

NANOPHASE TECHNOLOGIES CORPORATION

Form 10-Q

November 12, 2014

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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: September 30, 2014**

**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: 000-22333**

**Nanophase Technologies Corporation**

**(Exact name of registrant as specified in its charter)**

**Delaware** **36-3687863**  
**(State or other jurisdiction of** **(I.R.S. Employer**  
**incorporation or organization)** **Identification No.)**  
**1319 Marquette Drive, Romeoville, Illinois 60446**

**(Address of principal executive offices, and zip code)**

**Registrant's telephone number, including area code: (630) 771-6708**

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  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "accelerated filer," "large accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer   
Non-accelerated filer  Smaller Reporting Company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

As of November 7, 2014, there were 28,481,496 shares outstanding of common stock, par value \$.01, of the registrant.

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QUARTER ENDED SEPTEMBER 30, 2014

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Table of Contents**PART I FINANCIAL INFORMATION****Item 1. Financial Statements****NANOPHASE TECHNOLOGIES CORPORATION****BALANCE SHEETS**

	(in thousands except share and per share data)	
	September 30, 2014 (Unaudited)	December 31, 2013
<b>ASSETS</b>		
<b>Current assets:</b>		
Cash and cash equivalents	\$ 2,018	\$ 3,276
Investments		30
Trade accounts receivable, less allowance for doubtful accounts of \$6 on September 30, 2014 and December 31, 2013	1,326	52
Other receivables		1
Inventories, net	749	976
Prepaid expenses and other current assets	244	202
Total current assets	4,337	4,537
Equipment and leasehold improvements, net	2,267	2,464
Other assets, net	25	27
	\$ 6,629	\$ 7,028
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>Current liabilities:</b>		
Current portion of capital lease obligations	\$ 18	\$ 31
Accounts payable	589	503
Accrued expenses	559	323
Total current liabilities	1,166	857
Long-term portion of capital lease obligations		10
Long-term deferred rent	624	633
Asset retirement obligations	165	160
Total long-term liabilities	789	803
<b>Stockholders equity:</b>		
Preferred stock, \$.01 par value, 24,088 shares authorized and no shares issued and outstanding		

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Common stock, \$.01 par value, 35,000,000 shares authorized; 28,481,496 shares issued and outstanding on September 30, 2014 and December 31, 2013	285	285
Additional paid-in capital	95,916	95,761
Accumulated deficit	(91,527)	(90,678)
Total stockholders' equity	4,674	5,368
	\$ 6,629	\$ 7,028

*See Notes to Financial Statements.*

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## NANOPHASE TECHNOLOGIES CORPORATION

## STATEMENTS OF OPERATIONS

(Unaudited)

(in thousands except share and per share data)

	Three months ended September 30, 2014		Three months ended September 30, 2013		Nine months ended September 30, 2014		Nine months ended September 30, 2013	
	2014	2013	2014	2013	2014	2013	2014	2013
<b>Revenue:</b>								
Product revenue, net	\$ 2,647	\$ 2,157	\$ 8,070	\$ 7,810				
Other revenue	7	7	46	16				
Net revenue	2,654	2,164	8,116	7,826				
<b>Operating expense:</b>								
Cost of revenue	1,858	1,648	5,581	5,555				
Gross profit	796	516	2,535	2,271				
Research and development expense	316	375	990	1,257				
Selling, general and administrative expense	828	773	2,391	2,591				
Loss from operations	(348)	(632)	(846)	(1,577)				
Interest income			1	1				
Interest expense	(1)	(2)	(4)	(11)				
Other, net		1		18				
Loss before provision for income taxes	(349)	(633)	(849)	(1,569)				
Provisions for income taxes								
Net loss	\$ (349)	\$ (633)	\$ (849)	\$ (1,569)				
Net loss per share basic and diluted	\$ (0.01)	\$ (0.02)	\$ (0.03)	\$ (0.06)				
Weighted average number of basic and diluted common shares outstanding	28,481,496	28,468,162	28,481,496	28,467,686				

*See Notes to Financial Statements.*



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## NANOPHASE TECHNOLOGIES CORPORATION

## STATEMENTS OF CASH FLOWS

(Unaudited)

(in thousands)

	Nine months ended September 30,	
	2014	2013
<b>Operating activities:</b>		
Net loss	\$ (849)	\$ (1,569)
Adjustment to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	556	674
Gain on disposal of equipment		(18)
Stock compensation expense	150	192
Allowance for excess inventory quantities		47
Changes in assets and liabilities related to operations:		
Trade accounts receivable	(1,274)	43
Other accounts receivable	1	26
Inventories	227	102
Prepaid expenses and other assets	(42)	14
Accounts payable	109	(169)
Accrued expenses	232	67
Net cash used in operating activities	(890)	(591)
<b>Investing activities:</b>		
Proceeds from disposal of equipment		18
Acquisition of equipment and leasehold improvements	(352)	(178)
Payment of accounts payable incurred for the purchase of equipment and leasehold improvements	(23)	(20)
Net cash used in investing activities	(375)	(180)
<b>Financing activities:</b>		
Principal payments on capital leases	(23)	(49)
Proceeds from sale of short term investment	30	
Proceeds from exercise of stock options		3
Net cash provided by (used in) financing activities	7	(46)
Decrease in cash and cash equivalents	(1,258)	(817)
Cash and cash equivalents at beginning of period	3,276	4,124
Cash and cash equivalents at end of period	\$ 2,018	\$ 3,307



**Supplemental cash flow information:**

Interest paid	\$	4	\$	11
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**Supplemental non-cash investing activities:**

Accounts payable incurred for the purchase of equipment and leasehold improvements	\$		\$	92
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*See Notes to Financial Statements.*

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**NANOPHASE TECHNOLOGIES CORPORATION**

**NOTES TO FINANCIAL STATEMENTS**

**(Unaudited)**

**(in thousands, except share and per share data or as otherwise noted herein)**

**(1) Basis of Presentation**

The accompanying unaudited interim financial statements of Nanophase Technologies Corporation ( Nanophase or the Company , including we , our or us ) reflect all adjustments (consisting of normal recurring adjustments) which, in the opinion of management, are necessary for a fair presentation of the financial position and operating results of the Company for the interim periods presented. Operating results for the three and nine months ended September 30, 2014 are not necessarily indicative of the results that may be expected for the year ending December 31, 2014.

These financial statements should be read in conjunction with our audited financial statements and notes thereto for the year ended December 31, 2013, included in our Annual Report on Form 10-K for the year ended December 31, 2013, as filed with the Securities and Exchange Commission.

**(2) Description of Business**

Nanophase is a nanomaterials and applications developer and commercial manufacturer with an integrated family of nanomaterial and related technologies. We produce engineered nano and sub-micron materials for use in a variety of diverse existing and developing markets: personal care including sunscreens, architectural coatings, industrial coating applications, abrasion-resistant additives, plastics additives, medical diagnostics, energy and a variety of surface finishing technologies (polishing) applications. We target markets in which we believe practical solutions may be found using our products. We work closely with current and potential customers in these target markets to identify their material and performance requirements and market our materials to various end-use applications manufacturers. Recently developed technologies have made certain new products possible and opened potential new markets. Although our primary strategic focus has been the North American market, we currently sell material to customers overseas and have been working to expand our reach in foreign markets.

The Company was incorporated in Illinois on November 25, 1989, and became a Delaware corporation in November 1997. Our common stock trades on the OTCQB marketplace under the symbol NANX.

While product sales comprise the majority of our revenue, we also recognize revenue from other sources from time to time. These activities are not expected to drive the long-term growth of the business. For this reason we classify such revenue as other revenue in our Statement of Operations, as it does not represent revenue directly from our nanocrystalline materials.

The presentation of certain prior year disclosures has been modified to conform to current year presentation, as financial data is now presented in thousands of dollars rather than in dollars.

**(3) Financial Instruments**

We follow the Financial Accounting Standards Board ( FASB ) Accounting Standards Codification ( ASC ) Topic 820, *Fair Value Measurements and Disclosures*, which defines fair value, establishes a framework for measuring fair

value, and expands disclosures about fair value measurements. The fair value framework requires the categorization of assets and liabilities into three levels based upon the assumptions (inputs) used to price the assets or liabilities. Level 1 provides the most reliable measure of fair value, whereas Level 3 generally requires significant management judgment.

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Our financial instruments include cash and cash equivalents, accounts receivable, accounts payable and accrued expenses, along with the promissory note with no related borrowings described in Note 4, below. The fair values of all financial instruments were not materially different from their carrying values.

**(4) Investments**

Investments on December 31, 2013 were comprised of certificates of deposit in the amount of \$30, pledged as collateral for our rent and restricted as to withdrawal or usage under our facility lease agreement. During July 2014 we entered into a new bank-issued letter of credit and related promissory note for up to \$30 in borrowings to support our obligations under our facility lease agreement. We then sold our certificates of deposit. No borrowings have been incurred under this promissory note. Should any borrowings occur in the future, the interest rate would be the prime rate plus 1%, with the bank having the right to set off or apply unpaid balances against our checking account if we fail to meet our obligations under any borrowings under the note. It is our intention to renew this note annually, for as long as we need to pursuant to the terms of our facility lease agreement. Because there were no amounts outstanding on the note at any time during the period, we have recorded no related liability on our balance sheet.

**(5) Inventories**

Inventories consist of the following:

	<b>September 30, 2014</b>	<b>December 31, 2013</b>
Raw materials	\$ 185	\$ 132
Finished goods	616	896
	801	1,028
Allowance for excess inventory quantities	(52)	(52)
	\$ 749	\$ 976

**(6) Share-Based Compensation**

We follow FASB ASC Topic 718, *Share-Based Payments*, in which compensation expense is recognized only for share-based payments expected to vest. We recognized compensation expense related to stock options of \$45 and \$155 for the three and nine month periods ended September 30, 2014, respectively, compared to \$54 and \$193 for the same periods in 2013.

As of September 30, 2014, there was approximately \$306 of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under our stock option plans. That cost is expected to be recognized over a remaining weighted-average period of 2.0 years.

**Stock Options and Stock Grants**

During the nine months ended September 30, 2014, no stock options were exercised. During the nine months ended September 30, 2013, 10,000 shares of common stock were issued pursuant to stock option exercises with proceeds of \$3 realized. During the nine months ended September 30, 2014, 568,000 stock options were granted compared to

553,000 during the same period in 2013. During the nine months ended September 30, 2014, 22,000 stock options were forfeited compared to 112,799 stock options forfeited during the same period in 2013.

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Prior to 2011, we granted outside directors stock appreciation rights (SARs). The change in fair value of the awards granted during prior years is included in non-cash compensation expense for the three and nine months ended September 30, 2014 and 2013. The SARs granted vested immediately and are payable upon the directors' removal or resignation from the position of director. These awards are accounted for as liability awards, included in accrued expenses as of September 30, 2014 and 2013, and adjusted to fair value each reporting period. The fair value of the liability on September 30, 2014 was \$3 compared to \$8 on December 31, 2013.

As of September 30, 2014, we did not have any unvested restricted stock or performance shares outstanding.

The following table illustrates the various assumptions used to calculate the Black-Scholes option pricing model for stock options granted during the periods presented:

	September 30, 2014	September 30, 2013
For the three months ended		
Weighted-average risk-free interest rates:		
Dividend yield:		
Weighted-average expected life of the option:		
Weighted-average expected stock price volatility:		
Weighted-average fair value of the options granted:		
For the nine months ended		
Weighted-average risk-free interest rates:	2.01%	1.5%
Dividend yield:		
Weighted-average expected life of the option:	7 Years	7 Years
Weighted-average expected stock price volatility:	95%	92%
Weighted-average fair value of the options granted:	\$0.42	\$0.33

**(7) Significant Customers and Contingencies**

Sales to three customers constituted approximately 71%, 10% and 5%, respectively, of our total revenue for the three months ended September 30, 2014, and 73%, 7% and 6%, respectively, of our total revenue for the nine months ended September 30, 2014. Amounts included in accounts receivable on September 30, 2014 relating to these three customers were approximately \$747, \$270 and \$128, respectively. Revenue from these three customers constituted approximately 74%, 0% and 5%, respectively, of the Company's total revenue for the three months ended September 30, 2013 and 72%, 4% and 7%, respectively, for the nine months ended September 30, 2013. Amounts included in accounts receivable on September 30, 2013 relating to these three customers were approximately \$624, \$0 and \$111, respectively. The loss of one of these significant customers or the failure to attract new customers could have a material adverse effect on our business, results of operations and financial condition.

We currently have exclusive supply agreements with BASF Corporation ( "BASF" ), our largest customer, that have contingencies outlined which could potentially result in the license of technology and/or the sale of production equipment from the Company to the customer intended to provide capacity sufficient to meet the customer's production needs. This outcome may occur if we fail to meet certain performance requirements, certain other obligations and/or certain financial covenants. The most restrictive financial covenants in one of our supply agreements with BASF trigger a technology transfer right (license and equipment sale at BASF's option) in the event (a) that earnings for the twelve month period ending with our most recently published quarterly financial statements are less than zero and our

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cash, cash equivalents and certain investments are less than \$1 million, or (b) of an acceleration of any debt maturity having a principal amount of more than \$10 million. Our supply agreements with BASF also trigger a technology transfer right in the event of our insolvency, as further defined within the agreements. In the event of an equipment sale, upon incurring a triggering event, the equipment would be sold to the customer at either 115% of the equipment's net book value or the greater of 30% of the original book value of such equipment, and any associated upgrades to it, or 115% of the equipment's net book value, depending on the contract and related equipment.

We believe that we have sufficient cash (See Liquidity and Capital Resources in Management's Discussion and Analysis in Part I, Item 2 of this Form 10-Q for a further discussion) to operate our business throughout 2014. If a triggering event were to occur and BASF elected to proceed with the license and related equipment sale mentioned above, we would receive royalty payments from this customer for products sold using our technology; however, we would lose both significant revenue and the ability to generate significant revenue to replace that which was lost in the near term. Replacement of necessary equipment that could be purchased and removed by the customer pursuant to this triggering event could take in excess of twelve months. Any additional capital outlays required to rebuild capacity would probably be greater than the proceeds from the purchase of the assets as dictated by our agreement with the customer. Similar consequences would occur if we were determined to have materially breached certain other provisions of the supply agreement with BASF. Any such event would also likely result in the loss of many of our key staff and line employees due to economic realities. We believe that our employees are a critical component of our success and could be difficult to replace them quickly. Given the occurrence of any such event, we might not be able to hire and retain skilled employees given the stigma relating to such an event and its impact on us. Finally, any shortfall in capital needed to operate the business as management intends, including with respect to avoiding this triggering event as described above, may result in a curtailment of certain activities or anticipated investments.

## **(8) Business Segmentation and Geographical Distribution**

Revenue from international sources approximated \$376 and \$885 for the three and nine months ended September 30, 2014, respectively, compared to \$278 and \$735 for the same periods in 2013. All of this revenue was product revenue.

Our operations comprise a single business segment and all of our long-lived assets are located within the United States.

## **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations Overview**

Nanophase is an advanced materials and applications developer and commercial manufacturer with an integrated family of materials technologies. We produce engineered nano and sub-micron materials for use in a variety of diverse markets: personal care including sunscreens, architectural coatings, industrial coating applications, abrasion-resistant additives, plastics additives, medical diagnostics, energy, and a variety of surface finishing technologies (polishing) applications, including optics. We target markets in which we feel practical solutions may be found using our products. We work closely with current and potential customers in these target markets to identify their material and performance requirements and market our materials to various end-use applications manufacturers. Recently developed technologies have made certain new products possible and opened potential new markets. For example, we have applied our skills at producing precisely defined nanomaterials to now create and sell larger, sub-micron material products. Our focus is on customer need where we believe we have an advantage, as opposed to finding uses for one particular technology. We expect growth in end-user (manufacturing customers, including customers of our customers) adoption in 2014 and beyond. Our initiatives in targeted market areas are progressing at differing rates of



speed, but we have been broadly

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moving through testing and development cycles, and in a number of cases believe we are approaching first revenue or next stage revenue with particular customers in the industries referenced above. For example, we recently developed new solutions in the surface finishing technologies (polishing) and energy-management areas, with commercial order flow accelerating in the former and significant commercial testing happening in the latter. We expect that we will both work more deeply with current customers and attract additional customers, which should help us achieve growth in these markets in 2014 and beyond.

## **Results of Operations**

Total revenue increased to \$2,654,000 for the three months ended September 30, 2014, compared to \$2,164,000 for the same period in 2013. Total revenue also increased to \$8,116,000 for the nine months ended September 30, 2014, compared to \$7,826,000 for the same period in 2013. Product revenue, the primary component of our total revenue, increased to \$2,647,000 for the three months ended September 30, 2014, compared to \$2,157,000 for the same period in 2013. Orders from our largest customer in personal care and sunscreen applications were higher in 2014, and we received an additional order from our customer in medical diagnostics. Product revenue increased to \$8,070,000 for the nine months ended September 30, 2014, compared to \$7,810,000 for the same period in 2013. Increased order flows from our surface finishing technologies solutions (polishing), and increased order flows from our largest customer in personal care and sunscreen applications as well as medical diagnostics offset decreased orders from one large coatings customer which had a product ramp during 2013 that was not repeated during 2014, and another with reduced revenue and more aggressive supply chain management in 2014.

A substantial majority of our revenue for the three and nine month periods ended September 30, 2014 and 2013 was from our largest customer in personal care and sunscreen applications. Revenue from our top three customers was approximately 71%, 10% and 5%, respectively, during the three months ended September 30, 2014, and 73%, 7% and 6%, respectively, for the nine months ended September 30, 2014. Revenue from these three customers constituted approximately 74%, 0% and 5%, respectively, of our total revenue for the three months ended September 30, 2013 and 72%, 4%, and 7%, respectively, for the nine months ended September 30, 2013.

Other revenue was \$7,000 and \$46,000 for the three and nine months ended September 30, 2014, compared to \$7,000 and \$16,000 for the same periods in 2013. The increase for the nine months ended September 30, 2014 was primarily due to a sp