NANOPHASE TECHNOLOGIES CORPORATION
Form 10-Q
August 12, 2015
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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: June 30, 2015

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 incorporation or organization)	**(I.R.S. Employer 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 x 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 x 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 definition 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	x

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

As of August 7, 2015, there were 28,585,496 shares outstanding of common stock, par value $.01, of the registrant.

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NANOPHASE TECHNOLOGIES CORPORATION

QUARTER ENDED JUNE 30, 2015

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

NANOPHASE TECHNOLOGIES CORPORATION

BALANCE SHEETS

		(in thousands except share and per share data) June 30, 2015 (Unaudited)		December 31, 2014
ASSETS				
Current assets:				
Cash and cash equivalents	$	1,156	$	1,862
Trade accounts receivable, less allowance for doubtful accounts of $6 on June 30, 2015 and December 31, 2014		1,588		388
Inventories, net		535		950
Prepaid expenses and other current assets		288		367
Total current assets		3,567		3,567
Equipment and leasehold improvements, net		2,025		2,138
Other assets, net		24		25
	$	5,616	$	5,730
LIABILITIES AND STOCKHOLDERS EQUITY				
Current liabilities:				
Current portion of capital lease obligations	$	81	$	70
Line of credit		250		
Accounts payable		685		493
Accrued expenses		459		413
Total current liabilities		1,475		976
Long-term portion of capital lease obligations		134		121
Long-term deferred rent		570		621
Asset retirement obligations		169		166
Total long-term liabilities		873		908
Stockholders equity:				

Preferred stock, $.01 par value, 24,088 shares authorized and no shares issued and outstanding				
Common stock, $.01 par value, 35,000,000 shares authorized; 28,585,496 and 28,516,163 shares issued and outstanding on June 30, 2015 and December 31, 2014, respectively		286		285
Additional paid-in capital		96,086		95,966
Accumulated deficit		(93,104)		(92,405)
Total stockholders equity		3,268		3,846
	$	5,616	$	5,730

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 June 30, 2015	Three months ended June 30, 2014	Six months ended June 30, 2015	Six months ended June 30, 2014
Revenue:				
Product revenue	$ 2,921	$ 2,848	$ 5,221	$ 5,423
Other revenue	16	30	27	39
Total revenue	2,937	2,878	5,248	5,462
Operating expense:				
Cost of revenue	1,945	1,846	3,690	3,723
Gross profit	992	1,032	1,558	1,739
Research and development expense	343	336	645	673
Selling, general and administrative expense	739	765	1,606	1,563
Loss from operations	(90)	(69)	(693)	(497)
Interest income				1
Interest expense	(3)	(1)	(6)	(3)
Other, net				
Loss before provision for income taxes	(93)	(70)	(699)	(499)
Provisions for income taxes				
Net loss	$ (93)	$ (70)	$ (699)	$ (499)
Net loss per share basic and diluted	$ (0.00)	$ (0.00)	$ (0.02)	$ (0.02)
Weighted average number of basic and diluted common shares outstanding	28,585,496	28,481,496	28,564,133	28,481,496

See Notes to Financial Statements.

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NANOPHASE TECHNOLOGIES CORPORATION

STATEMENTS OF CASH FLOWS

(Unaudited)

	(in thousands) Six months ended June 30, 2015	2014
Operating activities:		
Net loss	$ (699)	$ (499)
Adjustment to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	366	371
Stock compensation expense	94	107
Changes in assets and liabilities related to operations:		
Trade accounts receivable	(1,202)	(936)
Other accounts receivable		1
Inventories	415	122
Prepaid expenses and other assets	80	(50)
Accounts payable	201	125
Accrued expenses	(4)	20
Net cash used in operating activities	(749)	(739)
Investing activities:		
Acquisition of equipment and leasehold improvements	(184)	(102)
Payment of accounts payable incurred for the purchase of equipment and leasehold improvements	(8)	(12)
Net cash used in investing activities	(192)	(114)
Financing activities:		
Principal payments on capital leases	(41)	(15)
Proceeds from line of credit	250	
Proceeds from exercise of stock options	26	
Net cash provided by (used in) financing activities	235	(15)
Decrease in cash and cash equivalents	(706)	(868)
Cash and cash equivalents at beginning of period	1,862	3,276
Cash and cash equivalents at end of period	$ 1,156	$ 2,408

Supplemental cash flow information:

Interest paid	$	6	$	3
Supplemental non-cash investing activities:				
Accounts payable incurred for the purchase of equipment and leasehold improvements	$	65	$	25
Capital lease obligations incurred in the purchase of equipment	$	65	$	

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 our financial position and operating results for the interim periods presented. Operating results for the three and six months ended June 30, 2015 are not necessarily indicative of the results that may be expected for the year ending December 31, 2015.

These financial statements should be read in conjunction with our audited financial statements and notes thereto for the year ended December 31, 2014, included in the Company s Annual Report on Form 10-K for the year ended December 31, 2014, as filed with the Securities and Exchange Commission.

(2) Description of Business

Nanophase is an advanced materials and applications developer and commercial manufacturer with an integrated family of nanomaterial and related technologies. We produce engineered nano and larger, 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. 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. We recently developed new material solutions in surface finishing technologies (polishing) and energy-management areas that have been taken to potential customers, and for which we are experiencing revenue growth (former) and small early commercial orders, testing and qualification (latter). 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 within 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 overwhelming 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 Statements of Operations, as it does not represent revenue directly from our nanocrystalline materials.

(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. The fair values of all financial instruments were not materially different from their carrying values.

(4) Notes

During July 2014, we entered into a bank-issued letter of credit and related promissory note for up to $30 in borrowings to support our obligations under our facility lease agreement. 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 at any time during 2014 or 2015, we have recorded no related liability on our balance sheet.

During March 2015, we entered into a Business Loan Agreement (the Line of Credit Agreement) with Libertyville Bank and Trust Company, a Wintrust Community Bank (Libertyville), our primary bank. This Line of Credit Agreement was subsequently amended on April 13, 2015. Under the Line of Credit Agreement, as amended, Libertyville will provide a maximum of $300, or 75% of our eligible accounts receivable, whichever is less, of revolving credit, collateralized by a senior priority lien on our accounts receivable, inventory, equipment, general intangibles and fixtures. Interest on any borrowings would be the prime rate at the time plus 1%. Availability to draw on the line requires us to have at least $1 million in cash, including any amounts borrowed, at Libertyville on the date of any advance. Advances may only occur at the beginning or end of a fiscal quarter and must be repaid in full within five days of the advance. The Line of Credit Agreement expires on March 4, 2016. Our only drawdown on this line was a borrowing of $250 on June 29, 2015 that was repaid on July 3, 2015.

(5) Inventories

Inventories consist of the following:

	June 30, 2015	December 31, 2014
Raw materials	$ 255	$ 173
Finished goods	332	829
	587	1,002
Allowance for excess inventory quantities	(52)	(52)
	$ 535	$ 950

(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 $47 and $94 for the three and six month periods ended June 30, 2015, respectively, compared to $53 and $111 for the three and six month periods ended June 30, 2014, respectively.

As of June 30, 2015, there was approximately $288 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.

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Stock Options and Stock Grants

During the six months ended June 30, 2015, 69,333 shares of common stock were issued pursuant to option exercises for proceeds of $26, while no stock options were exercised during the same period in 2014. During the six months ended June 30, 2015, 446,100 stock options were granted compared to 568,000 stock options granted during the same period in 2014. During the six months ended June 30, 2015, 182,534 stock options were forfeited compared to 22,000 stock options forfeited during the same period in 2014. We had 2,634,566 stock options outstanding at a weighted average exercise price of $1.00 on June 30, 2015, compared to 2,440,000 stock options outstanding at a weighted average exercise price of $1.15 on December 31, 2014.

Stock Appreciation Rights

Prior to 2011, we granted our 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 six months ended June 30, 2015 and 2014. 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 June 30, 2015 and 2014, and adjusted to fair value each reporting period. The fair value of the liability was $1 on both June 30, 2015 and December 31, 2014.

As of June 30, 2015, 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:

For the three months ended	June 30, 2015	June 30, 2014
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 six months ended	June 30, 2015	June 30, 2014
Weighted-average risk-free interest rates:	1.74%	2.01%
Dividend yield:		
Weighted-average expected life of the option:	7 Years	7 Years
Weighted-average expected stock price volatility:	95%	95%
Weighted-average fair value of the options granted:	$ 0.44	$ 0.42

(7) Significant Customers and Contingencies

Revenue from three customers constituted approximately 57%, 13% and 9%, respectively, of our total revenue for the three months ended June 30, 2015, and 58%, 9% and 8%, respectively, of our total revenue for the six months ended June 30, 2015. Amounts included in accounts receivable on June 30, 2015 relating to these three customers were approximately $858, $181 and $207, respectively. Revenue from these three customers constituted approximately 68%, none and none, respectively, of our total

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revenue for the three months ended June 30, 2014, and 74%, none and 1%, respectively, of our total revenue for the six months ended June 30, 2014. Amounts included in accounts receivable on June 30, 2014 relating to these three customers were approximately $632, none and none, respectively. The loss of one of these significant customers, a significant decrease in revenue from one or more of these 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 condition covenants. The financial condition 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 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 and credit availability (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 during 2015. 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 it 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.

Should events arise that make it appropriate for us to seek additional financing, such additional financing may not be available on acceptable terms or even at all, and any such financing could be dilutive to our stockholders. Such a financing could be necessitated by such things as the loss of one or more significant customers or a significant decline in revenue from those customers, currently unknown capital requirements, new regulatory requirements, the need to meet cash requirements under our BASF agreement to avoid a triggering event, or other circumstances not currently anticipated by us. The failure to obtain sufficient capital may impair or curtail our business plans and under such circumstances may raise doubt regarding our ability to continue as a going concern.

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(8) Business Segmentation and Geographical Distribution

Revenue from international sources approximated $189 and $564 for the three and six months ended June 30, 2015, respectively, compared to $398 and $509 for the same periods in 2014. 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 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. 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 2015 and beyond. Our initiatives in targeted market areas are progressing at differing rates of speed, but we have been broadly 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, during 2014 we developed new solutions in the surface finishing technologies (polishing) and energy-management areas that were presented to potential customers during the year and have already resulted in increasing order flows in the former and significant commercial testing and small early commercial orders in the latter. We believe that successful introduction of our materials with manufacturers may lead to follow-on orders for other materials in their applications. 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 2015 and beyond.

Results of Operations

Total revenue increased to $2,937,000 for the three months ended June 30, 2015, compared to $2,878,000 for the same period in 2014. Total revenue decreased to $5,248,000 for the six months ended June 30, 2015, compared to $5,462,000 for the same period of 2014. A substantial majority of our revenue for both periods was from our largest customer in personal care and suns