LOTUS PACIFIC INC
Form 10-Q
February 14, 2002

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

/x/ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Quarterly Period Ended December 31, 2001

OR

/ / **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from _____ to _____

Commission file number 000-24999

LOTUS PACIFIC, INC

(Exact name of registrant as specified in its charter)

Delaware	**52-1947160**
(State of incorporation)	(IRS Employer Identification No.)

200 Centennial Avenue, Suite 201
Piscataway, New Jersey 08854

(Address of principal executive offices, zip code)

Registrant's telephone number, including area code: (732) 885-0100

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 / /

As of February 12, 2002, there were 64,232,125 shares of common stock outstanding.

FORM 10-Q INDEX

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PART I
FINANCIAL INFORMATION

Item 1 Financial Statements:

LOTUS PACIFIC, INC
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands)

	December 31, 2001	June 30, 2001
	(Unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 21,947	$ 24,994
Short-term investments	8,631	4,237
Accounts receivable, net	2,712	12,772
Accounts receivable from related parties, net	6,855	14,822
Inventories	1,356	19,659
Prepaid expenses	581	897
Deferred tax asset	2,515	2,742
Other	29	152
Total current assets	44,626	80,275

	December 31, 2001	June 30, 2001
Property and equipment, net	1,689	3,598
Restricted cash	5,500	5,640
Notes receivable	6,926	4,734
Goodwill, net	47,574	43,031
Investment in unconsolidated subsidiary	2,398	2,469
Other assets		211
Total assets	$ 108,713	$ 139,958
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Line of credit	$	$ 3,000
Accounts payable and accrued expenses	6,263	29,571
Accounts payable to related parties	7,735	25,950
Income taxes payable	219	445
Total current liabilities	14,217	58,966
Minority interest in subsidiaries	10,862	18,454
Stockholders' equity:		
Common stock	64	64
Preferred stock, series A		
Additional paid-in capital	183,012	185,273
Deferred stock compensation	(1,467)	(2,720)
Treasury stock	(7,057)	(7,057)
Accumulated deficit	(90,918)	(113,022)
Total stockholders' equity	83,634	62,538
Total liabilities and stockholders'equity	$ 108,713	$ 139,958

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

LOTUS PACIFIC, INC
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)
(in thousands, except per share amounts)

	Three Months Ended December 31,		Six Months Ended December 31,	
	2001	2000	2001	2000
Sales	$ 32,804	$ 105,644	$ 69,475	$ 205,551
Cost of sales	29,349	93,857	63,883	175,191

	Three Months Ended December 31,		Six Months Ended December 31,	
Gross profit	3,455	11,787	5,592	30,360
Operating expenses:				
Selling, general and administrative	5,648	7,104	12,924	14,742
Research and development	3,318	3,936	7,840	12,281
Total operating expenses	8,966	11,040	20,764	27,023
Income (loss) from operations	(5,511)	747	(15,172)	3,337
Other income (expenses):				
Gain on sale of subsidiary	32,299		32,299	
Interest income, net	66	508	356	854
Minority interest in (income) loss of unconsolidated subsidiaries	976	408	2,785	(554)
Equity in loss of unconsolidated subsidiaries	(34)	(1,021)	(71)	(1,079)
Other	(113)	101	(139)	131
Income before income taxes	27,683	743	20,058	2,689
Provision (benefit) for income taxes	(290)	2,880	(2,046)	7,523
Net income (loss)	$ 27,973	$ (2,137)	$ 22,104	$ (4,834)
Net income (loss) per share basic and diluted	$ 0.44	$ (0.03)	$ 0.34	$ (0.07)
Common shares outstanding basic and diluted	64,232	64,134	64,232	64,134

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

LOTUS PACIFIC, INC
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)
(in thousands)

	Six Months Ended December 31,	
	2001	2000
Operating activities		
Net income (loss)	$ 22,104	$ (4,834)
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Gain on sale of subsidiary	(32,299)	
Equity in loss of unconsolidated subsidiaries	71	1,079

	Six Months Ended December 31,	
Depreciation and amortization	5,006	4,393
Amortization of deferred stock compensation	989	6,674
Minority interest in subsidiary	(2,785)	554
Changes in operating assets and liabilities:		
Accounts receivable	(3,389)	(35,943)
Accounts receivable from related party	7,967	(16,164)
Inventory	8,500	(6,959)
Prepaid expenses	76	7
Other current assets	123	90
Restricted cash		300
Other assets	(120)	572
Deferred tax asset	227	(1,313)
Accounts payable and accrued expenses	6,235	8,666
Accounts payable to related parties	(18,215)	14,890
Income taxes payable	(226)	754
Net cash used in operating activities	(5,736)	(27,234)
Investing activities		
Purchases of property and equipment	(650)	(1,442)
Proceeds from sale of subsidiary, net of cash sold	8,233	
Purchases of short term investments	(4,394)	
Proceeds from sale of subsidiary preferred stock		13,258
Net cash provided by investing activities	3,189	11,816
Financing activities		
Investment deposits		32
Proceeds from loans receivable		3,560
Proceeds from line of credit		1,722
Payments on line of credit	(500)	
Repayments of notes payable		(878)
Net cash (used in) provided by financing activities	(500)	4,436
Net decrease in cash and cash equivalents	(3,047)	(10,982)
Cash and cash equivalents at beginning of period	24,994	27,942
Cash and cash equivalents at end of period	$ 21,947	$ 16,960

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

LOTUS PACIFIC, INC
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2001

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements included herein have been prepared by Lotus Pacific, Inc. (Lotus or Company) in accordance with generally accepted accounting principles and pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations, although the Company believes that the disclosures in these financial statements are adequate to make the information presented not misleading. The unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended June 30, 2001.

In the opinion of management, the unaudited condensed consolidated financial statements contain all adjustments (consisting only of normal recurring adjustments) necessary for a fair presentation of the Company's financial position, results of operations and cash flows.

Current and future financial statements may not be directly comparable to the Company's historical financial statements. The results of operations for the three and six months ended December 31, 2001, are not necessarily indicative of the results of operations, which may be reported for any other interim period or for the fiscal year ending June 30, 2002.

Effective December 11, 2001, Acumen Technology, Inc. (Acumen), a Delaware corporation and wholly owned subsidiary of the Company, merged into Lotus. As a result of the merger, the Company assumed all the rights and obligations of Acumen and acquired the assets of Acumen which include, without limitation, shares of stock of Correlant Communications, Inc. (Correlant) and Arescom, Inc. (Arescom).

Effective December 18, 2001 Lotus sold a major portion of its investment in and cash advances to Arescom for $10,000,000 in cash, a promissory note for $2,192,000 and 11,048 shares of subordinated preferred stock of Arescom. The sale represented approximately 70.0% of the outstanding shares of Arescom. Lotus retains 4,000,000 million shares of common stock of Arescom, representing approximately 11.0% of the outstanding shares of Arescom with the balance owned by outside investors. Subsequent to December 18, 2001, the Company accounts for its investment in Arescom under the cost method and as such the accounts, results of operations and cash flows of Arescom are not included with the Company's financial statements.

The accompanying financial statements include the accounts of Lotus, its 90.5% owned subsidiary, Lotus World, Inc., (Lotus World) its 66.5% owned subsidiary Correlant, and its 81.0% owned subsidiary Arescom until December 18, 2001 when the ownership decreased to 11.0%. The portions of Correlant and Lotus World not owned by the Company at December 31, 2001 appear as minority interest in subsidiaries on the balance sheet. All intercompany transactions have been eliminated during the consolidation.

Reclassifications and Adjustments

Certain prior period amounts have been reclassified to conform to the current period presentation.

Previously, minority interest related to existing preferred stock when Correlant was acquired, and the related goodwill, was not recorded by Lotus. During the current period, minority interest and corresponding goodwill related to this preferred stock was recorded in the amount of $8,450,000. For

the period ending December 31, 2001 amortization expense of $1,000,000 was included in selling, general and administrative expense in conjunction with this write-up of goodwill.

Comprehensive Income (Loss)

Statement of Financial Accounting Standards (SFAS) 130, *Reporting Comprehensive Income*, requires that all components of comprehensive income (loss), including net income (loss), be reported in the financial statements in the period in which they are recognized. Comprehensive income (loss) is defined as the change in equity during a period from transactions and other events and circumstances from non-owner sources. Net income (loss) and other comprehensive income (loss), including foreign currency translation adjustments, and unrealized gains and losses on investments, shall be reported, net of their related tax effect, to arrive at comprehensive income (loss). The Company does not have any material other comprehensive income (loss) items at December 31, 2001 and June 30, 2001.

Basic and Diluted Net Income (Loss) Per Share

Basic net income (loss) per share is computed by dividing net income (loss) by the weighted average number of shares of common stock outstanding during the period. Diluted net income (loss) per share is computed by dividing net income (loss) by the weighted average number of shares of common stock and common stock equivalents outstanding during the period. For the three and six months ended December 31, 2001 and 2000, employee stock options, warrants and convertible securities were not considered in calculating basic and diluted net income (loss) per common share as their effect would be anti-dilutive. As a result, for all periods presented, the Company's basic and diluted net income (loss) per share are the same.

Inventories

Inventories are stated at the lower of cost (first in, first out) or market (net realizable value). Given the volatility of the market for the Company's products, the Company makes inventory write-downs for excess and obsolete inventory based on forecast demand. However, forecast demand is subject to revisions, cancellations, and rescheduling. Actual demand will inevitably differ from forecast demand, and such differences may be material to the financial statements. The components of inventory are as follows (*in thousands*):

	December 31, 2001	June 30, 2001
Raw materials	$ 1,356	$ 12,434
Work-in-process		3,439
Finished goods		3,786
Total	$ 1,356	$ 19,659

Revenue Recognition

The Company recognizes revenue upon passing of title and risk of ownership, which coincides with the timing of product shipment. The Company, under specific conditions, permits its customers to return products. The provision for estimated sales returns is recorded concurrently with the recognition of revenue. Contract services revenue is recognized over the term of the contract.

Segment Information

SFAS 131, *Segment Information*, (SFAS 131) amends the requirements for public enterprises to report financial and descriptive information about its reportable operating segments. Operating segments, as defined in SFAS 131, are components of an enterprise for which separate financial

information is available and is evaluated regularly by the Company in deciding how to allocate resources and in assessing performance. The financial information is required to be reported on the basis that is used internally for evaluating this segment performance. The Company operates in one business segment: the design, development and marketing of Internet related products and services.

Sale of Subsidiary

Effective December 18, 2001 Lotus sold a major portion of its investment in and cash advances to Arescom for $10,000,000 in cash, a promissory note for $2,192,000 and 11,048 shares of subordinated preferred stock of Arescom. The subsidiary was in the business of designing, developing and marketing a full line of DSL-based broadband access and networking devices that address the needs of DSL providers, systems integrators and users. In connection with this sale, the Company recognized a gain of $32,299,000. The gain, which is primarily a result of recaptured consolidated losses from Arescom, has no related tax liability. The Company accounts for its remaining investment in Arescom under the cost method. During fiscal 2001, management identified impairment losses associated with its investment in Arescom. As a result, the remaining investment in Arescom has no associated value.

Income Taxes

The Company's provision (benefit) for income taxes for the three and six months ended December 31, 2001 and 2000 differed from the amounts computed by applying the statutory U.S. Federal income tax rate to income before taxes and minority interest as follows (*in thousands*):

	Three Months Ended December 31,		Six Months Ended December 31,	
	2001	2000	2001	2000
U.S. Federal income tax provision at Federal Statutory rate	$ 9,689	$ 537	$ 7,020	$ 945
Gain on sale of subsidiary	(11,305)		(11,305)	
Amortization of goodwill	859	695	1,368	1,325
Deferred compensation amortization	134	250	356	2,747
Minority interest in subsidiary	(342)	(195)	(975)	195
Equity in loss of unconsolidated subsidiary	9	400	29	400
Increase in valuation allowance	800		1,575	
State income taxes, net of federal benefit		1,650		1,650
Other	(134)	(457)	(114)	261
Total provision (benefit)	$ (290)	$ 2,880	$ (2,046)	$ 7,523

Recent Accounting Pronouncements

In June 2001 the Financial Accounting Standards Board (FASB) issued SFAS 142, *Goodwill and Other Intangible Assets* (SFAS142), effective for fiscal years beginning after December 15, 2001. Under the new rules, goodwill and intangible assets deemed to have indefinite lives will no longer be amortized but will be subject to annual impairment tests in accordance with SFAS 142. Other intangible assets will continue to be amortized over their useful lives.

Although early adoption is allowed, the Company did not adopt SFAS 142 during the quarter ended September 30, 2001. Therefore, the Company's condensed consolidated financial statements for the three and six months ended December 31, 2001 and 2000 reflect goodwill amortization using the straight-line basis over an estimated 10-year life. The Company will adopt the new standard for the fiscal year beginning July 1, 2002. The impact of adopting SFAS 142 on the results of operations and financial position of the Company has not yet been determined. Goodwill will continue to be evaluated

under SFAS 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed of* (SFAS 121).

In August 2001, the FASB issued SFAS 143, *Accounting for Asset Retirement Obligations* (SFAS 143), which addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. SFAS 143 is required to be adopted for fiscal years beginning after June 15, 2002. The Company has not yet determined what effect this statement will have on its consolidated financial statements.

Also in August 2001, the FASB issued SFAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, which supersedes SFAS 121. This new statement also supersedes certain aspects of APB 30, *Reporting the Results of Operations-Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, with regard to reporting the effects of a disposal of a segment of a business and will require expected future operating losses from discontinued operations to be reported in discontinued operations in the period incurred (rather than as of the measurement date as presently required by APB 30). In addition, more dispositions may qualify for discontinued operations treatment. The provisions of this statement are required to be applied for fiscal years beginning after December 15, 2001 and interim periods within those fiscal years. The Company will adopt the new standard for the fiscal year beginning July 1, 2002. The Company has not yet determined what effect this statement will have on its consolidated financial statements.

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

You should read the following discussion in conjunction with Lotus Pacific, Inc.'s (Lotus) unaudited condensed consolidated financial statements and notes included herein. The results described below are not necessarily indicative of the results to be expected in any future period. Certain statements in this discussion and analysis, including statements regarding our strategy, financial performance and revenue sources, are forward-looking statements based on current expectations and entail various risks and uncertainties that could cause actual results to differ materially from those expressed in the forward-looking statements. Readers are referred to Lotus's Annual Report on Form 10-K dated October 15, 2001 and to the section entitled "*Certain Factors That May Affect Future Results*" contained herein which identify important risk factors that could cause actual results to differ from those contained in the forward looking statements.

Overview

We create, manage, and operate communications and network technology companies and serve as a holding company of two subsidiaries, Lotus World, Inc. (Lotus World) and Correlant Communications, Inc. (Correlant). We own 90.5% of Lotus World and 66.5% of Correlant. During the three and six months ended December 31, 2001 and 2000, Lotus World's results of operations were not material to our results of operations. Until December 18, 2001, we owned 81% of Arescom, Inc. (Arescom), at which time we sold a major portion of our investment in Arescom. Subsequent to December 18, 2001, we own approximately 11.0% of the outstanding shares of Arescom and account for the investment under the cost method. Arescom's accounts, results of operations and cash flows are included in our financial statements through December 18, 2001 and are excluded from our financial statements after December 18, 2001.

We provide solutions for the communications and network technology markets and engage in the development, manufacture and distribution of products used for broadband Internet access, including data-over-cable equipment and networking devices. Subsequent to the sale of our controlling interest in Arescom, we no longer compete in the DSL market space. We anticipate that our experience in communications and network technology will enable us to capitalize on new opportunities in diverse areas of the fast-growing telecommunications industry.

During the first half of calendar 2000, cable modem manufacturers experienced shortages and long lead times for component materials such as flash memory and capacitors. Due to these shortages, the production of cable modems was constrained and our customers placed substantial orders for our cable modems. We believe cable operators also overbought in the second half of calendar 2000 to ensure they had sufficient product to meet subscriber demand. As a result, we believe there was an inflated demand for cable modems during the three and six months ended December 31, 2000. Starting in January 2001, our customer orders began dropping sharply resulting in lower demand as end customers started to work through their inventory levels. This lower demand continued through the three and six months ended December 31, 2001.

The extremely competitive nature of the market for broadband access systems has resulted in significant price erosion over time. We experienced, and continue to experience downward pressure on our average selling price per unit. We are continuing to work with our contract manufacturer to decrease the cost of manufacturing our products in order to offset the decline in average selling price and gross margin pressure on DOCSIS certified cable modems.

Results of Operations

The following table summarizes certain aspects of our results of operations for the three and six months ended December 31, 2001 compared to the three and six months ended December 31, 2000 (*in millions*). Certain amounts for the three and six months ended December 31, 2000 have been restated as discussed in *"PART II Item 5 Other Information."*

	Three Months Ended December 31,			Six Months Ended December 31,		
	2001	2000	Change %	2001	2000	Change %
Sales	$ 32.8	$ 105.6	(69%)	$ 69.5	$ 205.6	(66%)
Gross profit	3.5	11.8	(70%)	5.6	30.4	(82%)
As a percentage of revenues	11%	11%		8%	15%	
Selling, general and administrative	5.6	7.1	(21%)	12.9	14.7	(12%)

	Three Months Ended December 31,			Six Months Ended December 31,		
Research and development	3.3	3.9	(15%)	7.8	12.3	(37%)
Gain on sale of subsidiary	32.3		NA	32.3		NA
Net income (loss)	28.0	(2.1)	1,433%	22.1	(4.8)	560%

Revenues

During the three months ended December 31, 2001, revenues attributable to Correlant and Arescom accounted for 42% and 58%, respectively, of total revenues as compared to 87% and 13%, respectively, for the same period in the prior year. During the six months ended December 31, 2001, revenues attributable to Correlant and Arescom accounted for 49% and 51%, respectively, of total revenues as compared to 87% and 13%, respectively, for the same period in the prior year. The decrease in overall revenues for the three and six months ended December 31, 2001 as compared to the three and six months ended December 31, 2000, as well as the change in relative percentage of revenues between Correlant and Arescom, was primarily attributable to the following factors:

Unit sales of DOCSIS cable modems produced by Correlant decreased 75% and 69% during the three and six months ended December 31, 2001, respectively;

An industry-wide downturn in broadband equipment purchase as cable operators, and in turn our customers, worked through their excess inventory;

Average sales price of our DOCSIS cable modems produced by Correlant declined due to heavy price competition.

The decrease in cable modem revenues of Correlant was offset slightly by the increase in Arescom's DSL broadband equipment sales.

Revenues generated by international sales as a percentage of revenues increased slightly to 56% from 51% during the three months ended December 31, 2001 as compared to the three months ended December 31, 2000. Additionally, revenues generated by international sales as a percentage of revenues increased slightly to 52% from 50% during the six months ended December 31, 2001 as compared to the six months ended December 31, 2000. Due to the recent significant economic slowdown in our industry, both domestic and international, we experienced a slowdown in customer orders. We anticipate that revenues will continue to be negatively impacted by the current economic slowdown and will decrease as a result of the sale of the controlling interest in Arescom. In addition, we anticipate the average sales price of cable modems will continue to decline in the near term.

Gross Profit

The reduction in gross profit absolute dollars for the three and six months ended December 31, 2001 as compared to the three and six months ended December 31, 2000 as well as the decrease in

gross profit percentage for the six months ended December 31, 2001 compared to the six months ended December 31, 2000 was due to the following:

Reduced revenues from declining unit sales;

Severe price competition. Selling prices decreased faster than the associated product cost reductions, which resulted in selling cable modems at negative gross profit in order to keep market share;

Loss on purchase commitments of cable modem components as we adjusted our inventories to reflect the decrease in product demand;

Write down of component inventories to market value.

The gross profit percentage remained a constant 11% for both the three months ended December 31, 2001 and 2000 due to a higher proportion of revenues from DSL broadband equipment sales which bear a higher gross margin percentage than cable modems.

Although we anticipate continued pressure on margins, we are taking steps to counter the impact of this price erosion by continuing to implement cost reduction efforts in the manufacturing of our products and introduce new lower cost technology driven products to the market.

In the near term, we also expect gross profit in absolute dollars and as a percentage of revenue to decrease as a result of the sale of our controlling interest in Arescom and the corresponding loss of revenues from DSL equipment sales.

Operating Expenses

Selling, general and administrative (SG&A). SG&A expenses consist primarily of personnel costs, including amortization of deferred stock compensation, for our administrative and support personnel, goodwill amortization, allowance for doubtful accounts, legal and accounting fees. The decrease in SG&A expenses for both the three and six months ended December 31, 2001 was due to the following factors:

Decrease in amortization of deferred stock compensation to $0.1 and $0.2 million in the three and six months ended December 31, 2001 from $0.2 and $1.7 million during the three and six months ended December 31, 2000;

$0.7 and $1.4 million decreased amortization of goodwill associated with the purchase of Arescom during the three and six months ended December 31, 2001. This goodwill was considered impaired at June 30, 2001 and was fully written off at that time.

The decrease in SG&A was partially offset by the following factors:

A $1.0 million incremental amortization of goodwill associated with our subsidiary Correlant;

Increased staffing and related personnel costs to support our ongoing activities;

Increased allowance for doubtful accounts to reserve against potentially uncollectible customer accounts.

In the near term, we believe SG&A expenditures in absolute dollars will decrease as a result of the sale of our controlling interest in Arescom.

Research and development (R&D). R&D expenses consist primarily of personnel costs, including amortization of deferred stock compensation, of employees engaged in research, design and development activities and, to a lesser extent, design prototype material expenditures and equipment and supplies required to develop new products and enhance our existing products. The decrease in R&D expense for both the three and six months ended December 31, 2001 was primarily attributable

to the decrease in amortization of deferred stock compensation to $0.4 and $1.0 million in the three and six months ended December 31, 2001 from $0.9 and $6.7 million during the three and six months ended December 31, 2000.

The decrease was offset in part by the following factors:

Growth of our research and development staff and consultants to support the commercial development of current and future products;

Increased fees related to the DOCSIS cable modem certification process;

Investment in expensed design tools for the development of new products and the enhancement of existing products.

In the near term, we believe R&D expenditures in absolute dollars will decrease as a result of the sale of our controlling interest in Arescom. However, we continue to invest in the future by funding research and development projects. Excluding the impact of the sale of Arescom and amortization of deferred compensation, we believe research and development expenditures will increase in the future as a result of new and existing product development.

Gain on Sale of Subsidiary

Effective December 18, 2001 we sold a major portion of our investment in and cash advances to Arescom for $10.0 million in cash, a promissory note for $2.2 million and 11,048 shares of subordinated preferred stock of Arescom. The subsidiary was in the business of designing, developing and marketing a full line of DSL-based broadband access and networking devices that address the needs of DSL providers, systems integrators and users. In connection with this sale, we recognized a one-time gain of $32.3 million. The gain, which is primarily a result of recaptured consolidated losses from Arescom, has no related tax liability. We account for our remaining investment in Arescom under the cost method and will no longer include Arescom's results of operations with our results of operations. During the six months ended December 31, 2001, Arescom realized operating losses of approximately $40,000.

Liquidity and Capital Resources

The following table summarizes our cash flows for the six months ended December 31, 2001 compared to the six months ended December 31, 2000 (*in millions*):

	December 31, 2001	December 31, 2000
Cash and cash equivalents	$ 21.9	$ 17.0
Short-term investments	8.6	
Net cash used in operating activities	(5.7)	(27.2)
Net cash provided by investing activities	3.2	11.8
Net cash provided by (used in) financing activities	(0.5)	4.4

As of December 31, 2001, our principal source of liquidity included cash and cash equivalents and short-term investments of $30.5 million. We used $5.7 million in cash for operating activities during the six month period ended December 31, 2001 primarily to fund the operating loss for the six months ended December 31, 2001 and to pay vendors according to current payment terms, partially offset by a decrease in inventory and collection on accounts receivable from related parties. In addition, although we have not changed our credit and collections policy, our unrelated customers have significantly slowed down payment as a result of the recent overall downturn in the economy and specifically our industry. This slowdown had a negative impact on cash flow used in operating activities.

For the six months ended December 31, 2002, our principal investing activities included selling a controlling portion of interest in our subsidiary Arescom, offset by the purchase of short-term

investments and capital expenditures to accommodate our expanding research and development technology infrastructure.

Financing activities for the six months ended December 31, 2001 consisted entirely of our subsidiary Arescom paying down its line of credit.

At December 31, 2001, we had working capital of $30.4 million, compared to $21.3 million at June 30, 2001. The increase in working capital was primarily due to the sale of our controlling interest in Arescom partially offset by a decrease in inventory resulting from timing

issues surrounding shipments of our completed cable modems. We believe our working capital, together with funds that may be generated from equity financings and operations, will be">Table of Contents

6. SUBSEQUENT EVENT

On August 12, 2002, BioTime completed a private placement of 1,852,785 common shares for $2,075,119 ($1,846,856 net proceeds after placement fees) through Ladenburg Thalmann Co. Inc. The money will be used for clinical and pre-clinical product development, and for working capital. The Company has agreed to register these shares for sale under the Securities Act of 1933, as amended. Under the private placement memorandum, the Company is required to file a registration statement with the SEC within fifteen business days after the termination of the offering, and must cause the registration statement to become effective within ninety days after filing. If the Company fails to file the registration statement, or fails to cause it to become effective in a timely fashion, then the Company must pay each holder of the shares, as liquidated damages, 1% of the purchase price of his or her shares for the first month of default, and 2% of the purchase price for each month thereafter until such time as the Company is able to cure the default. In connection with the offering, and in addition to the placement fees referred to above, the Company granted to Ladenburg Thalmann Co. Inc., warrants to purchase 129,695 common shares at an exercise price of $1.34 per share. The warrants are fully vested and non-forfeitable, and expire on August 11, 2007.

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

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

Since its inception in November 1990, the Company has been engaged primarily in research and development activities which have culminated in the commercial launch of Hextend, its lead product, and a clinical trial of PentaLyte. The Company s operating revenues have been generated primarily from licensing fees and royalties, including $2,500,000 of licensing fees received from Abbott Laboratories for the right to manufacture and market Hextend® in the United States and Canada. As a result of the developmental nature of its business and the limited sales of its product, since the Company s inception in November 1990 it has incurred $32,259,827 of losses. The Company s ability to generate substantial operating revenue depends upon its success in developing and marketing or licensing its plasma volume expanders and organ preservation solutions and technology for medical use.

Most of the Company s research and development efforts have been devoted to the Company s first three blood volume replacement products: Hextend,® PentaLyte,® and HetaCool. By testing and bringing all three products to the market, BioTime can increase its market share by providing the medical community with solutions to match patients needs. By developing technology for the use of HetaCool in low temperature surgery, trauma care, and organ and tissue transplant surgery, BioTime may also create new market niches for its product line.

The Company s first product, Hextend, is a physiologically balanced blood plasma volume expander, for the treatment of hypovolemia. Hextend is being sold in the United States by Abbott Laboratories under an exclusive license from the Company. Abbott also has the right to sell Hextend in Canada, where it has recently been approved for sale. Abbott also has a right to obtain licenses to manufacture and sell other BioTime products.

Under its License Agreement with the Company, Abbott will report sales of Hextend and pay the Company the royalties and license fees due on account of such sales within 90 days after the end of each calendar quarter. The Company recognizes such revenues in the quarter in which the sales report is received, rather than the quarter in which the sales took place, as the Company does not have sufficient sales history to accurately predict quarterly sales. Hextend sales are still in the ramp-up phase. Revenues for the three months ended June 30, 2002 consist of royalties on sales made by Abbott during the period beginning January 1, 2002 and ending March 31, 2002. Royalty

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revenues recognized for the three months ended June 30, 2002 were $60,812, a 103% increase over the $29,958 of royalty revenue during the same period of the prior year.

BioTime received royalty revenues of $85,843 on sales during the three months ended June 30, 2002. These royalties will be recognized as revenue during the third quarter of 2002. This represents a 41.2% increase from second quarter revenue, and a 135.7% increase from revenues recognized during the third quarter of 2001. The growth of royalty revenue from Hextend sales is shown graphically below:

Hextend has been approved for use and added to hospital formularies in hundreds of hospitals. Inclusion on hospital formularies is important because it enables physicians to obtain Hextend without the need to special order it. Obtaining formulary approval can be a lengthy process and requires diligent efforts by the sales force who not only provide Hextend to the hospital but also can provide the formulary committee with necessary information showing that the product is safe and effective.

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Hextend has become the standard plasma volume expander at a number of prominent teaching hospitals and leading medical centers. BioTime believes that as Hextend use proliferates within the leading US hospitals, other smaller hospitals will follow their lead and accelerate sales growth.

On June 14, 2002, a Blood Products Advisory Committee chosen by officials of the United States Food and Drug Administration (the FDA) advised the FDA that a warning regarding bleeding in cardiac surgery should be added to the labeling of plasma expanders consisting of 6% hetastarch in normal saline. This recommendation was made following reports of bleeding in patients and a request by a manufacturer to add a warning to the labeling of the saline-based hetastarch solution. The Committee recommendation did not pertain to Hextend, which includes 6% hetastarch in a balanced electrolyte solution rather than normal saline, and was considered by the Committee to be a different product.

BioTime has been informed that Hextend has been purchased for use by certain armed forces units deployed overseas, and arrangements have been made to facilitate additional purchases of Hextend by the military and other federal government agencies. BioTime is continuing to work to promote the use of Hextend by the United States armed forces. Military physicians and researchers are evaluating Hextend for use as part of the standard treatment of hypovolemia in combat casualties, and a number of laboratories under the direction of the armed forces or engaged in civilian-directed medical research projects receiving military funding, have conducted studies using Hextend in animal models of military trauma. Some of the results of these studies were discussed at a recent conference sponsored by the Office of Naval Research and other military organizations to create a consensus regarding animal models for research into military trauma. A group of military and civilian physicians meeting under the acronym STORMACT (Strategies TO Reduce Military And Civilian Transfusions), has recommended Hextend for use in the treatment of combat-related injuries.

The Company has completed a Phase I clinical trial of PentaLyte and is planning the next phase of its clinical trials in which PentaLyte will be used to treat hypovolemia in surgery. The results of the Phase I trial are scheduled for presentation at the upcoming meeting of the American Society of Anesthesiologists to be held in Orlando, Florida in October 2002.

The Company is also continuing to develop solutions for low temperature surgery. Once a sufficient amount of data from successful low temperature surgery has been compiled, the Company plans to seek permission to use Hextend as a complete replacement for blood under near-freezing conditions. BioTime currently plans to market Hextend for complete blood volume replacement at very low temperatures under the registered trademark HetaCool after FDA approval is obtained. In a recent article appearing in the April 2002 volume of the Canadian Journal of Anesthesia, Drs. David Moskowitz, Aryeh Shander and their colleagues at Engelwood Hospital in New Jersey reported that they replaced 35% of a patient s blood with Hextend in a procedure known as acute normovolemic hemodilution (ANH) prior to chilling to 15oC and surgically removing a tumor which had grown from the kidney capsule into the inferior vena cava, and up into the right side of the heart. The patient was released from the hospital one week later, and his recovery was uneventful.

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BioTime has recently launched a research program using HetaCool in animal models of trauma at the State University of New York Health Science Center in Brooklyn. Preliminary laboratory results there have already supported the feasibility of using HetaCool to treat subjects following severe hemorrhage. The use of HetaCool at near-freezing temperatures also will be studied in animal models of cardiovascular surgery at the Texas Heart Institute in Houston. The project has been approved by the appropriate internal committees, and is awaiting the beginning of experimentation.

BioTime scientists believe that the HetaCool program has the potential to produce a product that could be used in very high fluid volumes (50 liters or more per procedure if HetaCool were used as an organ preservation solution or to temporarily replace substantially all of the patient s circulating blood volume) in cardiovascular surgery, trauma treatment, and organ transplantation.

Abbott has an option to obtain a license to market PentaLyte and HetaCool in the United States and Canada, and BioTime would receive additional license fees if those options are exercised, in addition to royalties on subsequent sales of those products. BioTime and certain pharmaceutical companies are discussing potential manufacturing, distributing and marketing agreements for BioTime products in the rest of the world.

In order to commence clinical trials for regulatory approval of new products or new therapeutic uses of products, it will be necessary for the Company to prepare and file with the FDA an Investigational New Drug Application (IND) or an amendment to expand a previous filing. Filings with foreign regulatory agencies may require clinical trials overseas. The Company is working to obtain regulatory approval in Sweden, a member of the European Union. Regulatory approvals for other countries that are members of the European Union may be obtained through a mutual recognition process. If approvals can be obtained in the requisite number of member nations, then the Company would be permitted to market Hextend in all 16 member nations.

In addition to developing clinical trial programs, the Company plans to continue to provide funding for its laboratory testing programs at selected universities, medical schools and hospitals for the purpose of developing additional uses of Hextend, PentaLyte, HetaCool, and other new products, but the amount of research that will be conducted at those institutions will depend upon the

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Company s financial status. Because the Company s research and development expenses, clinical trial expenses, and production and marketing expenses will be charged against earnings for financial reporting purposes, management expects that there will be losses during the near future.

Hextend® and PentaLyte® are registered trademarks, and HetaCool and HetaFreeze are trademarks, of BioTime.

Results of Operations

Revenues

From inception (November 30, 1990) through June 30, 2002, the Company recognized $2,500,000 of license fee revenues. All license fees based upon milestones under the Abbott License Agreement were earned prior to the year ended December 31, 1999. See Note 2 to the accompanying condensed financial statements.

From inception (November 30, 1990) through June 30, 2002, the Company has recognized $322,456 in royalty revenue based on product sales. For the three months ended June 30, 2002, the Company recognized $60,812 in royalty revenue, whereas the Company recognized $29,958 for the three months ended June 30, 2001. This 103% increase in royalties is attributable to an increase in product sales by Abbott. See Note 2 to the accompanying condensed financial statements. For the six months ended June 30, 2002, the Company recognized $118,047 in royaly revenue, compared to $62,653 recognized for the six months ended June 30, 2001. Again, this 88% increase is due to an increase in product sales by Abbott. See Note 2 to the accompanying condensed financial statements.

Operating Expenses

From inception (November 30, 1990) through June 30, 2002, the Company incurred $22,234,562 of research and development expenses, including salaries, supplies and other related expense items. Research and development expenses were $343,473 for the three months ended June 30, 2002, compared to $541,894 for the three months ended June 30, 2001. The decrease is attributable to a concerted and ongoing effort to cut expenses. Specifically, the Company decreased its expenses for laboratory equipment and supplies, fees paid to scientific consultants, clinical trial work, and wages paid to scientific and research personnel within the Company. Research and development expenses decreased to $604,044 for the six months ended June 30, 2002, from $1,095,786 for the six months ended June 30, 2001. Research and development expenses include laboratory study expenses, European clinical trial expenses, salaries, preparation of additional regulatory applications in the United States and Europe, manufacturing of solution for trials, and consultants fees. It is expected that research and development expenses will increase if the Company commences new clinical studies of its products in the United States and Europe.

From inception (November 30, 1990) through June 30, 2002, the Company incurred $14,049,761 of general and administrative expenses. General and administrative expenses were $290,627 for the three months ended June 30, 2002, compared to $613,490 for the three months ended June 30, 2001. General and administrative expenses decreased to $622,034 for the six months ended June 30, 2002, from $1,050,487 for the six months ended June 30, 2001. The decrease is

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primarily attributable to a reduction in personnel costs, while efforts to cut other expenses have also been a contributing factor. General and administrative expenses include salaries, consultants fees, and general operating expenses.

Interest Expense

For the three months and six months ended June 30, 2002, the Company had interest expense of $215,349 and $387,014, respectively. This interest expense is related to $3,350,000 of debentures issued by the Company to a group of investors in August, 2001. See Note 3 to the condensed financial statements for further details.

Liquidity and Capital Resources

Since inception, the Company has primarily financed its operations through the sale of equity securities, licensing fees, and borrowings. On August 12, 2002, BioTime completed a private placement of 1,852,785 common shares for $2,075,119 ($1,846,856 net proceeds after placement fees) through Ladenburg Thalmann Co., Inc. The money will be used for clinical and pre-clinical product development, and for working capital. The Company has agreed to register these shares for sale under the Securities Act of 1933, as amended. Under the private placement memorandum, the Company is required to file a registration statement with the SEC within fifteen business days after the termination of the offering, and must cause the registration statement to become effective within ninety days after filing. If the Company fails to file the registration statement, or fails to cause it to become effective in a timely fashion, then the Company must pay each holder of the shares, as liquidated damages, 1% of the purchase price of his or her shares for the first month of default, and 2% of the purchase price for each month thereafter until such time as the Company is able to cure the default. In connection with the offering, and in addition to the placement fees referred to above, the Company granted to Ladenburg Thalmann Co., Inc., warrants to purchase 129,695 common shares at an exercise price of $1.34 per share. The warrants are fully vested and non-forfeitable, and expire on August 11, 2007.

During August 2001, the Company received cash and converted debt totaling $3,350,000 through the sale of debentures to a group of private investors, including Alfred D. Kingsley, an investor and consultant to the Company, who purchased $1,500,000 of debentures, and Milton Dresner, a director of the Company. Mr. Kingsley s investment included the conversion of the $1,000,000 principal balance of a line of credit that he had previously provided.

Interest on the debentures is payable at an annual rate of 10% and is payable semiannually. The principal amount of the debentures will be due and payable on August 1, 2004. BioTime may prepay the debentures, in whole or in part, at any time without premium or penalty. Under the terms of the debentures BioTime has agreed to restrict its quarterly cash payments for operating expenses to not more than $450,000 (excluding interest payable on the debentures) plus the amount of cash revenues (excluding interest and dividends) it collects for the quarter. To the extent BioTime s expenditures during any quarter are less than $450,000 over its revenues, it may expend the difference in one or more subsequent quarters. The spending restriction will expire when BioTime obtains at least $5,000,000 in cash through sales of equity securities or pays off the debenture indebtedness in full. For this purpose, cash revenues will include royalties, license fees, and other proceeds from the sale or licensing of its products and technology, but will not include interest, dividends, and any monies borrowed or the proceeds from the issue or sale of any debt or equity securities. BioTime has also agreed not to declare or pay any cash dividends on its capital stock or to redeem or repurchase any shares of its capital stock, until it has paid off the debenture indebtedness in full.

Investors who purchased the debentures also received warrants to purchase a total of 515,383 common shares at an exercise price of $6.50 per share. The warrants will expire if not exercised by August 1, 2004. Since the end of June 2002, the Company has had the right to call the warrants for redemption at a redemption price of $0.01 per share if the closing price of the Company s common shares on the American Stock Exchange equals or exceeds 150% of the exercise price for fifteen (15)

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consecutive trading days and the shares issuable upon the exercise of the warrants have been registered for sale under the Securities Act of 1933, as amended.

On March 27, 2002, the Company entered into a new Credit Agreement with Alfred D. Kingsley under which the Company may borrow up to $300,000 for working capital purposes. Amounts borrowed under the 2002 Credit Agreement will bear interest at 10% per annum and will be due on March 27, 2003 or when BioTime receives at least $600,000 through the sale of capital stock, loans from other lenders, fees under licensing agreements (excluding royalty payments), or any combination of those sources. Mandatory prepayments of principal will be due to the extent that the Company receives funds from any one or more of those sources in excess of $300,000 but less than $600,000, and the amount of any such mandatory prepayments of principal will reduce the maximum amount available under the 2002 Credit Agreement and will not be available for future borrowings. The Company has the right to make voluntary prepayments of principal that would otherwise not be due, without penalty or premium but with accrued interest, at any time, and any amounts voluntarily prepaid will be available for future borrowings, so long as the Company is not in default under the 2002 Credit Agreement, and the outstanding principal balance loaned under the 2002 Credit Agreement does not exceed $300,000. At June 30, 2002, no amounts were outstanding under the 2002 Credit Agreement.

In connection with entering into the 2002 Credit Agreement on March 27, 2002, the Company issued to Mr. Kingsley warrants to purchase 30,000 shares of the Company s common stock at $4.00 per share. The warrants are fully exercisable and non-forfeitable on the date of grant and expire on March 26, 2007. The fair value of the warrant was $60,390 and was determined using the Black-Scholes option pricing model with the following assumptions: contractual life of 5 years; risk-free interest rate of 4.4%; volatility of 84.6%; and no dividends during the expected term. The fair value of the warrant was included in other current assets at June 30, 2002, and is being amortized over the term of the 2002 Credit Agreement.

BioTime will need to obtain additional equity capital from time to time in the future, as long as the fees it receives from licensing its products to pharmaceutical companies, profits from sales of its products and/or royalty revenues are not sufficient to fund its operations. Sales of additional equity securities could result in the dilution of the interests of present shareholders. The amount of license fees and royalties that may be earned through the licensing and sale of the Company s products and technology, the timing of the receipt of license fee payments, and the future availability and terms of equity financing, is uncertain. The unavailability or inadequacy of financing or revenues to meet future capital needs could force the Company to modify, curtail, delay or suspend some or all aspects of its planned operations.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

The Company did not hold any market risk sensitive instruments as of June 30, 2002, December 31, 2001, or June 30, 2001.

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PART II OTHER INFORMATION

Item 2. Changes in Securities and Use of Proceeds.

During August 2002, the Company sold 1,852,785 common shares at $1.12 per share. In connection with the offering, the Company granted to Ladenburg Thalmann Co., Inc., warrants to purchase 129,695 common shares at an exercise price of $1.34 per share. The shares and warrants were offered and sold without registration under the Securities Act of 1933, as amended, pursuant to the exemption provided in Section 4(2) and Rule 506 thereunder. The Company has agreed to register these shares for sale under the Securities Act of 1933, as amended.

Item 5. Other Information

On August 13, 2002, Ronald S. Barkin informed the Company that he has decided to resign from the board of directors. Mr. Barkin had served as a director since 1990, and as President of the Company from 1997 until April 1, 2002.

Item 6. Exhibits and Reports of Form 8-K

(a) Exhibits.

Exhibit Numbers	Description
3.1	Articles of Incorporation, as Amended.
3.3	By-Laws, As Amended.#
4.1	Specimen of Common Share Certificate.+
10.1	Lease Agreement dated July 1, 1994 between the Registrant and Robert and Norah Brower, relating to principal executive offices of the Registrant.*
10.2	Intellectual Property Agreement between the Company and Paul Segall.+
10.3	Intellectual Property Agreement between the Company and Hal Sternberg.+
10.4	Intellectual Property Agreement between the Company and Harold Waitz.+
10.5	Intellectual Property Agreement between the Company and Judith Segall.+
10.6	Intellectual Property Agreement between the Company and Steven Seinberg.**
10.7	Agreement between CMSI and BioTime Officers Releasing Employment Agreements, Selling Shares, and Transferring Non-Exclusive License.+
10.8	Agreement for Trans Time, Inc. to Exchange CMSI Common Stock for BioTime, Inc. Common Shares.+
10.9	1992 Stock Option Plan, as amended.##
10.10	Intellectual Property Agreement between the Company and Ronald S. Barkin.^

10.11 Addenda to Lease Agreement between the Company and Donn Logan.

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Exhibit Numbers	Description
10.12	Exclusive License Agreement between Abbott Laboratories and BioTime, Inc. (Portions of this exhibit have been omitted pursuant to a request for confidential treatment).###
10.13	Modification of Exclusive License Agreement between Abbott Laboratories and BioTime, Inc. (Portions of this exhibit have been omitted pursuant to a request for confidential treatment).^^^
10.14	Revolving Line of Credit Agreement, dated March 27, 2001, between BioTime, Inc. and Alfred D. Kingsley
10.15	Warrant Agreement, dated March 27, 2001, between BioTime, Inc. and Alfred D. Kingsley
10.16	Form of Series 2001-A 10% Debenture due August 1, 2004
10.17	Warrant Agreement between BioTime, Inc. and Purchasers of Series 2001-A Debentures
10.18	Revolving Line of Credit Agreement, dated March 27, 2002, between BioTime, Inc. and Alfred D. Kingsley**
10.19	Warrant Agreement, dated March 27, 2002, between BioTime, Inc. and Alfred D. Kingsley**
10.20	Warrant for the Purchase of Common Shares, dated August 12, 2002, issued to Ladenburg Thalmann Co., Inc.***
99.1	Certification Pursuant to 18 U.S.C. Section 1350.***

Incorporated by reference to the Company s Form 10-K for the fiscal year ended June 30, 1998.

+ Incorporated by reference to Registration Statement on Form S-1, File Number 33-44549 filed with the Securities and Exchange Commission on December 18, 1991, and Amendment No. 1 and Amendment No. 2 thereto filed with the Securities and Exchange Commission on February 6, 1992 and March 7, 1992, respectively.

Incorporated by reference to Registration Statement on Form S-1, File Number 33-48717 and Post-Effective Amendment No. 1 thereto filed with the Securities and Exchange Commission on June 22, 1992, and August 27, 1992, respectively.

* Incorporated by reference to the Company s Form 10-K for the fiscal year ended June 30, 1994.

^ Incorporated by reference to the Company s Form 10-Q for the quarter ended March 31, 1997.

Incorporated by reference to Registration Statement on Form S-8, File Number 333-30603 filed with the Securities and Exchange Commission on July 2, 1997.

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^ ^ Incorporated by reference to the Company s Form 10-Q for the quarter ended March 31, 1999.

Incorporated by reference to the Company s Form 8-K, filed April 24, 1997.

^^^ Incorporated by reference to the Company s Form 10-Q for the quarter ended June 30, 1999.

Incorporated by reference to the Company s Form 10-K for the year ended December 31, 1999.

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Incorporated by reference to the Company s Form 10-Q for the quarter ended June 30, 2001.

** Incorporated by reference to the Company s Form 10-K for the year ended December 31, 2001.

*** Previously filed.

(b) Reports on Form 8-K
The Company filed a report on Form 8-K on July 9, 2002, reporting under Item 5 disclosing Canadian regulatory approval for the sale of Hextend in Canada.

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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.

BIOTIME, INC.

Date: August 28, 2002 /s/Paul Segall

Paul Segall
Chief Executive Officer

Date: August 28, 2002 /s/Steven Seinberg

Steven Seinberg
Chief Financial Officer

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