INTERLEUKIN GENETICS INC
Form 10-Q
November 12, 2010

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 AND EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2010

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

For the transition period from _______ to _______

Commission File Number: 001-32715

INTERLEUKIN GENETICS, INC.
(Exact name of registrant in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	94-3123681 (I.R.S. Employer Identification No.)
135 Beaver Street, Waltham, MA (Address of principal executive offices)	02452 (Zip Code)

Registrant's Telephone Number: (781) 398-0700

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 o

Indicate by check mark whether each 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 (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
YES o NO o

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 the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o	Accelerated filer o
Non-Accelerated filer o (Do not check if a smaller reporting company)	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 o NO x

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Outstanding at October 31, 2010
Common Stock, par value $0.001 per share	36,584,799

INTERLEUKIN GENETICS, INC.

FORM 10-Q
FOR THE QUARTER ENDED September 30, 2010

Table of Contents

PART I —FINANCIAL INFORMATION

Item 1. Financial Statements

INTERLEUKIN GENETICS, INC.

CONDENSED BALANCE SHEETS

	September 30, 2010 (Unaudited)	December 31, 2009
ASSETS		
Current assets:		
Cash and cash equivalents	$ 5,202,022	$ 906,248
Accounts receivable from related party	3,432	24,594
Trade accounts receivable	24,525	9,285
Inventory	94,140	118,430
Prepaid expenses and other current assets	466,472	225,493
Current assets of discontinued operations	32,666	31,941
Total current assets	5,823,257	1,315,991
Fixed assets, net	618,709	769,981
Intangible assets, net	658,901	745,490
Other assets	38,001	238,001
Total assets	$ 7,138,868	$ 3,069,463
LIABILITIES AND STOCKHOLDERS' DEFICIT		
Current liabilities:		
Accounts payable	$ 389,011	$ 321,444
Accrued expenses	647,393	281,806
Deferred revenue	464,049	107,792
Liabilities of discontinued operations	164,700	1,123,049
Total current liabilities	1,665,153	1,834,091
Convertible long-term debt	11,000,000	7,000,000
Total liabilities	12,665,153	8,834,091
Commitments and contingencies (Note 7)		
Stockholders' deficit:		
Convertible preferred stock, $0.001 par value — 6,000,000 shares authorized; 5,000,000 shares of Series A issued and outstanding at September 30, 2010 and December 31, 2009; aggregate liquidation preference of $18,000,000 at September 30, 2010	5,000	5,000
Common stock, $0.001 par value — 100,000,000 shares authorized; 36,551,015 and 32,102,435 shares issued and outstanding at September 30, 2010 and December 31, 2009, respectively	36,551	32,102
Additional paid-in capital	90,815,660	85,763,379
Accumulated deficit	(96,383,496)	(91,565,109)
Total stockholders' deficit	(5,526,285)	(5,764,628)
Total liabilities and stockholders' deficit	$ 7,138,868	$ 3,069,463

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

3

INTERLEUKIN GENETICS, INC.

CONDENSED STATEMENTS OF OPERATIONS

(Unaudited)

	Three Months Ended Sept. 30,		Nine Months Ended Sept. 30,	
	2010	2009	2010	2009
Revenue:				
Genetic testing	$ 531,151	$ 119,309	$ 1,460,601	$ 352,130
Contract research and development	—	198,203	—	520,935
Other	13,593	5,370	25,805	20,274
Total revenue	544,744	322,882	1,486,406	893,339
Cost of revenue	409,010	305,303	1,254,033	912,150
Gross profit (loss)	135,734	17,579	232,373	(18,811)
Operating expenses:				
Research and development	427,407	873,195	1,428,523	2,628,943
Selling, general and administrative	1,058,062	1,660,235	3,840,806	4,473,860
Amortization of intangibles	28,863	28,863	86,590	86,590
Total operating expenses	1,514,332	2,562,293	5,355,919	7,189,393
Loss from operations	(1,378,598)	(2,544,714)	(5,123,546)	(7,208,204)
Other income (expense):				
Interest income	1,522	740	2,724	9,905
Interest expense	(73,726)	(40,959)	(213,254)	(108,363)
Gain on disposal of assets	8,659	—	33,159	—
Total other income (expense)	(63,545)	(40,219)	(177,371)	(98,458)
Loss from continuing operations before income taxes	(1,442,143)	(2,584,933)	(5,300,917)	(7,306,662)
Benefit for income taxes	—	—	—	—
Loss from continuing operations	(1,442,143)	(2,584,933)	(5,300,917)	(7,306,662)
Income (loss) from discontinued operations, net of income taxes	—	40,661	482,530	(1,405,214)
Net loss	$ (1,442,143)	$ (2,544,272)	$ (4,818,387)	$ (8,711,876)
Basic and diluted net loss per common share from:				
Continuing operations	$ (0.04)	$ (0.08)	$ (0.15)	$ (0.23)
Discontinued operations	—	—	0.01	(0.04)
Net Loss	$ (0.04)	$ (0.08)	$ (0.14)	$ (0.27)
Weighted average common shares outstanding, basic and diluted	36,545,747	32,059,258	35,410,705	31,975,953

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

INTERLEUKIN GENETICS, INC.

CONDENSED STATEMENTS OF STOCKHOLDERS' DEFICIT

For the Nine Months Ended September 30, 2010 and 2009

(Unaudited)

	Convertible Preferred Stock		Common Stock		Additional Paid-in	Accumulated	
	Shares	Amount	Shares	Amount	Capital	Deficit	Total
Balance as of December 31, 2008	5,000,000	$ 5,000	31,799,381	$ 31,799	$ 85,458,334	$ (81,012,706)	$ 4,482,427
Net loss	—	—	—	—	—	(8,711,876)	(8,711,876)
Common stock issued:							
Employee stock purchase	—	—	126,500	126	34,030	—	34,156
Exercise of stock option	—	—	15,000	15	3,885	—	3,900
Employee stock purchase plan	—	—	126,452	127	24,759	—	24,886
Restricted stock awards	—	—	12,500	13	(13)	—	—
Stock-based compensation expense	—	—	—	—	208,886	—	208,886
Balance as of September 30, 2009	5,000,000	$ 5,000	32,079,833	$ 32,080	$ 85,729,881	$ (89,724,582)	$ (3,957,621)
Balance as of December 31, 2009	5,000,000	$ 5,000	32,102,435	$ 32,102	$ 85,763,379	$ (91,565,109)	$ (5,764,628)
Net loss	—	—	—	—	—	(4,818,387)	(4,818,387)
Common stock issued:							
Private placement, net of offering costs of $365,329	—	—	4,375,002	4,375	4,880,299	—	4,884,674
Exercise of stock option	—	—	1,300	2	336	—	338
Employee stock purchase plan	—	—	72,278	72	33,908	—	33,980
Stock-based compensation expense	—	—	—	—	137,738	—	137,738
Balance as of September 30,	5,000,000	$ 5,000	36,551,015	$ 36,551	$ 90,815,660	$ (96,383,496)	$ (5,526,285)

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

5

INTERLEUKIN GENETICS, INC.

CONDENSED STATEMENTS OF CASH FLOWS

(Unaudited)

	For the Nine Months Ended Sept. 30, 2010	2009
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (4,818,387)	$ (8,711,876)
Income (loss) from discontinued operations	482,530	(1,405,214)
Loss from continuing operations	(5,300,917)	(7,306,662)
Adjustments to reconcile loss from continuing operations to net cash used in operating activities:		
Depreciation and amortization	320,179	380,208
Stock-based compensation expense	137,738	170,109
Changes in operating assets and liabilities, net of business sold:		
Accounts receivable, net	5,922	(4,002)
Inventory	24,290	(95,913)
Prepaid expenses and other current assets	(241,705)	(80,050)
Accounts payable	67,570	(159,159)
Accrued expenses	365,587	228,440
Deferred revenue	356,256	(325,654)
Cash provided on sale of Alan James Group business	—	4,372,292
Net cash used in operating activities of discontinued operations	(475,819)	(1,093,403)
Net cash used in operating activities	(4,740,899)	(3,913,794)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capital additions	(82,318)	(709,005)
Other assets	200,000	28,997
Net cash provided by (used in) investing activities	117,682	(680,008)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from issuance of notes payable	4,000,000	1,000,000
Proceeds from registered direct offering of common stock	5,250,002	—
Registered direct offering costs	(365,329)	—
Proceeds from issuance of common stock	—	34,156
Proceeds from employee stock purchase plan	33,980	24,886
Proceeds from exercise of employee stock options	338	3,900
Net cash provided by financing activities	8,918,991	1,062,942
Net increase (decrease) in cash and cash equivalents	4,295,774	(3,530,860)
Cash and cash equivalents, beginning of period	906,248	4,952,481
Cash and cash equivalents, end of period	$ 5,202,022	$ 1,421,621
Supplemental disclosures of cash flow information:		
Cash paid for income taxes	$ —	$ 61,300
Cash paid for interest	$ 189,925	$ 108,363

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

INTERLEUKIN GENETICS, INC.
NOTES TO CONDENSED FINANCIAL STATEMENTS
(UNAUDITED)

Note 1—Basis of Presentation

The condensed financial statements include the accounts of Interleukin Genetics, Inc. (the Company) as of September 30, 2010 and December 31, 2009 and for the three and nine months ended September 30, 2010. The condensed financial statements for the three and nine months ended September 30, 2009 include the accounts of the Company and its then wholly-owned subsidiaries. Prior to the opening of business on July 1, 2009 the Company and its then wholly-owned subsidiary AJG Brands, Inc. sold substantially all of the Alan James Group business and assets of AJG Brands, Inc. Operating results for AJG Brands, Inc. are reflected herein in discontinued operations.

The financial statements have been prepared by the Company in accordance with accounting principles generally accepted in the United States of America for interim financial reporting. Accordingly, they do not include all of the information and notes required by generally accepted accounting principles for complete financial statements. As of September 30, 2009 all intercompany accounts and transactions have been eliminated in consolidation. These unaudited condensed financial statements, which, in the opinion of management, reflect all adjustments (including normal recurring adjustments) necessary for a fair presentation, should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2009. Operating results are not necessarily indicative of the results that may be expected for any future interim period or for the entire fiscal year.

For information regarding our critical accounting policies and estimates, please refer to "Management's Discussion and Analysis of Financial Condition and Results of Operations – Critical Accounting Policies and Estimates" contained in our Annual Report on Form 10-K for the year ended December 31, 2009 and Note 4 to our condensed financial statements contained herein.

The Company applies the provisions of FASB Accounting Standards Codification ("ASC") 280, Segment Reporting, which established standards for reporting information about operating segments in annual and interim financial statements, and requires that companies report financial and descriptive information about their reportable segments based on management's approach. The standard also established related disclosures about products and services, geographic areas and major customers. As a result of the Company's acquisition of the assets and business of the Alan James Group in August 2006 and until prior to the opening of business on July 1, 2009 when substantially all of the assets and business were sold, the Company had two reportable segments: Personalized Health and Consumer Products.

As of September 30, 2010, the Company has one segment remaining, the genetic test business, which was formerly defined as the Personalized Health segment and is reflected herein as continuing operations. The Company develops genetic tests for sale into the emerging personalized health market and performs testing services that can help individuals improve and maintain their health through preventive measures. The Company's principal operations and markets are located in the United States.

The Company has evaluated all events or transactions that occurred after September 30, 2010 through the date of issuance of these financial statements. The Company did not have any material recognizable or non-recognizable subsequent events.

Note 2—Operating Matters and Liquidity

The Company has experienced net operating losses since its inception through September 30, 2010, including a net loss of $4.8 million for the nine months then ended, contributing to an accumulated deficit of $96.4 million as of September 30, 2010. The Company has increased its borrowings at September 30, 2010 to $11.0 million under its line of credit with Pyxis Innovations Inc., an affiliate of Alticor ("Pyxis").

The Company continues to take steps to control expenses and enhance its liquidity and cash flow. Prior to the opening of business on July 1, 2009, the Company sold substantially all of the Alan James Group business of its subsidiary AJG Brands, Inc. for $4.6 million consisting of $4.4 million in cash and a $0.2 million holdback. The Company decided to sell these non-core assets as a way to concentrate on its genetic test business. The Company no longer has the positive cash flow of this business but now has lower administrative and operating costs as a result of the focus on the genetic test business. The Company continues to further reduce operating costs such as consulting and research expenses to focus on our product development efforts. On May 24, 2010, the Company completed a sublease of approximately 6,000 square feet of underutilized office and laboratory space. The sublease represents approximately one-third of the total space leased by the Company and will not adversely affect current operations. The Company's current laboratory space is deemed to be adequate and able to process high volumes of genetic tests. The Company is able to add additional employees before any additional office space would be needed.

On March 5, 2010, the Company entered into a definitive agreement with certain institutional investors to sell $5.3 million of securities in a registered direct offering. Net proceeds of approximately $4.9 million were received on March 10, 2010. In addition, the Company has access to $3.3 million of available credit under the credit facility with Pyxis which permits borrowings any time prior to June 30, 2012.

We expect that our current financial resources, including the amount available under our credit facility with Pyxis, are adequate to fund our current and planned operations for the next 18 months.

Note 3—Discontinued Operations

In August 2006, the Company acquired the assets and business of the Alan James Group, LLC (the Alan James Group). The Alan James Group was a provider of products and services in the consumer healthcare marketplace and the acquired business primarily developed, marketed and sold nutritional products and engaged in related activities.

Prior to the opening of business on July 1, 2009, the Company and its wholly-owned subsidiary, AJG Brands, Inc. entered into an asset purchase agreement with Nutraceutical Corporation and Pep Products, Inc., a wholly-owned subsidiary of Nutraceutical Corporation, pursuant to which substantially all of the Alan James Group business and assets of AJG Brands, Inc. were sold to Pep Products, Inc. for an aggregate price of $4,572,292. The proceeds consisted of a $200,000 holdback reflected in other current assets at September 30, 2010 and $4,372,292 of cash received on July 1, 2009. The holdback is available to satisfy potential amounts owed to the buyer pursuant to the agreement and may be payable to the Company on July 1, 2011. The assets sold consisted primarily of accounts receivable, inventories, property and equipment and other assets related to the business, which primarily develops, markets and sells nutritional supplements and related products into retail consumer channels. The buyer did not assume accounts payable and accrued liabilities. Subsequent to the closing, AJG Brands, Inc's name was changed to Interleukin Brands, Inc. ("IBI"). On December 29, 2009 IBI was merged with Interleukin Genetics, Inc. At September 30, 2010 remaining assets of the former subsidiary consisted primarily of prepaid expenses and liabilities consisted of accruals for inventory remaining in the retail channel with the right of return.

The Company recognized a loss on the sale of discontinued operations of $1,346,202 in the quarter ended June 30, 2009 including direct costs of the disposition of $674,243.

AJG Brands, Inc.'s sales reported in discontinued operations for the three and nine months ended September 30, 2009 were $0 and $3,580,169, respectively.

The following is a summary of the net assets sold at the close of business on June 30, 2009.

Accounts receivable	$ 1,114,835
Inventories	783,512
Property and equipment, net.	21,073
Other assets	72,993
	$ 1,992,413

We have continued to reserve for estimated sales returns, discontinued items and trade promotions applicable to the non-acquired accounts resulting from our sale of substantially all of the assets of the Alan James Group business. During the quarter ended June 30, 2010 we completed an analysis of all payments made for these items since the sale occurred on July 1, 2009, including the final settlement with a large customer and determined that the reserve should be reduced by approximately $0.5 million. The remaining balance of $0.2 million at June 30, 2010 represented management's best estimate of the cost of future returns. The adjustment is reflected in income from discontinued operations in the June 30, 2010 statement of operations. During the quarter ended September 30, 2010, $35,000 was paid to former customers leaving approximately $165,000 for future returns.

Note 4—Significant Accounting Policies

Revenue Recognition

Revenue from genetic testing services is recognized when there is persuasive evidence of an arrangement, service has been rendered, the sales price is determinable and collectability is reasonably assured. Service is deemed to be rendered when the results have been reported to the individual who ordered the test. To the extent that tests have been prepaid but results have not yet been reported, recognition of all related revenue is deferred. As of September 30, 2010 and December 31, 2009, the Company has deferred genetic test revenue of $454,030 and $107,792, respectively.

Revenue from contract research and development is recognized over the term of the contract as the Company performs its obligations under that contract (including revenue from Alticor, a related party).

Accounts Receivable

Accounts receivable is stated at estimated net realizable value, which is generally the invoiced amount less any estimated discount related to payment terms. The Company offers its commercial genetic test customers a 2% cash discount if payment is made by bank wire transfer within 10 days of the invoice date.