic products that are substantially the same as ours. If Agen were to have its in-clinic canine heartworm products made by the same contract manufacturer as we use, it would further diminish our ability to distinguish our products in the marketplace and achieve satisfactory pricing.

As previously mentioned, as a result of Agen ceasing to contract manufacture our Witness® products our sales were materially adversely affected in the second have of 2003 and the first quarter of 2004, and we believe that our sales could be materially adversely affected for the remainder of 2004 and beyond if we are unable to fully succeed in reintroducing the alternate-source products into the market. There can be no assurances that we will be able to achieve our previous sales levels of these in-clinic products.

We have a history of losses and an accumulated deficit

Although we were profitable in 2003, we had a loss for the six months ended June 30, 2004, and we have had a history of annual losses. We have incurred a consolidated accumulated deficit of $45,441,000 at June 30, 2004. We may not achieve annual profitability again, and if we are profitable in the future there can be no assurance that profitability can be sustained.

We rely on third party distributors for a substantial portion of our sales

We have historically depended upon distributors for a large portion of our sales, and we may not have the ability to establish and maintain an adequate independent sales and marketing capability in any or all of our targeted markets. Distributor agreements render our sales exposed to the efforts of third parties who are not employees of Synbiotics and over whom we have no control. Their failure to generate significant sales of our products could materially harm our business. Reduction by these distributors of the quantity of our products which they distribute would materially harm our business. Also, the distributors are not bound to us by long-term agreements, and a decision by any major distributor to stop doing business with us could materially hurt our revenues. Agen is currently distributing its products through a co-operative buying group. Several of the members/owners of this buying group distribute our products, and have decided to promote Agen s canine heartworm product instead of ours. IDEXX Laboratories prohibition against its distributors carrying competitors products, including ours, has made, and could continue to make, some distributors unavailable to us. In the past, we have lost major distributors to IDEXX Laboratories.

We depend on key executives and personnel, but we have experienced executive turnover

Our future success will depend, to a significant extent, on the ability of our management to operate effectively, both individually and as a group. Competition for qualified personnel in the animal health care products industry is intense, and we may not be successful in attracting and retaining such personnel. There are only a limited number of persons with the requisite skills to serve in

those positions and it may become increasingly difficult to hire such persons. The loss of the services of any of our key personnel or the inability to attract or retain qualified personnel could harm our business.

We depend on third party manufacturers, and may experience problems in obtaining supplies of our key products

We contract for the manufacture of some of our products, including our Witness® in-clinic canine heartworm, feline leukemia, and canine parvovirus diagnostic products and our SCA 2000™ instrument products. We also expect that some of our anticipated new products will be manufactured by third parties. In addition, some of the products manufactured for us by third parties are licensed to us by their manufacturers. There are a number of risks associated with our dependence on third-party manufacturers including:

the potential for a decision by the manufacturer to cease supplying us and/or to make and market competing products;

reduced control over delivery schedules;

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quality assurance;

manufacturing yields and costs;

whether the manufacturer maintains financial and operational stability;

the potential lack of adequate capacity during periods of excess demand;

limited warranties on products supplied to us;

increases in prices and the potential misappropriation of our intellectual property; and

limited negotiating leverage in the event of disputes with the third-party manufacturers.

If our third party manufacturers fail to supply us with an adequate number of finished products, our business would be significantly harmed. We have no long-term contracts or arrangements with any of our vendors that guarantee product availability, the continuation of particular payment terms or the extension of credit limits.

If we encounter delays or difficulties in our relationships with our manufacturers, the resulting problems could have a material adverse effect on us.

As mentioned above, in 2003 Agen, the previous contract manufacturer of certain of our Witness® in-clinic products, ceased to supply us with those products, and entered the market with competing products.

We rely on new and recent products

We rely to a significant extent on new and recently developed products, and expect that we will need to continue to introduce new products to be successful in the future. There can be no assurance that we will obtain and maintain market acceptance of our products. There can be no assurance that future products, including our alternate-source in-clinic diagnostic products, will meet applicable regulatory standards, be capable of being produced in commercial quantities at acceptable cost or be successfully commercialized.

There can be no assurance that new products can be manufactured at a cost or in quantities necessary to make them commercially viable. If we are unable to produce internally, or to contract for, a sufficient supply of our new products on acceptable terms, or if we should encounter delays or difficulties in our relationships with manufacturers, the introduction of new products would be delayed, which could have a material adverse effect on our business.

Our canine heartworm business is seasonal

Our operations are seasonal due to the timing of sales of our canine heartworm diagnostic products. Our sales and profits tend to be concentrated in the first half of the year as our distributors prepare for the heartworm season by purchasing diagnostic products for resale to veterinarians. One effect of this is a need to devote large amounts of cash to building canine heartworm diagnostic products inventory in preparation for the canine heartworm selling season at a time when our working capital is relatively low.

Any failure to adequately establish or protect our proprietary rights may adversely affect us, and our canine heartworm diagnostic patent expires in December 2005

We rely on a combination of patent, copyright, and trademark laws, trade secrets, and confidentiality and other contractual provisions to protect our proprietary rights. These measures afford only limited protection. Our means of protecting our proprietary rights in the U.S. or abroad may not be adequate and competitors may independently develop similar technologies. Our future success will depend in part on our ability to protect our proprietary rights and the technologies used in our principal products. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or to obtain and use trade secrets or other information that we regard as proprietary. In addition, the laws of some foreign

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countries do not protect our proprietary rights as fully as do the laws of the United States. Issued patents may not preserve our proprietary position. Even if they do, competitors or others may develop technologies similar to or superior to our own. If we do not enforce and protect our intellectual property, our business will be harmed. From time to time, third parties, including our competitors, have asserted patent, copyright, and other intellectual property rights to technologies that are important to us. We expect that we will increasingly be subject to infringement claims as the number of products and competitors in the animal health care market increases.

The results of any litigated matter are inherently uncertain. Litigation is costly regardless of its outcome and can require significant management attention. In the event of an adverse result in any litigation with third parties that could arise in the future, we could be required to:

- pay substantial damages, including treble damages if we are held to have willfully infringed;
- cease the manufacture, use and sale of infringing products;
- expend significant resources to develop non-infringing technology; or
- obtain licenses to the infringing technology.

Licenses may not be available from any third party that asserts intellectual property claims against us on commercially reasonable terms, or at all.

Also, because our patents and patent applications cover novel diagnostic approaches:

- the patent coverage which we receive could be significantly narrower than the patent coverage we seek in our patent applications; and
- our patent positions involve complex legal and factual issues which can be hard for patent examiners or lawyers asserting patent coverage to successfully resolve.

Because of this, our patent position could be vulnerable and our business could be materially harmed. In any event, our important United States canine heartworm diagnosis patent will expire in December 2005.

The U.S. patent application system also exposes us to risks. In the United States, the first party to make a discovery is granted the right to patent it and patent applications are generally maintained in secrecy for 18 months. For these reasons, we can never know if we are the first to discover particular technologies. Therefore, we can never be certain that our technologies will be patented and we could become involved in lengthy, expensive, and distracting disputes concerning whether we were the first to make the disputed discovery. Any of these events would materially harm our business.

Our business is regulated by the United States and various foreign governments

Our business is subject to substantial regulation by the United States government, most notably the United States Department of Agriculture, and the French government. In addition, our operations may be subject to future legislation and/or rules issued by domestic or foreign governmental agencies with regulatory authority relating to our business. There can be no assurance that we will continue to be in compliance with any of these regulations.

For marketing outside the United States, we and our suppliers are subject to foreign regulatory requirements, which vary widely from country to country. There can be no assurance that we and our suppliers will meet and sustain compliance with any such requirements.

Redwood controls us

The Series C preferred stock owned by Redwood West Coast LLC represents a majority of the voting power of all our stock. Redwood can and does control the election of our entire Board of Directors, and also controls all fundamental strategic decisions.

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We use hazardous materials

Our business requires that we store and use hazardous materials and chemicals. Although we believe that our procedures for storing, handling, and disposing of these materials comply with the standards prescribed by local, state, and federal regulations, the risk of accidental contamination or injury from these materials cannot be completely eliminated. If any of these materials were mishandled, or if an accident with them occurred, the consequences could be extremely damaging and we could be held liable for them. Our liability for such an event would materially harm our business and could exceed all of our available resources for satisfying it.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Our market risk consists primarily of the potential for changes in interest rates and foreign currency exchange rates.

Interest Rate Risk

The fair value of our debt at June 30, 2004 was approximately $4,549,000, which has a variable interest rate based on the prime rate.

A change in interest rates of five percentage points would have a material impact on our financial condition, results of operations and cash flows as it relates to our variable rate debt. In addition, if interest rates increased by five percentage points our ability to refinance our bank debt would be seriously compromised

Foreign Currency Exchange Rate Risk

Our foreign currency exchange rate risk relates to the operations of SBIO-E as it transacts business in Euros, its local currency. However, this risk is limited to our intercompany receivable from SBIO-E and the conversion of its financial statements into the U.S. dollar for consolidation. There is no foreign currency exchange rate risk related to SBIO-E s transactions outside of the European Union as those transactions are denominated in Euros. Similarly, all of the foreign transactions of our U.S. operations are denominated in U.S. dollars. We do not hedge our cash flows on intercompany transactions, nor do we hold any other derivative securities or hedging instruments based on currency exchange rates. As a result, the effects of a 5% change in exchange rates would have a material impact on our financial condition, results of operations and cash flows, but only to the extent that it relates to the conversion of SBIO-E s financial statements, including its intercompany payable to us, into the U.S. dollar for consolidation. For the three and six months ended June 30, 2004, 37% and 39%, respectively, of our net sales were net sales of SBIO-E.

Item 4. Controls and Procedures

Our principal executive officer and principal financial officer, after evaluating the effectiveness of our disclosure controls and procedures (as defined in Securities Exchange Act Rule 13a-15(e)), have concluded that, as of June 30, 2004, our disclosure controls and procedures are effective.

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PART II - OTHER INFORMATION

Item 1. Legal Proceedings

Synbiotics Corporation v. Agen Biomedical Limited United States District Court for the Southern District of California

In September 2003, we filed a lawsuit against Agen Biomedical, Ltd. (Agen) in the United States District Court for the Southern District of California alleging that Agen infringed a patent owned by us relating to heartworm diagnostic technology. In June 2004, we entered into a settlement agreement with Agen which has resolved all outstanding claims in the lawsuit. As part of the agreement, each party has licensed certain intellectual property rights from the other party, including Agen licensing from us the patent relating to the heartworm diagnostic technology.

Agen Biomedical Limited v. Synbiotics Corporation San Diego County Superior Court

On March 8, 2004, Agen filed an action against us in the San Diego County Superior Court seeking a declaratory judgment and specific performance requiring us to sell them certain biologicals, including the patented canine heartworm test biologicals, even after the 2003 termination of the supply agreement between Agen and us. In June 2004, we entered into a settlement agreement with Agen which has resolved all outstanding claims in the lawsuit. As part of the agreement, we will supply certain biologicals to Agen at specified prices, and we will receive a percentage of Agen s sales of Agen products containing the supplied biologicals.

Item 2. Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities

None.

Item 3. Defaults Upon Senior Securities

On the date of filing this report, a cumulative dividend arrearage of $105,000 existed on our Series C preferred stock.

Item 4. Submission of Matters to a Vote of Security Holders

None.

Item 5. Other Information

None.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

Exhibit	Title
10.96#	Settlement Agreement and Mutual Release of Claims by and between the Registrant and Agen Biomedical Limited and their affiliates, dated as of June 25, 2004.
31.1	Certification Under Section 302 of the Sarbanes-Oxley Act of 2002/SEC Rule 13a-14(a).

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Exhibit	Title
31.2	Certification Under Section 302 of the Sarbanes-Oxley Act of 2002/SEC Rule 13a-14(a).
32	Certification Under Section 906 of the Sarbanes-Oxley Act of 2002.

Certain confidential portions of this Exhibit were omitted by means of redacting a portion of the text (the Mark). This Exhibit has been filed separately with the Secretary of the Securities and Exchange Commission without the Mark pursuant to an Application Requesting Confidential Treatment under Rule 12b-24 under the Securities Exchange Act of 1934.

(b) Reports on Form 8-K

On June 2, 2004, we furnished, on Form 8-K, a press release disclosing our results of operations and financial condition for the year ended December 31, 2003 and the quarter ended March 31, 2004 (Item 12).

On June 30, 2004, we filed a Form 8-K announcing that we had entered into a settlement with Agen Biomedical Ltd. resolving all ongoing litigation regarding Synbiotics US heartworm patent and other contractual matters (Items 5 and 7).

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

SYNBIOTICS CORPORATION

Date: August 16, 2004

/s/ Keith A. Butler

Keith A. Butler

Vice President Finance and Chief Financial Officer

(signing both as a duly authorized officer and as principal financial officer)

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SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C.

EXHIBITS

TO

FORM 10-Q

UNDER

SECURITIES EXCHANGE ACT OF 1934

SYNBIOTICS CORPORATION

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