

SYNBIOTICS CORP  
Form 10-Q  
August 15, 2005  
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## U.S. SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

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### FORM 10-Q

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

For the quarterly period ended June 30, 2005

OR

.. **TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Commission file number 0-11303

## SYNBIOTICS CORPORATION

(Exact name of registrant as specified in its charter)

**California**  
(State or other jurisdiction of  
incorporation or organization)

**11011 Via Frontera**

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

**95-3737816**  
(I.R.S. Employer  
Identification No.)

**92127**  
(Zip Code)

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

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

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

As of August 15, 2005, there were 33,822,033 shares of our common stock outstanding.

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**Table of Contents****PART I FINANCIAL INFORMATION****Item 1. Financial Statements****Synbiotics Corporation****Condensed Consolidated Balance Sheet**

|  | <b>June 30,<br/>2005</b> | <b>December 31,<br/>2004</b> |
|--|--------------------------|------------------------------|
|  | <b>(unaudited)</b>       | <b>(audited)</b>             |
| <b>Assets</b>  |                          |                              |
| Current assets:  |                          |                              |
| Cash and equivalents   | \$ 509,000               | \$ 792,000                   |
| Accounts receivable  | 2,679,000                | 2,574,000                    |
| Inventories  | 6,418,000                | 6,208,000                    |
| Other current assets   | 752,000                  | 1,424,000                    |
|  | <u>10,358,000</u>        | <u>10,998,000</u>            |
| Property and equipment, net  | 1,058,000                | 979,000                      |
| Goodwill   | 1,397,000                | 1,397,000                    |
| Intangibles, net   | 1,499,000                | 1,851,000                    |
| Other assets   | 221,000                  | 297,000                      |
|  | <u>\$ 14,533,000</u>     | <u>\$ 15,522,000</u>         |
| <b>Liabilities and Shareholders Equity:</b>  |                          |                              |
| Current liabilities:   |                          |                              |
| Accounts payable and accrued expenses  | \$ 4,503,000             | \$ 4,557,000                 |
| Current portion of long-term debt  | 535,000                  | 546,000                      |
| Other current liabilities  | 993,000                  | 952,000                      |
|  | <u>6,031,000</u>         | <u>6,055,000</u>             |
| Long-term debt   | 3,636,000                | 3,835,000                    |
| Other liabilities  | 1,370,000                | 1,313,000                    |
|  | <u>5,006,000</u>         | <u>5,148,000</u>             |
| Shareholders' equity:  |                          |                              |
| Series C preferred stock, \$1,000 liquidation preference per share (aggregating \$1,531,000 and \$3,100,000 at June 30, 2005 and December 31, 2004), 4,000 shares authorized, 1,531 and 3,100 shares issued and outstanding at June 30, 2005 and December 31, 2004 | 1,445,000                | 2,904,000                    |
| Common stock, no par value, 70,000,000 shares authorized, 33,822,000 and 21,154,000 shares issued and outstanding at June 30, 2005 and December 31, 2004   | 48,153,000               | 46,636,000                   |
| Common stock warrants  | 1,110,000                | 1,110,000                    |

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|                                      |                             |                             |
|--------------------------------------|-----------------------------|-----------------------------|
| Accumulated other comprehensive loss | (496,000)                   | (218,000)                   |
| Accumulated deficit                  | (46,716,000)                | (46,113,000)                |
|                                      | <u>                    </u> | <u>                    </u> |
| Total shareholders' equity           | 3,496,000                   | 4,319,000                   |
|                                      | <u>                    </u> | <u>                    </u> |
|                                      | \$ 14,533,000               | \$ 15,522,000               |
|                                      | <u>                    </u> | <u>                    </u> |

See accompanying notes to condensed consolidated financial statements.

**Table of Contents****Synbiotics Corporation****Condensed Consolidated Statement of Operations and Comprehensive (Loss) Income (unaudited)**

|  | Three Months Ended<br>June 30, |                   | Six Months Ended<br>June 30, |                     |
|--|--------------------------------|-------------------|------------------------------|---------------------|
|  | 2005                           | 2004              | 2005                         | 2004                |
| <b>Revenues:</b>                                   |                                |                   |                              |                     |
| Net sales  | \$ 5,259,000                   | \$ 4,560,000      | \$ 10,234,000                | \$ 9,691,000        |
| Royalties  | 80,000                         | 168,000           | 177,000                      | 215,000             |
|  | <u>5,339,000</u>               | <u>4,728,000</u>  | <u>10,411,000</u>            | <u>9,906,000</u>    |
| <b>Operating expenses:</b>                         |                                |                   |                              |                     |
| Cost of sales                                      | 2,664,000                      | 2,006,000         | 4,665,000                    | 4,454,000           |
| Research and development                           | 364,000                        | 316,000           | 754,000                      | 739,000             |
| Selling and marketing                              | 1,267,000                      | 1,025,000         | 2,551,000                    | 2,138,000           |
| General and administrative                         | 1,517,000                      | 1,727,000         | 2,715,000                    | 3,304,000           |
| Patent litigation settlement                       |                                | (850,000)         |                              | (850,000)           |
|  | <u>5,812,000</u>               | <u>4,224,000</u>  | <u>10,685,000</u>            | <u>9,785,000</u>    |
| (Loss) income from operations                      | (473,000)                      | 504,000           | (274,000)                    | 121,000             |
| <b>Other income (expense):</b>                     |                                |                   |                              |                     |
| Interest, net                                      | (131,000)                      | (147,000)         | (262,000)                    | (257,000)           |
| (Loss) income before income taxes                  | (604,000)                      | 357,000           | (536,000)                    | (136,000)           |
| Provision for income taxes                         |                                |                   | 9,000                        | 2,000               |
| Net (loss) income                                  | (604,000)                      | 357,000           | (545,000)                    | (138,000)           |
| Translation adjustment                             | (157,000)                      | (23,000)          | (278,000)                    | (110,000)           |
| Comprehensive (loss) income                        | <u>\$ (761,000)</u>            | <u>\$ 334,000</u> | <u>\$ (823,000)</u>          | <u>\$ (248,000)</u> |
| Net (loss) income available to common shareholders | <u>\$ (633,000)</u>            | <u>\$ 304,000</u> | <u>\$ (631,000)</u>          | <u>\$ (243,000)</u> |
| Basic net (loss) income per share                  | <u>\$ (0.02)</u>               | <u>\$ 0.01</u>    | <u>\$ (0.02)</u>             | <u>\$ (0.01)</u>    |
| Diluted net (loss) income per share                | <u>\$ (0.02)</u>               | <u>\$ 0.01</u>    | <u>\$ (0.02)</u>             | <u>\$ (0.01)</u>    |

See accompanying notes to condensed consolidated financial statements.



**Table of Contents****Synbiotics Corporation****Condensed Consolidated Statement of Cash Flows (unaudited)**

|   | <b>Six Months Ended<br/>June 30,</b> |                   |
|---|--------------------------------------|-------------------|
|   | <b>2005</b>                          | <b>2004</b>       |
| <b>Cash flows from operating activities:</b>  |                                      |                   |
| Net (loss)  | \$ (545,000)                         | \$ (138,000)      |
| <b>Adjustments to reconcile net (loss) to net cash (used for) provided by operating activities:</b> |                                      |                   |
| Depreciation and amortization   | 534,000                              | 576,000           |
| Receivable from patent litigation settlement  |                                      | (425,000)         |
| <b>Changes in assets and liabilities:</b>   |                                      |                   |
| Accounts receivable   | (224,000)                            | 102,000           |
| Inventories   | (366,000)                            | (705,000)         |
| Other assets  | 34,000                               | (131,000)         |
| Accounts payable and accrued expenses   | 250,000                              | 645,000           |
| Other liabilities   | 97,000                               | 87,000            |
| <b>Net cash (used for) provided by operating activities</b>   | <b>(220,000)</b>                     | <b>11,000</b>     |
| <b>Cash flows from investing activities:</b>  |                                      |                   |
| Acquisition of property and equipment   | (361,000)                            | (83,000)          |
| Receipts from notes receivable  | 550,000                              | 116,000           |
| <b>Net cash provided by investing activities</b>  | <b>189,000</b>                       | <b>33,000</b>     |
| <b>Cash flows from financing activities:</b>  |                                      |                   |
| Payments of long-term debt  | (210,000)                            | (256,000)         |
| <b>Net cash (used for) financing activities</b>   | <b>(210,000)</b>                     | <b>(256,000)</b>  |
| <b>Net (decrease) in cash and equivalents</b>   | <b>(241,000)</b>                     | <b>(212,000)</b>  |
| Effect of exchange rates on cash  | (42,000)                             | (25,000)          |
| Cash and equivalents beginning of period  | 792,000                              | 1,045,000         |
| <b>Cash and equivalents end of period</b>   | <b>\$ 509,000</b>                    | <b>\$ 808,000</b> |

See accompanying notes to condensed consolidated financial statements.

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**SYNBIOTICS CORPORATION**

**Notes to Condensed Consolidated Financial Statements (unaudited)**

**Note 1 Interim Financial Statements:**

The accompanying condensed consolidated balance sheet as of June 30, 2005 and the condensed consolidated statements of operations and comprehensive income (loss) and of cash flows for the three and six months ended June 30, 2005 and 2004 have been prepared by Synbiotics Corporation (the Company) and have not been audited. The condensed consolidated financial statements of the Company include the accounts of its wholly-owned subsidiary Synbiotics Europe SAS ( SBIO-E ). All significant intercompany transactions and accounts have been eliminated in consolidation. These financial statements, in the opinion of management, include all adjustments (consisting only of normal recurring accruals) necessary for a fair presentation of the financial position, results of operations and cash flows for all periods presented. The financial statements should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-K filed for the year ended December 31, 2004. Interim operating results are not necessarily indicative of operating results for the full year.

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

**Note 2 Going Concern:**

The accompanying consolidated financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. The Company incurred a net loss of \$545,000 and \$647,000 for the six months ended June 30, 2005 and the year ended December 31, 2004, respectively, and had an accumulated deficit of \$46,716,000 as of June 30, 2005.

The Company has a \$1,000,000 contractual obligation due in July 2005, and another \$1,500,000 contractual obligation, to the same party, due in July 2006. These contractual obligations are unsecured and are recorded at their accreted value in the accompanying consolidated balance sheet under other current liabilities and other liabilities. The Company's cash position is not sufficient to fund its operations and service its secured debt for the next twelve months if it also paid the \$1,000,000 contractual obligation when it became due in July 2005. The Company did not make the payment when it came due, and the \$1,500,000 due in July 2006 became immediately due, and the entire \$2,500,000 will begin bearing interest at 10.5%. The remaining unaccreted portion of the 2006 contractual obligation totaling \$130,000 will be charged to interest expense in July 2005. The Company is in the process of renegotiating this unsecured debt; however, there can be no assurance that any such renegotiation will be successful.

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



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## SYNBIOTICS CORPORATION

## Notes to Condensed Consolidated Financial Statements (unaudited) (Continued)

**Note 3 Inventories:**

Inventories consist of the following:

|                 | June 30,<br>2005    | December 31,<br>2004 |
|-----------------|---------------------|----------------------|
|                 | (unaudited)         | (audited)            |
| Raw materials   | \$ 3,279,000        | \$ 3,125,000         |
| Work in process | 428,000             | 357,000              |
| Finished goods  | 2,711,000           | 2,726,000            |
|                 | <u>\$ 6,418,000</u> | <u>\$ 6,208,000</u>  |

**Note 4 Goodwill and Other Intangible Assets:**

The Company has allocated all of its goodwill to its only reporting unit, which is also its only reportable segment (Note 8). There were no changes in the carrying amount of goodwill from December 31, 2003 to June 30, 2005.

Other intangible assets were as follows:

|          | June 30, 2005           |                             | December 31, 2004       |                             |
|----------|-------------------------|-----------------------------|-------------------------|-----------------------------|
|          | Gross Carrying<br>Value | Accumulated<br>Amortization | Gross Carrying<br>Value | Accumulated<br>Amortization |
|          | (unaudited)             |                             | (audited)               |                             |
| Patents  | \$ 4,949,000            | \$ 3,641,000                | \$ 5,423,000            | \$ 3,685,000                |
| Licenses | 718,000                 | 527,000                     | 618,000                 | 505,000                     |
|          | <u>\$ 5,667,000</u>     | <u>\$ 4,168,000</u>         | <u>\$ 6,041,000</u>     | <u>\$ 4,190,000</u>         |

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The weighted-average amortization periods for patents and licenses are 9 years and 10 years, respectively, and the weighted-average amortization period for total intangible assets is 9 years. Annual pretax amortization for other intangibles over the next five years (including the remaining six months of 2005) is estimated to be as follows:

|      |              |
|------|--------------|
| 2005 | \$ 320,000   |
| 2006 | 629,000      |
| 2007 | 522,000      |
| 2008 | 89,000       |
| 2009 | 45,000       |
|      | <hr/>        |
|      | \$ 1,605,000 |
|      | <hr/>        |

### Note 5 Preferred Stock and Preferred Stock Dividends:

On April 6, 2005, Redwood West Coast, LLC ( Redwood ) converted 1,569 shares of the Company s Series C preferred stock into 12,216,000 shares of the Company s common stock.

On March 1, 2005, the Company declared a dividend on the Series C preferred stock, in the form of common stock with a value totaling \$58,000, for dividends accrued and payable as of January 31, 2005. Redwood, the majority holder of the Series C preferred stock, as permitted by the Certificate of Determination of

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## SYNBIOTICS CORPORATION

## Notes to Condensed Consolidated Financial Statements (unaudited) (Continued)

the Series C preferred stock, elected for the holders of Series C preferred stock to receive a dividend in the form of shares of the Company's common stock in lieu of the cash dividends. As a result, the Company issued 452,000 shares of the Company's common stock on March 2, 2005.

**Note 6 (Loss) Income per Share:**

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

|   | Three Months Ended<br>June 30, |             | Six Months Ended<br>June 30, |              |
|---|--------------------------------|-------------|------------------------------|--------------|
|   | 2005                           | 2004        | 2005                         | 2004         |
|   | (unaudited)                    | (unaudited) | (unaudited)                  | (unaudited)  |
| Basic net (loss) income used:   |                                |             |                              |              |
| Net (loss) income   | \$ (604,000)                   | \$ 357,000  | \$ (545,000)                 | \$ (138,000) |
| Less cumulative preferred stock dividends   | (29,000)                       | (53,000)    | (86,000)                     | (105,000)    |
| Net (loss) income used in computing basic net (loss) income per share   | \$ (633,000)                   | \$ 304,000  | \$ (631,000)                 | \$ (243,000) |
| Diluted net (loss) income used:   |                                |             |                              |              |
| Net (loss) income used in computing basic (loss) income   | \$ (633,000)                   | \$ 304,000  | \$ (631,000)                 | \$ (243,000) |
| Add cumulative preferred stock dividends  |                                | 53,000      |                              |              |
| Net (loss) income used in computing diluted net (loss) income per share   | \$ (633,000)                   | \$ 357,000  | \$ (631,000)                 | \$ (243,000) |
| Shares used:  |                                |             |                              |              |
| Weighted average common shares outstanding used in computing basic (loss) income per share                          | 27,714,000                     | 20,378,000  | 25,527,000                   | 20,261,000   |
| Weighted average options and warrants to purchase common stock as determined by the treasury method                 |                                | 1,054,000   |                              |              |
| Weighted average common shares issuable upon conversion of preferred stock as determined by the if-converted method |                                | 21,797,000  |                              |              |
| Shares used in computing diluted (loss) income per share  | 27,714,000                     | 43,229,000  | 25,527,000                   | 20,261,000   |

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Weighted average options and warrants to purchase common stock as determined by the application of the treasury method and weighted average shares of common stock issuable upon conversion of the Series C preferred stock as determined by the if-converted method totaling 15,763,000 and 996,000 shares for the three months ended June 30, 2005 and 2004, respectively, and totaling 21,870,000 and 23,664,000 shares for the six months ended June 30, 2005 and 2004, respectively, have been excluded from the shares used in computing diluted net (loss) income per share as their effect is anti-dilutive.

**Table of Contents****SYNBIOTICS CORPORATION****Notes to Condensed Consolidated Financial Statements (unaudited) (Continued)****Note 7 Income Taxes:**

The Company's provision for income taxes for the six months ended June 30, 2005 and 2004, is less than the amount expected by applying the Federal statutory rate to income before income taxes, resulting from the Company's net operating loss for the period, and the corresponding change in the Company's valuation allowance for deferred tax assets.

**Note 8 Segment Information and Significant Customers:**

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

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

|                | <b>Three Months Ended<br/>June 30,</b> |                     | <b>Six Months Ended<br/>June 30,</b> |                     |
|----------------|--|---------------------|--------------------------------------|---------------------|
|                | <b>2005</b>                            | <b>2004</b>         | <b>2005</b>                          | <b>2004</b>         |
|                | <b>(unaudited)</b>                     | <b>(unaudited)</b>  | <b>(unaudited)</b>                   | <b>(unaudited)</b>  |
| Diagnosics     | \$ 4,876,000                           | \$ 4,156,000        | \$ 9,478,000                         | \$ 8,872,000        |
| Instruments    | 383,000                                | 404,000             | 756,000                              | 819,000             |
| Other revenues | 80,000                                 | 168,000             | 177,000                              | 215,000             |
|                | <b>\$ 5,339,000</b>                    | <b>\$ 4,728,000</b> | <b>\$ 10,411,000</b>                 | <b>\$ 9,906,000</b> |

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

|  | <b>Three Months Ended<br/>June 30,</b> | <b>Six Months Ended<br/>June 30,</b> |
|--|--|--------------------------------------|
|--|--|--------------------------------------|

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|                         | <u>2005</u>         | <u>2004</u>         | <u>2005</u>          | <u>2004</u>         |
|-------------------------|---------------------|---------------------|----------------------|---------------------|
|                         | (unaudited)         | (unaudited)         | (unaudited)          | (unaudited)         |
| <b>Revenues:</b>        |                     |                     |                      |                     |
| United States           | \$ 3,186,000        | \$ 2,788,000        | \$ 6,082,000         | \$ 5,735,000        |
| France                  | 567,000             | 511,000             | 1,290,000            | 1,224,000           |
| Other foreign countries | 1,586,000           | 1,429,000           | 3,039,000            | 2,947,000           |
|                         | <u>\$ 5,339,000</u> | <u>\$ 4,728,000</u> | <u>\$ 10,411,000</u> | <u>\$ 9,906,000</u> |

|                           | <u>June 30,</u>     | <u>December 31,</u> |
|---------------------------|---------------------|---------------------|
|                           | 2005                | 2004                |
|                           | (unaudited)         | (audited)           |
| <b>Long-lived assets:</b> |                     |                     |
| United States             | \$ 2,449,000        | \$ 2,574,000        |
| France                    | 1,726,000           | 1,950,000           |
|                           | <u>\$ 4,175,000</u> | <u>\$ 4,524,000</u> |

Sales to one customer totaled 10% of total revenues during the three months ended June 30, 2005. There were no sales to any one customer that totaled 10% or more of total revenues during the three months ended June 30, 2004 and the six months ended June 30, 2005 and 2004.

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The Company measures its stock-based employee compensation using the intrinsic value method. The following disclosures present as reported amounts, utilizing the intrinsic value method, and pro forma amounts, after applying the fair value method, related to stock-based awards made to employees that were outstanding as of June 30, 2005 and 2004:

|                                      | Three Months Ended<br>June 30, |             | Six Months Ended<br>June 30, |              |
|--------------------------------------|--------------------------------|-------------|------------------------------|--------------|
|                                      | 2005                           | 2004        | 2005                         | 2004         |
|                                      | (unaudited)                    | (unaudited) | (unaudited)                  | (unaudited)  |
| Net (loss) income:                   |                                |             |                              |              |
| As reported                          | \$ (604,000)                   | \$ 357,000  | \$ (545,000)                 | \$ (138,000) |
| Pro forma                            | \$ (621,000)                   | \$ 342,000  | \$ (578,000)                 | \$ (169,000) |
| Basic net (loss) income per share:   |                                |             |                              |              |
| As reported                          | \$ (0.02)                      | \$ 0.01     | \$ (0.02)                    | \$ (0.01)    |
| Pro forma                            | \$ (0.02)                      | \$ 0.01     | \$ (0.03)                    | \$ (0.01)    |
| Diluted net (loss) income per share: |                                |             |                              |              |
| As reported                          | \$ (0.02)                      | \$ 0.01     | \$ (0.02)                    | \$ (0.01)    |
| Pro forma                            | \$ (0.02)                      | \$ 0.01     | \$ (0.03)                    | \$ (0.01)    |
| Stock-based employee compensation:   |                                |             |                              |              |
| As reported                          | \$                             | \$          | \$                           | \$           |
| Pro forma                            | \$ 17,000                      | \$ 15,000   | \$ 33,000                    | \$ 31,000    |

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

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

#### ***Overview***

We are still working to recover from the effects of our cash crisis in 2002. Our total revenues and net sales have been declining annually since 2000, although they were essentially flat in 2004 from 2003. We believe that our operations have stabilized and that, with continued attention to steady and careful execution of our turnaround business plan, we can increase shareholder value.

Our main challenge in 2005 will be to resolve our unsecured contractual obligations of \$1,000,000 due in July 2005 and \$1,500,000 due in July 2006, both to the same unrelated third party. We cannot afford to make these payments as scheduled. We missed the July 2005 payment, and the entire obligation was accelerated and began bearing interest at 10.5%. The remaining unaccrued portion of the 2006 contractual obligation totaling \$130,000 was charged to interest expense in July 2005. We are currently in negotiations to restructure these obligations.

In September 2004, we successfully resolved a similar situation, where we were unable to pay at maturity (January 25, 2004) the remaining \$4,804,000 principal amount of our loan from Comerica Bank. The resolution involved extension and amendment of the loan terms and the sale by Comerica of most of the loan to a company affiliated with Redwood West Coast, LLC, our majority shareholder.

Our auditors' report on our 2004 financial statements contains a going-concern explanatory paragraph—a statement that there is substantial doubt about our ability to continue as a going concern.

The profitability of our canine heartworm diagnostic products has diminished due to competition from new entrants to the in-clinic canine heartworm diagnostics market, Heska and Agen. We believe their products infringed our U.S. patent in this area, and we separately sued them for patent infringement. Although we incurred significant litigation costs, the final settlements of these cases in 2003 and 2004 did not include barring their products from the market. Agen's U.S. distributor appears to be following a price-cutting strategy, so this new competition is adversely affecting both our market share and our average selling price. In any event, our U.S. patent in this area expires in December 2005, and after then we would be unable to prevent any further additional competitors from entering this market.

We believe our results in 2005 and thereafter will benefit if we can avoid the heavy patent litigation expense we experienced in 2002, 2003 and, particularly, 2004. We currently are not involved in any litigation.

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On April 19, 2005, we announced that we will seek shareholder approval for us to go private. Specifically, we are proposing a 1-for-2,000 reverse split of our common stock, with a payment in lieu of issuing fractional shares, followed by a 2,000-for-1 forward split of our common stock. The cash payment in lieu of fractional shares will be at the rate of \$0.13 per pre-reverse-split share traceable to the fractional shares.

The purpose of the proposal is to reduce the number of our shareholders of record to below 300. This, in turn, will enable us under the applicable legal standards to elect to deregister our securities under the Securities

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Exchange Act of 1934 (the 1934 Act ), thereby going private. We would deregister as soon as possible, in order to (i) eliminate the costs associated with preparing and filing documents under the 1934 Act with the U.S. Securities and Exchange Commission, (ii) eliminate or reduce the costs and other burdens associated with being a 1934 Act registrant, including the costs of complying with Section 404 of the Sarbanes-Oxley Act of 2002 as to internal control over financial reporting, (iii) avoid the requirement of regular mandatory disclosure of financial information and management analyses, to the public but also to our competitors and commercial counterparties, even when such disclosure would be adverse to an objective of ours, (iv) reduce the costs of administering shareholder accounts and responding to shareholder requests, (v) provide liquidity to shareholders holding less than 2,000 pre-reverse-split shares of common stock, and (vi) provide greater flexibility in the management and governance of us. We believe the cost savings associated with going private would be a minimum of \$245,000 in the first full year alone.

In order to finance the cash payment in lieu of fractional shares and defray some of the other expenses of the going private transaction, we have entered into an agreement to sell 180 newly issued and unregistered shares of Series C preferred stock to Redwood Holdings, LLC for \$180,000 cash. Redwood Holdings, LLC is an affiliate of our controlling shareholder, Redwood West Coast, LLC, and our directors Thomas A. Donelan and Christopher P. Hendy. Any such sale of Series C preferred stock is contingent upon the shareholder approval of the proposed transaction. This equity investment to maintain cash levels is required by our lender Comerica Bank as a condition to its waiver of our covenant not to repurchase common stock.

***Results of Operations***

Our net sales for the second quarter of 2005 increased by \$699,000 or 15% over the second quarter of 2004. The increase reflects an increase in our diagnostic product sales of \$720,000 and a decrease in our instrument product sales of \$21,000, and also reflects a 4% increase in the value of the euro versus the U.S. dollar which affects the consolidation of SBIO-E and itself added \$88,000 to our second quarter 2005 revenues. Our net sales for the six months ended June 30, 2005 increased by \$543,000 or 6% over the six months ended June 30, 2004. The increase reflects an increase in our diagnostic product sales of \$606,000 and a decrease in our instrument product sales of \$63,000, and also reflects a 5% increase in the value of the euro versus the U.S. dollar which affects the consolidation of SBIO-E and itself added \$179,000 to our 2005 revenues. The increase in sales of our diagnostic products for the quarter and six month periods are due primarily to: 1) increased sales of tuberculin products of \$368,000 and \$275,000, respectively, resulting from the timing of contractual deliveries; 2) increased sales of Witness® products of \$215,000 and \$151,000, respectively, resulting from the fact that Witness® feline leukemia and Witness® canine parvovirus products were available for sale in the 2005 periods and not in the 2004 periods (only our Witness® canine heartworm product was available for sale in the 2004 periods); 3) increased sales of poultry products of \$52,000 and \$199,000, respectively; 4) decreased rebates of \$50,000 and \$116,000, respectively, resulting from the January 1, 2005 discontinuation our rebate program; and 5) a general price increase in December 2004.

It should also be considered that our sales in 2005 have been negatively impacted due to the fact that in December 2004, one of our distributor customers placed an order totaling \$546,000, which was shipped and invoiced in December 2004. The order represented approximately 50% of the customer's prior twelve months purchases. We believed, at the time the order was placed, that due to the size of the order, the customer would not be placing any significant orders with us during the first half of 2005. In fact, sales to this customer in the first half of 2005 were only \$277,000 as compared to \$794,000 in the first half of 2004. Because the heartworm selling season straddles December and the first part of the next year, our year-to-year periodic results often vary as a result of such timing differences.

Agen Biomedical Ltd. ( Agen ), which entered the US. canine heartworm diagnostic market in the fourth quarter of 2003, is currently distributing its products in the U.S. through Vedco, a co-operative buying group. Several of the member-owners of this buying group also distribute our canine heartworm and other products, but have decided to promote Agen's canine heartworm product instead of ours. Additionally, Agen's distributors



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marketed the canine heartworm product with a price which is significantly less than previously established prices in this market. As a result, we have been forced to compete on price and our average selling prices for our Witness® canine heartworm product during the second quarter of 2005 and the six months ended June 30, 2005 were 5% less than during the 2004 periods. We do not believe that this price erosion will be easily reversed, especially after our U.S. canine heartworm detection patent expires in late 2005.

We recognize revenue from product sales when title and risk of loss transfers to our customer, which is generally upon shipment. Amounts we charge to our customers for shipping and handling are included in our net sales. From time to time, we provide promotional discounts and rebates to certain of our distributors. Based upon the structure of these rebate programs and our past history, we are able to accurately estimate the amount of rebates at the time of sale. These rebates are recorded as a reduction of our net sales. We recognize license fee revenue ratably over the license term when we have further performance obligations to our licensee. In the event that we have no further performance obligations to our licensee, we recognize license fee revenue upon receipt.

Our cost of sales as a percentage of our net sales was 51% during the second quarter of 2005 as compared to 44% during the second quarter of 2004. The increase is due to an increase in the sales of products which are manufactured for us, and which carry lower gross margins, as opposed to products we manufacture. A significant portion of our manufacturing costs are fixed. Among our major products, our DiroCHEK® canine heartworm diagnostic products are manufactured at our facilities, whereas our WITNESS® in-clinic canine heartworm, feline leukemia, and canine parvovirus diagnostic products and our SCA 2000 instrument products are manufactured by third parties. We manufacture the key biological materials contained in our WITNESS® canine heartworm, feline leukemia and canine parvovirus diagnostic products. In addition to affecting our gross margins, outsourcing of manufacturing renders us relatively more dependent on the third-party manufacturers. Our cost of sales as a percentage of our net sales was 46% during the six months ended June 30, 2005 and 2004.

Our research and development expenses increased by \$48,000 or 15% during the second quarter of 2005 as compared to the second quarter of 2004. The increase is a result of an increase of \$23,000 in laboratory supplies, increased consulting costs of \$16,000, increased payroll costs of \$14,000 (resulting from salary and insurance increases) and \$7,000 directly reflecting an increase in the value of the euro versus the U.S. dollar over the first quarter of 2004 of 4% (affecting the consolidation of SBIO-E), offset by a \$12,000 decrease in research and development expenses contracted by us from a third party. Our research and development expenses increased by \$15,000 or 2% during the six months ended June 30, 2005 as compared to the six months ended June 30, 2004. The increase is a result of an increase of \$28,000 in laboratory supplies, increased consulting costs of \$48,000, increased payroll costs of \$30,000 (resulting from salary and insurance increases) and \$14,000 directly reflecting an increase in the value of the euro versus the U.S. dollar over the first six months of 2004 of 5% (affecting the consolidation of SBIO-E), offset by a \$105,000 decrease in research and development expenses contracted by us from a third party. Our research and development expenses as a percentage of our net sales were 7% during the second quarter of 2005 and 2004, and were 7% and 8% during the six months ended June 30, 2005 and 2004, respectively.

Our selling and marketing expenses increased by \$242,000 or 24% during the second quarter of 2005 as compared to the second quarter of 2004. The increase is primarily related to a \$165,000 increase in payroll and benefits resulting from an increase in the size of our sales force, a \$30,000 increase in advertising and promotional costs, increased consulting costs of \$29,000 and an increase of \$18,000 directly reflecting an increase in the value of the euro versus the U.S. dollar over the second quarter of 2004 of 4% (affecting the consolidation of SBIO-E). Our selling and marketing expenses increased by \$413,000 or 19% during the six months ended June 30, 2005 as compared to the six months ended June 30, 2004. The increase is primarily related to a \$383,000 increase in payroll and benefits resulting from an increase in the size of our sales force. Our selling and marketing expenses as a percentage of our net sales were 24% and 22% during the first quarter of 2005 and 2004, respectively, and were 25% and 22% during the six months ended June 30, 2005 and 2004, respectively.

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Our general and administrative expenses decreased by \$210,000 or 24% during the second quarter of 2005 as compared to the second quarter of 2004. The decrease is primarily due to a \$901,000 decrease in legal expenses as we currently are not involved in any litigation, offset by \$283,000 of severance costs related to a reduction in force at SBIO-E, an increase in payroll and benefits of \$64,000 (resulting from salary and insurance increases), increased consulting costs of \$25,000, an increase of \$29,000 in foreign currency transaction losses on payments from the U.S. to foreign suppliers, an increase of \$33,000 directly reflecting an increase in the value of the euro versus the U.S. dollar over the second quarter of 2004 of 4% (affecting the consolidation of SBIO-E) and \$257,000 related to the 11% change in exchange rates used in consolidating our intercompany account with SBIO-E. Our general and administrative expenses decreased by \$589,000 or 18% during the six months ended June 30, 2005 as compared to the six months ended June 30, 2004. The decrease is primarily due to a \$1,282,000 decrease in legal expenses as we currently are not involved in any litigation, offset by \$283,000 of severance costs, an increase in payroll and benefits of \$136,000 (resulting from salary and insurance increases), increased consulting costs of \$29,000, an increase of \$55,000 directly reflecting an increase in the value of the euro versus the U.S. dollar over the first six months of 2004 of 5% (affecting the consolidation of SBIO-E) and \$190,000 related to the 11% change in exchange rates used in consolidating our intercompany account with SBIO-E. Our general and administrative expenses as a percentage of our net sales were 29% and 38% during the second quarter of 2005 and 2004, respectively, and were 27% and 34% during the six months ended June 30, 2005 and 2004, respectively.

In December 2004, the Financial Accounting Standards Board ( FASB ) issued FASB Statement No. 123R, Share-Based Payments ( FAS 123R ). FAS 123R is a revision of FASB Statement No. 123, Accounting for Stock-Based Compensation , and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees and its related implementation guidance.

FAS 123R requires that the cost of all awards of equity instruments made to employees in exchange for employment services be recorded at fair value on the grant date, and the cost be charged to expense as the award vests. The determination of fair value is based upon option-pricing models (for example, Black-Scholes) adjusted for characteristics unique to the equity instrument.

We will be required to charge to expense the fair value of employee stock options which vest on or after January 1, 2006, and we expect to record compensation expense related to unvested employee stock options outstanding as of June 30, 2005, as follows: 2006 \$67,000; 2007 \$46,000; 2008 \$9,000.

Our royalty income during the second quarter of 2005 and the six months ended June 30, 2005, decreased by \$38,000 or 18% and \$88,000 or 52%, respectively, as compared to the same periods in 2004. We became entitled to royalties under the June 2004 settlement of our patent litigation with Agen, and we are also entitled to royalties from Heska. Our royalty income, and any future royalty income, will, of course, depend on the other companies' net sales, which tend to be at the expense of our own product sales; also, depressed pricing in the market will tend to reduce the other companies' net sales and thus reduce our future royalty income. As a result of the 2004 settlement with Agen, we recorded a one-time credit to operating expenses of \$850,000 in the second quarter of 2004.

Our net interest expense decreased by \$16,000 or 11% during the second quarter of 2005 as compared to the second quarter of 2004, and increased by \$5,000 or 2% during the six months ended June 30, 2005 as compared to the six months ended June 30, 2004. The changes are due to the 7.75% fixed rate on our note payable to Remington Capital, LLC (which had a principal balance of \$3,652,000 as of June 30, 2005) and increases in the variable rate on our note payable to Comerica Bank, offset by decreases in the principal balance of these notes payable.

We recognized a provision for income taxes of \$9,000 during the six months ended June 30, 2005 as compared to a provision for income taxes of \$2,000 during the six months ended June 30, 2004. We incurred net operating losses for both the periods, and the provisions for income taxes for the six months ended June 30, 2005 and 2004 represent minimum state income taxes.



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A review of our business, in light of the market, reveals that our food animal diagnostics are not meeting their relative geographic sales potentials. Food animal diagnostics measure the health of herds or flocks and provide information for the economic management of herds or flocks. We currently manufacture all our poultry products at our San Diego, California facility and the majority of our livestock products at our Lyon, France facility. Both lines perform better in their local markets. Our intent is to better internationalize those portfolios. We are also seeking to develop, both internally and through in-licensing arrangements, new food animal diagnostic products that would expand and enhance our existing product line. These growth opportunities will necessitate additional expenses in research and development as well as improved marketing to effectively target this market if the development projects come to fruition successfully. In March 2005, we effected a two-person reduction in force at SBIO-E, in part as a result of this review. The reduction in force related to senior management positions. Due to severance costs associated with this reduction in force, the net impact on our 2005 results of operations will be negligible. The savings from the reduction in force will be more readily evident in our 2006 results of operations.

***Financial Condition and Liquidity***

The following table summarizes the future cash payments related to our contractual obligations (other than trade payables) as of June 30, 2005 (amounts are in thousands):

|                             | <u>Total</u> | <u>2005</u> | <u>2006</u> | <u>2007</u> | <u>2008</u> | <u>2009</u> | <u>Thereafter</u> |
|-----------------------------|--------------|-------------|-------------|-------------|-------------|-------------|-------------------|
| Long-term debt              | \$ 4,171     | \$ 336      | \$ 542      | \$ 390      | \$ 343      | \$ 371      | \$ 2,189          |
| Operating leases            | 4,355        | 478         | 766         | 524         | 414         | 414         | 1,759             |
| Other long-term obligations | 2,500        | 1,000       | 1,500       |             |             |             |                   |

As of June 30, 2005, we had working capital of \$4,327,000, including a cash balance of only \$509,000. We have a \$1,000,000 contractual obligation due in July 2005, and another \$1,500,000 contractual obligation, to the same party, due in July 2006. These contractual obligations are unsecured. We believe that our cash position is not sufficient to fund our operations and service our secured debt for the next twelve months if we also paid the \$1,000,000 contractual obligation when it became due. We did not make the payment when it came due, and the \$1,500,000 due in July 2006 became immediately due, and the entire \$2,500,000 began bearing interest at 10.5%. The remaining unaccrued portion of the 2006 contractual obligation totaling \$130,000 was charged to interest expense in July 2005. We are currently negotiating with the party to whom we owe these contractual obligations in an effort to enter into a payment arrangement; however, there can be no assurance that any such renegotiation will be successful. As a result, we may well require additional financing in the future, and there can be no assurance that such financing would be available to us on favorable terms, or at all. Because our stock price is low, any equity financing would significantly dilute current shareholders.

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

***Certain Risk Factors***

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

**We have a short-term obligation that we cannot afford to pay in accordance with its terms; we may need additional capital in the future**

Our auditors' report on our 2004 financial statements contains a going-concern explanatory paragraph.

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As of June 30, 2005, we had working capital of \$4,327,000, including a cash balance of only \$509,000. We have a \$1,000,000 contractual obligation due in July 2005, and another \$1,500,000 contractual obligation, to the same party, due in July 2006. These contractual obligations are unsecured. We believe that our cash position is not sufficient to fund our operations and service our secured debt for the next twelve months if we also paid the \$1,000,000 contractual obligation when it became due. We did not make the payment when it came due, and the \$1,500,000 due in July 2006 became immediately due, and the entire \$2,500,000 began bearing interest at 10.5%. The remaining unaccrued portion of the 2006 contractual obligation totaling \$130,000 was charged to interest expense in July 2005. We are currently renegotiating this unsecured debt; however, there can be no assurance that any such renegotiation will be successful. As a result, we may well require additional financing in the future, and there can be no assurance that such financing would be available to us on favorable terms, or at all. Because our stock price is low, any equity financing would significantly dilute current shareholders. We may also need to raise additional funds if our estimates of revenues, working capital and/or capital expenditure requirements change or prove inaccurate or in order for us to respond to unforeseen technological or marketing hurdles or to take advantage of unanticipated opportunities.

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

If we are unable to fully succeed in responding to competition in the canine heartworm market and in other business, it could also hinder our ability to obtain any other necessary additional capital and/or create sooner the need to obtain financing.

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

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

Our canine heartworm diagnostic products constituted 24% of our sales for the year ended December 31, 2004. In addition to our historic competition with IDEXX Laboratories, the sales leader in this product category, our sales have been substantially affected by Heska entering the market in 1999, and their benefiting from us being out of the market after Agen terminated our supply agreement. In October 2003, Agen also entered the market. Additional competition, including erosion of the average selling price, from Agen in this key market with this product has seriously damaged us. We could face renewed competition from other new competitors when our U.S. heartworm patent expires in December 2005.

Under our settlement with Agen in June 2004, we licensed Agen our U.S. heartworm patent. In addition we agreed to sell to Agen the same biological components as are used in our own Witness<sup>®</sup> in-clinic canine heartworm and canine parvovirus diagnostic products. Agen is therefore able to manufacture and sell canine heartworm diagnostic and canine parvovirus products that are substantially the same as ours. If Agen were to



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have its in-clinic canine heartworm diagnostic products made by the same contract manufacturer as we use, it would further diminish our ability to distinguish our products in the marketplace and achieve satisfactory pricing.

As previously mentioned, as a result of Agen ceasing to contract manufacture our Witness® products our sales were materially adversely affected in 2003 and 2004, and we believe that our sales could be materially adversely affected in 2005 and beyond if we are unable to fully succeed in reintroducing the alternate-source products into the market. There can be no assurances that we will be able to achieve our previous sales levels of these in-clinic products.

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

Agen was the contract manufacturer of certain of our Witness® in-clinic diagnostic products, and Agen ceased supplying these products in April 2003. We have licensed the alternate-source Witness® canine heartworm, feline leukemia virus and canine parvovirus products with the USDA (now supplied by another contract manufacturer), and we began selling the canine heartworm product in January 2004, the feline leukemia virus product in August 2004 and the canine parvovirus product in February 2005. In addition to the risks that the alternate-source products will experience quality issues, cannot be supplied reliably, etc., we cannot ensure that after our products have been off the market for several months we will necessarily be able to regain our previous market share and our previous price points.

### **We have a history of losses and an accumulated deficit**

Although we were profitable in 2003, we had a loss in 2004 and for the six months ended June 30, 2005, and we have had a history of annual losses. We have incurred a consolidated accumulated deficit of \$46,716,000 at June 30, 2005. We may not achieve annual profitability again, and if we are profitable in the future there can be no assurance that profitability can be sustained.

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

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

### **Our plan to go private may have adverse effects**

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In April 2005 we announced a plan to, subject to shareholder approval, go private and deregister our stock under the Securities Exchange Act of 1934. Not only would this render our shares almost entirely illiquid, the absence of a publicly traded vehicle might diminish our status in the commercial market, reduce our ability to raise additional capital in the future, and deprive us of compensation tools which may be necessary to recruit or retain valuable employees in the future.

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### **We depend on key executives and personnel**

Our future success will depend, to a significant extent, on the ability of our management to operate effectively, both individually and as a group. Competition for qualified personnel in the animal health care products industry is intense, and we may not be successful in attracting and retaining such personnel. There are only a limited number of persons with the requisite skills to serve in those positions and it may become increasingly difficult to hire such persons. The loss of the services of any of our key personnel or the inability to attract or retain qualified personnel could harm our business.

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

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

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

reduced control over delivery schedules;

quality assurance;

manufacturing yields and costs;

whether the manufacturer maintains financial and operational stability;

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

limited warranties on products supplied to us;

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

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

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

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

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

**We rely on new and recent products**

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

There can be no assurance that new products can be manufactured at a cost or in quantities necessary to make them commercially viable. If we are unable to produce internally, or to contract for, a sufficient supply of

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our new products on acceptable terms, or if we should encounter delays or difficulties in our relationships with manufacturers, the introduction of new products would be delayed, which could have a material adverse effect on our business.

### **Our canine heartworm business is moderately seasonal**

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

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

We rely on a combination of patent, copyright, and trademark laws, trade secrets, and confidentiality and other contractual provisions to protect our proprietary rights. These measures afford only limited protection. Our means of protecting our proprietary rights in the U.S. or abroad may not be adequate and competitors may independently develop similar technologies. Our future success will depend in part on our ability to protect our proprietary rights and the technologies used in our principal products. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or to obtain and use trade secrets or other information that we regard as proprietary. In addition, the laws of some foreign countries do not protect our proprietary rights as fully as do the laws of the United States. Issued patents may not preserve our proprietary position. Even if they do, competitors or others may develop technologies similar to or superior to our own. If we do not enforce and protect our intellectual property, our business will be harmed. From time to time, third parties, including our competitors, have asserted patent, copyright, and other intellectual property rights to technologies that are important to us. We expect that we will increasingly be subject to infringement claims as the number of products and competitors in the animal health care market increases.

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

pay substantial damages, including treble damages if we are held to have willfully infringed;

cease the manufacture, use and sale of infringing products;

expend significant resources to develop non-infringing technology; or

obtain licenses to the infringing technology.

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

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

the patent coverage which we receive could be significantly narrower than the patent coverage we seek in our patent applications; and

our patent positions involve complex legal and factual issues which can be hard for patent examiners or lawyers asserting patent coverage to successfully resolve.

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

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

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

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

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

### **Redwood controls us**

The common stock and Series C preferred stock owned by Redwood represents a majority of the voting power of all our stock. Redwood can, and does, control the election of our entire Board of Directors, and also controls all fundamental strategic decisions. In addition, an affiliate of Redwood acquired from Comerica Bank a \$3,873,000 note issued by us and secured by our assets. At June 30, 2005, the outstanding balance on this note was \$3,652,000. Our ability to negotiate effectively with the note holder, if such negotiation were ever to be necessary or desirable, might be compromised by Redwood's multifaceted control of us.

### **We use hazardous materials**

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

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**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

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

**Interest Rate Risk**

The fair value of our debt at June 30, 2005 was approximately \$4,171,000, of which \$519,000 has a variable interest rate based on the prime rate. A change in interest rates of five percentage points would not have a material impact on our financial condition, results of operations and cash flows as it relates to our variable rate debt.

**Foreign Currency Exchange Rate Risk**

Our foreign currency exchange rate risk relates to the operations of SBIO-E as it transacts business in euros, its local currency. However, this risk is limited to our intercompany receivable from SBIO-E and the conversion of its financial statements into the U.S. dollar for consolidation. There is no additional foreign currency exchange rate risk related to SBIO-E's transactions outside of the European Union as those transactions are generally denominated in euros. Similarly, the foreign transactions of our U.S. operations are generally denominated in U.S. dollars. To be sure, an increase in the value of the euro or the dollar would make our products more expensive to customers in countries with other currencies, and therefore could result in decreased unit sales; we are unable to calculate how large such an affect might be.

We do not generally hedge our cash flows on intercompany transactions, nor do we hold any other significant derivative securities or hedging instruments based on currency exchange rates. As a result, the effects of a 5% change in exchange rates would have a material impact on our financial condition, results of operations and cash flows, based primarily on the conversion of SBIO-E's financial statements, including its intercompany payable to us, into the U.S. dollar for consolidation. For example, the 5% increase in the value of the euro over the dollar as of and for the six months ended June 30, 2005, resulted in a \$179,000 increase in our revenues, a \$202,000 increase in our expenses, a \$33,000 decrease in our assets and a \$11,000 decrease in our liabilities.

For the three and six months ended June 30, 2005, 39% and 40%, respectively, of our net sales were net sales of SBIO-E.

**Item 4. Controls and Procedures**

Our principal executive officer and principal financial officer, after evaluating the effectiveness of our disclosure controls and procedures (as defined in Securities Exchange Act Rule 13a-15(e)), have concluded that, as of June 30, 2005, our disclosure controls and procedures are effective.

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**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

None

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

None.

**Item 3. Defaults Upon Senior Securities**

On the date of filing this report, a cumulative dividend arrearage of \$57,000 existed on our Series C preferred stock.

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

None.

**Item 5. Other Information**

As previously reported, on April 6, 2005, Redwood West Coast, LLC voluntarily converted 1,569 shares of our Series C preferred stock into 12,215,907 shares of our common stock, pursuant to the Securities Act Section 3(a)(9) registration exemption.

**Item 6. Exhibits**

| <u>Exhibit</u> | <u>Title</u>  |
|----------------|---|
| 10.106*        | Series C Purchase Agreement between the Registrant and Redwood Holdings, LLC, dated April 19, 2005, incorporated herein by reference to Exhibit 10.106 to the Registrant's Current Report on Form 8-K dated April 19, 2005. |
| 31.1           | Certification Under Section 302 of the Sarbanes-Oxley Act of 2002/SEC Rule 13a-14(a).   |
| 31.2           | Certification Under Section 302 of the Sarbanes-Oxley Act of 2002/SEC Rule 13a-14(a).   |
| 32             | Certification Under Section 906 of the Sarbanes-Oxley Act of 2002/SEC Rule 13a-14(b).   |

\* Incorporated by reference.



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**SIGNATURES**

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

**SYNBIOTICS CORPORATION**

Date: August 15, 2005

/s/ KEITH A. BUTLER  
**Keith A. Butler**  
**Vice President Finance and Chief Financial Officer**  
**(signing both as a duly authorized officer and as principal financial officer)**

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**Exhibit Index**

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**SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, D.C.**

**EXHIBITS**

**TO**

**FORM 10-Q**

**UNDER**

**SECURITIES EXCHANGE ACT OF 1934**

**SYNBIOTICS CORPORATION**