SOMANETICS CORP
Form 10-Q
July 06, 2001

1

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

(x) Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended MAY 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 0-19095

SOMANETICS CORPORATION
(Exact name of registrant as specified in its charter)

MICHIGAN	38-2394784
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identificat

1653 EAST MAPLE ROAD,
TROY, MICHIGAN
48083-4208
(Address of principal executive offices)
(Zip Code)

(248) 689-3050
(Registrant's telephone number, including area code)

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

Number of common shares outstanding at July 6, 2001: 8,075,081

2

PART I FINANCIAL INFORMATION

SOMANETICS CORPORATION

BALANCE SHEETS

ASSETS	May 31, 2001
CURRENT ASSETS:	(Unaudited)
Cash and cash equivalents	$ 1,036,141
Accounts receivable	809,620
Inventory	1,077,430
Prepaid expenses	50,962
Total current assets	2,974,153
PROPERTY AND EQUIPMENT (at cost):	
Machinery and equipment	1,567,497
Furniture and fixtures	183,497
Leasehold improvements	165,642
Total	1,916,636
Less accumulated depreciation and amortization	(1,508,913)
Net property and equipment	407,723
OTHER ASSETS:	
Intangible assets, net	925,543
Other	15,000
Total other assets	940,543
TOTAL ASSETS	$ 4,322,419
LIABILITIES AND SHAREHOLDERS' EQUITY	
CURRENT LIABILITIES:	
Accounts payable	$ 517,931
Accrued liabilities	136,452
Total current liabilities	654,383
COMMITMENTS AND CONTINGENCIES	--
SHAREHOLDERS' EQUITY:	
Preferred shares; authorized, 1,000,000 shares of $.01 par value; no shares issued or outstanding	--
Common shares; authorized, 20,000,000 shares of $.01 par value; issued and outstanding, 8,075,081 shares at May 31, 2001 and 6,637,087 shares at November 30, 2000	80,751
Additional paid-in capital	55,271,963
Accumulated deficit	(51,684,678)
Total shareholders' equity	3,668,036

TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY............................	$ 4,322,419

See notes to financial statements

SOMANETICS CORPORATION

STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended May 31,	
	2001	2000
NET REVENUES	$ 1,261,513	$ 1,430,066
COST OF SALES	417,679	718,469
GROSS MARGIN	843,834	711,597
OPERATING EXPENSES:		
Research, development and engineering	194,816	112,501
Selling, general and administrative	1,505,019	1,491,944
Total operating expenses	1,699,835	1,604,445
OPERATING LOSS	(856,001)	(892,848)
OTHER INCOME (EXPENSE):		
Loss on sale of securities	--	(55,062)
Interest expense	(2,458)	--
Interest income	8,684	25,025
Total other income (expense)	6,226	(30,037)
NET LOSS	$ (849,775)	$ (922,885)
NET LOSS PER COMMON SHARE - BASIC AND DILUTED	$ (0.11)	$ (0.15)
WEIGHTED AVERAGE SHARES OUTSTANDING	7,513,396	6,158,429

See notes to financial statements

3

4

SOMANETICS CORPORATION

STATEMENTS OF CASH FLOWS
(UNAUDITED)

	For the Six M Periods Ended M
	2001
CASH FLOWS FROM OPERATING ACTIVITIES:	
Net loss	$(1,560,931)
Adjustments to reconcile net loss to net cash used in operations:	
Depreciation and amortization	254,764
Changes in assets and liabilities:	
Accounts receivable (increase) decrease	540,106
Inventory (increase)	(463,500)
Prepaid expenses decrease	32,138
Accounts payable increase (decrease)	9,284
Accrued liabilities (decrease)	(130,732)
Net cash (used in) operations	(1,318,871)
CASH FLOWS FROM INVESTING ACTIVITIES:	
Proceeds from sale of marketable securities	--
Acquisition of property and equipment (net)	(113,088)
Net cash (used in) provided by investing activities ...	(113,088)
CASH FLOWS FROM FINANCING ACTIVITIES:	
Proceeds from issuance of common shares	2,345,801
Net cash provided by financing activities	2,345,801
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	913,842
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	122,299

CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 1,036,141
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See notes to financial statements

SOMANETICS CORPORATION

NOTES TO FINANCIAL STATEMENTS
(UNAUDITED)

MAY 31, 2001

1. ORGANIZATION AND OPERATIONS

We are a Michigan corporation that was formed in January 1982. We develop, manufacture and market the INVOS(R) Cerebral Oximeter, the only non-invasive patient monitoring system commercially available in the United States that continuously measures changes in the blood oxygen level in the brain. The Cerebral Oximeter is based on our proprietary In Vivo Optical Spectroscopy, or INVOS, technology. INVOS analyzes various characteristics of human blood and tissue by measuring and analyzing low-intensity visible and near infrared light transmitted into portions of the body. We are also developing the CorRestore(TM) patch for use in cardiac repair and reconstruction, including heart surgeries called surgical anterior ventricular restoration, or SAVR.

2. FINANCIAL STATEMENT PRESENTATION

We prepared our unaudited interim financial statements pursuant to the Securities and Exchange Commission's rules. Accordingly, they do not include all of the information and footnotes normally included in our annual financial statements prepared in accordance with generally accepted accounting principles. We believe, however, that the disclosures are adequate to make the information presented not misleading.

The unaudited interim financial statements in this report reflect all adjustments which are, in our opinion, necessary to a fair statement of the results for the interim periods presented. All of these adjustments that are material are of a normal recurring nature. Our operating results for the six-month period ended May 31, 2001 do not necessarily indicate the results that you should expect for the year ending November 30, 2001. You should read the unaudited interim financial statements together with the financial statements and related footnotes for the year ended November 30, 2000 included in our Annual Report on Form 10-K for the fiscal year ended November 30, 2000.

We have incurred an accumulated deficit of $51,684,678 through May 31, 2001. We had working capital of $2,319,770, cash and cash equivalents of $1,036,141, total current liabilities of $654,383 and shareholders' equity of $3,668,036 as of May 31, 2001.

We believe that markets exist for the products we have developed and are developing; however, whether our products will be successful is uncertain. You should consider the following factors in evaluating the likelihood of our success: our limited resources and current financial condition, the problems and expenses frequently encountered by companies developing a new business, our ability to raise new funds, our ability to develop, apply and market new technology, and our industry and competitive environment.

For further discussion of our financial condition, including recent sales of securities, our working capital, our liquidity resources, requirements and plans, and our ability to continue as a going concern, please refer to "Liquidity and Capital Resources" in "Management's Discussion and Analysis of Financial Condition and Results of Operations."

SOMANETICS CORPORATION

NOTES TO FINANCIAL STATEMENTS
(UNAUDITED)

MAY 31, 2001

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Inventory is stated at the lower of cost or market on a first-in, first-out (FIFO) basis. Inventory consists of:

	May 31, 2001	November 30, 2000
Finished goods..................	$ 77,932	$ 36,374
Work in process.................	268,227	124,127
Purchased components............	731,271	453,429
Total......................	$1,077,430	$ 613,930

Intangible Assets consist of patents and trademarks, and license acquisition costs. Patents and trademarks are recorded at cost and are being amortized on the straight-line method over 17 years. License acquisition costs are related to our acquisition of exclusive, worldwide, royalty-bearing licenses to specified rights relating to the CorRestore(TM) patch and related products and accessories.

We entered into a License Agreement as of June 2, 2000 with the inventors and their company, CorRestore LLC. The license grants us exclusive, worldwide, royalty-bearing licenses to specified rights relating to the CorRestore(TM) patch and related products and accessories for SAVR, subject to the terms and conditions of the license agreement. Pursuant to the license agreement, CorRestore LLC has agreed to provide various consulting services to us. We have agreed to pay all of the expenses of such consultation, of clinical testing of the CorRestore(TM) patch, training doctors in SAVR and training our personnel and customers in the use of the CorRestore(TM) patch.

In exchange for the licenses and consulting services, we agreed to the following compensation for CorRestore LLC and its agent, Wolfe & Company: (1) a royalty of 10% of our "net sales" of products subject to the licenses, (2) five-year warrants to purchase up to 400,000 Common Shares at $3.00 a share, exercisable to purchase 300,000 shares immediately and to purchase an additional 50,000 shares upon our receipt of clearance or approval from the FDA to market the CorRestore(TM) patch in the United States and another 50,000 shares upon our receipt of CE certification for the CorRestore(TM) patch, (3) additional five-year warrants to purchase up to 2,100,000 common shares at $3.00 a share, to be granted when we receive clearance or approval from the FDA to market the CorRestore(TM) patch in the United States, exercisable based on our cumulative net sales of the CorRestore(TM) patch products, and (4) a consulting fee of $25,000 a year to each of the inventors until we sell 1,000 CorRestore(TM) patches.

SOMANETICS CORPORATION

NOTES TO FINANCIAL STATEMENTS
(UNAUDITED)

MAY 31, 2001

License acquisition costs consist of professional service fees recorded at cost, our estimate of the fair value of the ten-year vested stock options to purchase 50,000 common shares at $3.00 a share granted to one of our directors in connection with negotiating and assisting us in completing the transaction, and our estimate of the fair value of the 300,000 common share vested portion of the five-year warrants to purchase up to 400,000 common shares at $3.00 a share issued in the transaction. We estimated the value of the stock options to purchase 50,000 common shares using the Black-Scholes valuation model with the following assumptions: expected volatility (the measure by which the stock price has fluctuated or is expected to fluctuate during the period) 111.16%, risk-free interest rate of 7.5%, expected life of 4 years and dividend yield of 0%. We estimated the value of the warrants to purchase 300,000 common shares using the Black-Scholes valuation model with the following assumptions: expected volatility (the measure by which the stock price has fluctuated or is expected to fluctuate during the period) 111.16%, risk-free interest rate of 7.5%, expected life of 5 years and dividend yield of 0%.

These costs are being amortized on the straight-line method over 5 years. Intangible assets consist of:

	May 31, 2001	November 30, 2000
License acquisition costs	$ 1,096,898	$ 1,096,898
Patents and trademarks	111,733	111,733
Sub-total	1,208,631	1,208,631
Less accumulated amortization	(283,088)	(169,943)
Total	$ 925,543	$ 1,038,688

Intangible assets are reviewed periodically for impairment whenever events or changes in circumstances indicate that the carrying value of the asset may not be recovered.

Loss Per Common Share - basic and diluted, is computed using the weighted average number of common shares outstanding during each period. Common shares issuable under stock options and warrants have not been included in the computation of the net loss per Common Share - diluted, because such inclusion would be antidilutive. As of May 31, 2001 and May 31, 2000, we had outstanding 2,685,515 and 1,944,981, respectively, of warrants and options to purchase common shares.

Accounting Pronouncements Effective December 1, 2000, we adopted Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities." This statement had no impact on our financial statements.

Reclassifications - Certain reclassifications have been made to the financial statements for 2000 to conform to the 2001 presentation.

SOMANETICS CORPORATION

NOTES TO FINANCIAL STATEMENTS
(UNAUDITED)

MAY 31, 2001

4. ACCRUED LIABILITIES

Accrued liabilities consist of the following:

	May 31, 2001	November 30, 20
Accrued sales commissions	$ 70,000	$117,045
Professional fees	21,500	94,000
Accrued insurance	11,932	24,361
Accrued incentive	24,220	17,500
Accrued warranty	8,800	7,000
Other	--	7,278
Total	$136,452	$267,184

5. COMMITMENTS AND CONTINGENCIES

We may become subject to products liability claims by patients or physicians, and may become a defendant in products liability or malpractice litigation. We have obtained products liability insurance and an umbrella policy. We might not be able to maintain such insurance or such insurance might not be sufficient to protect us against products liability.

6. COMMON STOCK

On December 4, 2000, we completed the sale of 112,994 common shares to Kingsbridge, at a price of $1.77 per share, for gross proceeds of $200,000.

Effective December 4, 2000, we granted 10-year options under the 1991 Stock Option Plan to purchase 14,667 common shares, and we granted 10-year options under the 1997 Stock Option Plan to purchase 180,333 common shares, to 27 of our key employees (including officers) and one of our consultants at an exercise price of $1.97 per share (the closing sale price of the common shares as of the date of grant). Effective March 5, 2001, we granted 10-year options under the 1997 Stock Option Plan to purchase 322,800 common shares to seven of our key employees (including officers) at an exercise price of $2.00 per share (the closing sale price of the common shares as of the date of grant). Stock Options issued to non-employees are valued at the date of grant using the Black Scholes valuation model, and are expensed as compensation expense over the vesting period of the stock option.

Effective February 22, 2001, we granted to five of our directors, who are not officers or employees, 10-year options under the 1997 Stock Option Plan to purchase an aggregate of 10,000 common shares at an exercise price of $2.31 per share (the closing sale price of the common shares as of the date of grant).

On February 22, 2001, our shareholders approved the issuance of warrants to purchase 2,100,000 common shares to CorRestore LLC under specified circumstances pursuant to our CorRestore(TM) license agreement and to issue the underlying shares upon exercise of those warrants.

On February 22, 2001, our shareholders approved an amendment to the Somanetics Corporation 1997 Stock Option Plan to increase the number of common shares reserved for issuance pursuant to the exercise of options granted under the 1997 Plan by 325,000 shares, from 1,335,000 to 1,660,000 shares.

SOMANETICS CORPORATION

NOTES TO FINANCIAL STATEMENTS
(UNAUDITED)

MAY 31, 2001

Effective March 5, 2001, we de-registered the remaining shares originally registered for resale by Kingsbridge Capital Limited under the Private Equity Line Agreement, because we no longer intend to sell any more shares to Kingsbridge, except upon any exercise of its warrant, and Kingsbridge is no longer publicly offering for resale the shares subject to the warrant we granted to them. On April 10, 2001, we mutually agreed with Kingsbridge to terminate the Private Equity Line Agreement, the related Registration Rights Agreement, and Kingsbridge's right to the discount on any unsold shares, in exchange for our payment of $200,000 to Kingsbridge.

On April 9, 2001, we completed the private placement of 1,325,000 newly-issued common shares at a price of $1.75 per share, for gross proceeds of $2,318,750. Our estimated net proceeds, after deducting the placement agent's commission and the estimated expenses of the offering, were approximately $2,159,000. Brean Murray & Co., Inc. was our exclusive placement agent for the offering and received for its services (1) $104,362.50 as a placement agent fee, and (2) warrants to purchase 25,000 common shares at $2.10 per share exercisable during the four-year period beginning April 9, 2002. A. Brean Murray, one of our directors, and his wife control Brean Murray & Co., Inc. In addition, the Brean Murray & Co., Inc. Profit Sharing Plan purchased 32,285 common shares in the offering, and Robert R. Henry, one of our directors, purchased 100,000 common shares in the offering.

7. NOTES PAYABLE - BANK LINE OF CREDIT

On February 13, 2001, we entered into a Loan and Security Agreement with Crestmark Bank for a working capital line of credit for up to $750,000, collateralized by all of our assets. Under the Agreement, Crestmark Bank may, but is not obligated to, lend us amounts we request from time to time, up to $750,000, if no default exists. The loans are limited by a borrowing base based on qualifying accounts receivable and lender reserves. The loan is payable on demand, and collections of our receivables are directed to Crestmark Bank in payment of any outstanding balance of the loan.

The principal amount outstanding bears interest, payable monthly, at the prime rate (6.75% at July 2, 2001) plus 2% plus a 2.4% service fee, and we paid a $45,000 commitment fee for the loan. Through May 31, 2001, we have borrowed $920,050 under the agreement and repaid $920,050 in principal amount through Crestmark's collection of our receivables and by using some of the proceeds from our April 9, 2001 offering. As of May 31, 2001, $628,629 was available for borrowing, at Crestmark's discretion, under the facility. We have agreed to use the proceeds of the loans solely as working capital. The line of credit requires us to maintain minimum tangible net worth of $500,000 and a ratio of total liabilities to tangible net worth not to exceed 3:1. The line of credit terminates upon Crestmark's demand.

SOMANETICS CORPORATION

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

MAY 31, 2001

Some of the statements in this report are forward-looking statements. These forward-looking statements include statements relating to our performance in this Management's Discussion and Analysis of Financial Condition and Results of Operations. In addition, we may make forward-looking statements in future filings with the Securities and Exchange Commission and in written material, press releases and oral statements issued by us or on our behalf. Forward-looking statements include statements regarding the intent, belief or current expectations of us or our officers, including statements preceded by, followed by or including forward-looking terminology such as "may," "will," "should," "believe," "expect," "anticipate," "estimate," "continue," "predict" or similar expressions, with respect to various matters.

It is important to note that our actual results could differ materially from those anticipated from the forward-looking statements depending on various important factors. These important factors include our history of losses and ability to continue as a going concern, our current dependence on the Cerebral Oximeter and SomaSensor, the challenges associated with developing new products, the uncertainty of acceptance of our products by the medical community, the lengthy sales cycle for our products, competition in our markets, our need for additional financing, our dependence on our distributors, and the other factors discussed under the caption "Risk Factors" and elsewhere in our Registration Statement on Form S-3 (file no. 333-59376) effective May 3, 2001 and elsewhere in this report.

All forward-looking statements in this report are based on information available to us on the date of this report. We do not undertake to update any forward-looking statements that may be made by us or on our behalf in this report or otherwise. In addition, please note that matters set forth under the caption "Risk Factors" in our registration statement constitute cautionary statements identifying important factors with respect to the forward-looking statements, including certain risks and uncertainties, that could cause actual results to differ materially from those in such forward-looking statements.

RESULTS OF OPERATIONS

OVERVIEW

We develop, manufacture and market the INVOS Cerebral Oximeter, the only non-invasive patient monitoring system commercially available in the United States that continuously measures changes in the blood oxygen level in the brain. We are also developing the CorRestore(TM) patch for use in cardiac repair and reconstruction, including heart surgeries called surgical anterior ventricular restoration, or SAVR. The model 4100 Cerebral Oximeter was introduced in October 1997 and we began shipping the model 4100 in the first quarter of fiscal 1998. During the third quarter of fiscal 1999, we introduced our new model 5100 Cerebral Oximeter at an international trade show, and began international shipments of the model 5100 in August 1999. The model 5100 Cerebral Oximeter has the added capability of being able to monitor pediatric patients. In September 2000, we received clearance from the FDA to market the model 5100 Cerebral Oximeter in the United States. In June 2000, we entered into a license agreement for the CorRestore patch, which requires testing and FDA clearance or approval before we can sell it in the United States. During the second quarter of fiscal 2001, we submitted our 510(k) application to the FDA for the CorRestore patch, and are awaiting FDA clearance to market the CorRestore patch in the United States.

SOMANETICS CORPORATION

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

MAY 31, 2001

During fiscal 2000 and the first two quarters of fiscal 2001, our primary activities consisted of sales and marketing of the Cerebral Oximeter and the related disposable SomaSensor. We had an accumulated deficit of $51,684,678 through May 31, 2001. We believe that our accumulated deficit will continue to increase for the foreseeable future.

We derive our revenues from sales of Cerebral Oximeters and SomaSensors to our distributors and to hospitals in the United States through our direct sales employees. We recognize revenues when we ship our products to our distributors or to hospitals. Payment terms are generally net 30 days for United States sales and net 60 days or longer for international sales. Our primary expenses, excluding the cost of our products, are selling, general and administrative and research, development and engineering. During fiscal 1998, we began a no-cap sales program whereby we ship the Cerebral Oximeter to the customer at no charge, in exchange for the customer agreeing to purchase at a premium a minimum monthly quantity of SomaSensors.

THREE MONTHS ENDED MAY 31, 2001 COMPARED TO THREE MONTHS ENDED MAY 31, 2000

Our net revenues decreased approximately $169,000, or 12%, from $1,430,066 in the three-month period ended May 31, 2000 to $1,261,513 in the three-month period ended May 31, 2001. The decrease in net revenues is primarily attributable to a decrease in international sales of approximately $694,000, from approximately $769,000 in the second quarter of fiscal 2000 to approximately $75,000 in the second quarter of fiscal 2001. This decrease is primarily due to the initial stocking order for model 4100 and model 5100 Cerebral Oximeters and SomaSensors by Tyco Healthcare AG, formerly Nellcor Puritan Bennett Export Inc., in the second quarter of fiscal 2000, delays in marketing the Cerebral Oximeter in 39 markets, including Europe, in fiscal 2001, and reduced purchases by Baxter Limited in Japan in the second quarter of fiscal 2001. We expect international revenues to return to more normal levels by the fourth quarter of fiscal 2001.

The decrease in net revenues was partially offset by

- An increase in United States sales of approximately $525,000, from approximately $661,000 in the second quarter of fiscal 2000 to approximately $1,186,000 in the second quarter of fiscal 2001. This increase is primarily attributable to increased sales of the disposable SomaSensor, increased sales of the Cerebral Oximeter, and initial purchases of demonstration equipment by independent sales representatives.

- a 35% increase in the average selling price of Cerebral Oximeters, and a 26% increase in the average selling price of SomaSensors, primarily as a result of a change in the sales mix between sales in the United States and sales to international distributors, a change in the United States sales mix between direct sales of the Cerebral Oximeter and no-cap placements of the Cerebral Oximeter, and the initial stocking purchase by Tyco Healthcare AG, at lower per unit prices, in the second quarter of fiscal 2000.

Approximately 6% of our net revenues in the second quarter of fiscal 2001 were export sales, compared to approximately 54% of our net revenues in the second quarter of fiscal 2000. Sales of SomaSensors, model 5100 Cerebral Oximeters, and model 4100 Cerebral Oximeters as a percentage of net revenues were as follows:

	PERCENT OF NET REVENUE SECOND QUARTER OF FISCAL	
PRODUCT	2001	2000
SomaSensors	59%	46%
Model 5100 Cerebral Oximeters	27%	24%
Model 4100 Cerebral Oximeters	14%	30%
Total	100%	100%

Two international distributors accounted for approximately 33% and 13%, respectively, of net revenues for the three months ended May 31, 2000.

Gross margin as a percentage of net revenues was approximately 67% for the quarter ended May 31, 2001 and approximately 50% for the quarter ended May 31, 2000. The increase in gross margin as a percentage of net revenues is primarily attributable to a 35% increase in the average selling price of Cerebral Oximeters and a 26% increase in the average selling price of SomaSensors described above.

Our research, development and engineering expenses increased approximately $82,000, or 73%, from $112,501 for the three months ended May 31, 2000 to $194,816 for the three months ended May 31, 2001. The increase is primarily attributable to a $94,000 increase in costs associated with the development of the CorRestore patch.

Selling, general and administrative expenses increased approximately $13,000, or 1%, from $1,491,944 for the three months ended May 31, 2000 to $1,505,019 for the three months ended May 31, 2001. The increase in selling, general and administrative expense is primarily attributable to

- a $200,000 termination fee related to the Kingsbridge Capital Limited Private Equity Line, and

- a $54,000 increase in intangible amortization expense related to the amortization of license acquisition costs.

These increases were partially offset by

- a $144,000 decrease in salaries, wages, commissions and related expenses, primarily as a result of a reduction in the number of employees, principally sales and marketing, since June 1, 2000 (from an average of 42 employees for the quarter ended May 31, 2000 to an average of 33 employees for the quarter ended May 31, 2001), and

- a $130,000 decrease in travel and selling-related expenses primarily related to reduced trade show and travel expenses.

SOMANETICS CORPORATION

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

MAY 31, 2001

For the three-month period ended May 31, 2001, we realized a 8% decrease in our net loss over the same period in fiscal 2000. The decrease is primarily attributable to

- a 17% increase in gross margin percentage, and

- a $55,000 decrease in realized losses on sales of securities due to a realized loss on the sale of marketable securities in the second quarter of fiscal 2000.

The decreased net loss was achieved despite

- a 12% decrease in net revenues, and

- a 6% increase in operating expenses.

SIX MONTHS ENDED MAY 31, 2001 COMPARED TO SIX MONTHS ENDED MAY 31, 2000

Our net revenues increased approximately $231,000, or 9%, from $2,467,680 in the six-month period ended May 31, 2000 to $2,699,006 in the six-month period ended May 31, 2001. The increase in net revenues is primarily attributable to

- An increase in United States sales of approximately $734,000, from approximately $1,247,000 in the first two quarters of fiscal 2000 to approximately $1,981,000 in the first two quarters of fiscal 2001. This increase is primarily attributable to increased sales of the disposable SomaSensor, increased sales of the Cerebral Oximeter, and initial purchases of demonstration equipment by independent sales representatives.

- a 16% increase in the average selling price of Cerebral Oximeters, and a 10% increase in the average selling price of SomaSensors, primarily as a result of a change in the sales mix between sales in the United States and sales to international distributors, and a change in the United States sales mix between direct sales of the Cerebral Oximeter and no-cap placements of the Cerebral Oximeter.

The increase in net revenues was partially offset by a decrease in international sales of approximately $503,000, from approximately $1,220,000 in the first two quarters of fiscal 2000 to approximately $717,000 in the first two quarters of fiscal 2001. This decrease is primarily due to reduced purchases by Baxter Limited in Japan, the initial stocking order for model 4100 and model 5100 Cerebral Oximeters and SomaSensors by Tyco Healthcare AG in the second quarter of fiscal 2000, and delays in marketing the Cerebral Oximeter in 39 markets, including Europe, in fiscal 2001.

Approximately 27% of our net revenues in the first two quarters of fiscal 2001 were export sales, compared to approximately 49% of our net revenues in the first two quarters of fiscal 2000. Sales of SomaSensors, model 4100 Cerebral Oximeters, model 5100 Cerebral Oximeters, and model 4100 exchanges as a percentage of net revenues were as follows:

SOMANETICS CORPORATION

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

MAY 31, 2001

PRODUCT	PERCENT OF NET REVENUE FIRST TWO QUARTERS OF FISCAL 2001	2000
SomaSensors........................	55%	47%
Model 4100 Cerebral Oximeters......	30%	33%
Model 5100 Cerebral Oximeters......	15%	17%
Model 4100 Exchanges...............	0%	3%
Total..........................	100%	100%

One international distributor accounted for approximately 13% of net revenues for the six months ended May 31, 2001, and two international distributors accounted for approximately 19% and 17%, respectively, of net revenues for the six months ended May 31, 2000.

Gross margin as a percentage of net revenues was approximately 62% for the six months ended May 31, 2001 and approximately 51% for the six months ended May 31, 2000. The increase in gross margin as a percentage of net revenues is primarily attributable to a 16% increase in the average selling price of Cerebral Oximeters, and a 10% increase in the average selling price of SomaSensors described above.

Our research, development and engineering expenses increased approximately $187,000, or 87%, from $215,526 for the six months ended May 31, 2000 to $402,104 for the six months ended May 31, 2001. The increase is primarily attributable to a $193,000 increase in costs associated with the development of the CorRestore patch.

Selling, general and administrative expenses decreased approximately $1,000, from $2,852,865 for the six months ended May 31, 2000 to $2,851,677 for the six months ended May 31, 2001. The decrease in selling, general and administrative expense is primarily attributable to

- a $166,000 decrease in travel and selling-related expenses primarily related to reduced trade show and travel expenses,

- a $155,000 decrease in salaries, wages, commissions and related expenses, primarily as a result of a reduction in the number of employees, principally sales and marketing, since June 1, 2000 (from an average of 42 employees for the six months ended May 31, 2000 to an average of 34 employees for the six months ended May 31, 2001), and

- an $84,000 decrease in incentive compensation expense primarily due to our executive officers not participating in the 2001 Employee Incentive Compensation Plan in exchange for a grant of stock options.

These decreases were partially offset by

- a $200,000 termination fee related to the Kingsbridge Capital Limited Private Equity Line,

- a $110,000 increase in intangible amortization expense related to the amortization of license acquisition costs, and

- $45,000 in connection with the Loan and Security Agreement with Crestmark Bank.

For the six-month period ended May 31, 2001, we realized a 14% decrease in our net loss over the same period in fiscal 2000. The decrease is primarily attributable to

- a 9% increase in net revenues,

- an 11% increase in gross margin percentage, and

- a $55,000 decrease in realized losses on sales of securities due to a realized loss on the sale of marketable securities in the second quarter of fiscal 2000.

The decreased net loss was achieved despite

- a 6% increase in operating expenses, and

- an approximately $44,000 decrease in interest income, primarily due to the absence of marketable securities for fiscal 2001.

LIQUIDITY AND CAPITAL RESOURCES

Net cash used in operations during the six-month period ended May 31, 2001 was approximately $1,319,000. Cash was used primarily to

- fund our net loss, primarily selling, general and administrative expenses and research, development and engineering expenses, totaling approximately $1,306,000, before depreciation and amortization expense,

- increase inventories by approximately $464,000, primarily due to a depletion of inventory resulting from fourth quarter 2000 sales, and the purchase of components related to our new generation SomaSensor, and

- decrease accrued liabilities by approximately $131,000 as a result of payments made in fiscal 2001.

These uses of cash were partially offset by a decrease in accounts receivable of approximately $540,000, primarily because of lower second quarter 2001 sales than fourth quarter 2000 sales.

We expect our working capital requirements to increase if sales increase. Capital expenditures in the first six months of fiscal 2001 were approximately $113,000. Approximately $64,000 of these expenditures were for Cerebral Oximeter demonstration units and no-cap units, and approximately $49,000 of these expenditures were for manufacturing tooling for our new generation SomaSensor. We expect our capital requirements to increase as a result of the costs of developing and testing the CorRestore patch.

SOMANETICS CORPORATION

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

MAY 31, 2001

On December 4, 2000, we completed the sale of 112,994 common shares to Kingsbridge Capital Limited, at a price of $1.77, for gross proceeds of $200,000. Our net proceeds, after deducting the commissions and the estimated expenses of the offering, were approximately $187,000. Effective March 5, 2001, we de-registered the remaining shares originally registered for resale by Kingsbridge under the Private Equity Line Agreement, because we no longer intend to sell any more shares to Kingsbridge, except upon any exercise of its warrant, and Kingsbridge is no longer publicly offering for resale the shares subject to the warrant we granted to them. On April 10, 2001, we mutually agreed with Kingsbridge to terminate the Private Equity Line Agreement, the related Registration Rights Agreement, and Kingsbridge's right to the discount on any unsold shares, in exchange for our payment of $200,000 to Kingsbridge.

On February 13, 2001, we entered into a Loan and Security Agreement with Crestmark Bank for a working capital line of credit for up to $750,000, collateralized by all of our assets. Under the agreement, Crestmark Bank may, but is not obligated to, lend us amounts we request from time to time, up to $750,000, if no default exists. The loans are limited by a borrowing base based on qualifying accounts receivable and lender reserves. The loan is payable on demand, and our collections of our receivables are directed to Crestmark Bank in payment of any outstanding balance of the loan.

The principal amount outstanding bears interest, payable monthly, at the prime rate (6.75% at July 2, 2001) plus 2% plus a 2.4% service fee, and we paid a $45,000 commitment fee for the loan. Through May 31, 2001, we have borrowed $920,050 under the agreement and repaid $920,050 in principal amount through Crestmark's collection of our receivables, and by using some of the proceeds from our April 9, 2001 offering. As of May 31, 2001, $628,629 was available for borrowing, at Crestmark's discretion, under the facility. We have agreed to use the proceeds of the loans solely as working capital. The line of credit requires us to maintain minimum tangible net worth of $500,000 and a ratio of total liabilities to tangible net worth not to exceed 3:1. The line of credit terminates upon Crestmark's demand.

On April 9, 2001, we completed the private placement of 1,325,000 newly-issued common shares at a price of $1.75 per share, for gross proceeds of $2,318,750. Our estimated net proceeds, after deducting the placement agent's commission and the estimated expenses of the offering, were approximately $2,159,000. Brean Murray & Co., Inc. was our exclusive placement agent for the offering and received for its services (1) $104,362.50 as a placement agent fee, and (2) warrants to purchase 25,000 common shares at $2.10 per share exercisable during the four-year period beginning April 9, 2002. A. Brean Murray, one of our directors, and his wife control Brean Murray & Co., Inc. In addition, the Brean Murray & Co., Inc. Profit Sharing Plan purchased 32,285 common shares in the offering, and Robert R. Henry, one of our directors, purchased 100,000 common shares in the offering.

As of May 31, 2001, we had working capital of $2,319,770, cash and cash equivalents of $1,036,141, total current liabilities of $654,383 and shareholder's equity of $3,668,036.

Assuming the FDA requires 510(k) clearance and not PMA approval for the CorRestore patch, and human clinical trials are not required, we expect the process of development, testing, application, clearance and preparing to manufacture the product to take approximately one year and to cost us approximately $750,000. If the 510(k) process requires human clinical trials, we expect the process of development, testing, application, clearance and preparing to manufacture the product to take approximately two years and to cost us approximately $1,500,000.

SOMANETICS CORPORATION

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

MAY 31, 2001

We believe that the cash and cash equivalents on hand at May 31, 2001, together with the estimated net borrowings available under the Crestmark Bank Loan and Security Agreement, will be adequate to satisfy our operating and capital requirements through the second quarter of fiscal 2002. By that time we will be required to raise additional cash either through additional sales of our products, through sales of securities, by incurring indebtedness or by some combination of these alternatives. If we are unable to raise additional cash by that time, we will be required to reduce or discontinue our operations.

The estimated length of time current cash and cash equivalents will sustain our operations is based on estimates and assumptions we have made. These estimates and assumptions are subject to change as a result of actual experience. Actual capital requirements necessary to market the Cerebral Oximeter and SomaSensor, to develop and test the CorRestore patch, to undertake other product development activities, and for working capital might be substantially greater than current estimates.

We do not believe that product sales will be sufficient to fund our operations in fiscal 2001. Although we expect to incur an operating loss for fiscal year 2001, we expect to achieve positive earnings before interest, taxes, depreciation and amortization by the fourth quarter of fiscal 2001.

The underwriter of the June 1997 public offering received warrants to purchase 200,000 common shares exercisable at $4.80 per share until May 29, 2002. In addition, Kingsbridge Capital Limited has warrants to purchase 203,108 common shares exercisable at $4.29 per share until September 3, 2005 pursuant to the Private Equity Line Agreement. Also, CorRestore, LLC and its agent, Wolfe & Company, received warrants to purchase 400,000 common shares exercisable at $3.00 per share until June 2, 2005 pursuant to the CorRestore license agreement, and when specified events occur we agreed to issue them five-year warrants to purchase an additional 2,100,000 common shares exercisable at $3.00 per share pursuant to the CorRestore license agreement. Also, as described above, the placement agent in the April 9, 2001 private placement received warrants to purchase 25,000 common shares exercisable at $2.10 per share until April 9, 2006. It is unlikely that these warrants will be exercised if the exercise price exceeds the market price of the common shares.

We are a party to the Loan and Security Agreement with Crestmark Bank described above. As of July 2, 2001, we had no outstanding principal loan balance, and $495,830 was available for borrowing, at Crestmark's discretion, under the facility. We do not have any other loan commitments.

Even if we receive additional capital, we might not be able to achieve the level of sales necessary to sustain our operations, and we will incur the costs of developing and testing the CorRestore patch before we realize any revenues from the patch. We might not be able to obtain any funds on terms acceptable to us and at times required by us through sales of our products, sales of securities or loans in sufficient quantities. Our Independent Auditors' report in our Annual Report on Form 10-K for the fiscal year ended November 30, 2000 contains an explanatory paragraph relating to an uncertainty concerning our ability to continue as a going concern.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not applicable.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

10.1 Registration Rights Agreement, dated as of April 9, 2001, among Somanetics Corporation and the selling shareholders, incorporated by reference to Exhibit 4.3 to the Somanetics Corporation Registration Statement on Form S-3 (file no. 333-59376) filed April 23, 2001 and effective May 3, 2001.

10.2 Form of Warrant Agreement and Warrant, dated April 9, 2001, between Somanetics Corporation and Brean Murray & Co., Inc., incorporated by reference to Exhibit 4.4 to the Somanetics Corporation Registration Statement on Form S-3 (file no. 333-59376) filed April 23, 2001 and effective May 3, 2001.

(b) Reports on Form 8-K

No reports on Form 8-K were filed by us during the quarter for which this report is filed.

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.

Somanetics Corporation
(Registrant)

Date: July 6, 2001

By:/s/ William M. Iacona
William M. Iacona
Vice President, Finance, Controller, and Treasurer (Duly Authorized and Principal Financial Officer)

EXHIBIT INDEX

EXHIBIT	DESCRIPTION
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21