PENNEXX FOODS INC
Form 10QSB
August 19, 2002

U.S. SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549
FORM 10-QSB

(Mark One)

[X] Quarterly report under Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended June 30, 2002

[ ] Transition report under Section 13 or 15(d) of the Exchange Act

For the transition period from ___________ to _________

Commission file number 000-31148

PENNEXX FOODS, INC.

(Exact Name of Small Business Issuer as Specified in Its Charter)

Pennsylvania	23-3008972
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

5501 Tabor Avenue, Philadelphia, PA 19120

(Address of Principal Executive Offices)

215-743-4331

(Issuer's Telephone Number, Including Area Code)

980 Glasgow Street, Pottstown, PA 19464

(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

Check whether the issuer: (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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 ______

APPLICABLE ONLY TO ISSUERS INVOLVED IN
BANKRUPTCY PROCEEDINGS DURING THE
PRECEDING FIVE YEARS

Check whether the registrant filed all documents and reports required to be filed by Section 12, 13 or 15(d) of the Exchange Act after the distribution of securities under a plan confirmed by a court.

Yes No

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APPLICABLE ONLY TO CORPORATE ISSUERS

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: 25,324,822

Transitional Small Business Disclosure Format (check one):

Yes ----- No X ------

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PART I -- FINANCIAL INFORMATION

Item 1. Financial Statements

PENNEXX FOODS, INC.
Balance Sheets

ASSETS

	June 30, 2002 (Unaudited)	December 31,
Current Assets:		
Cash	$ 1,169,288	$ 2,415,7
Trade Receivables, net of allowance for doubtful accounts (2002, $177,736; 2001, $25,595)	3,595,835	2,595,4
Inventory	1,938,790	1,142,2
Prepaid Expenses	188,332	201,8
Total Current Assets	6,892,245	6,355,3
Fixed Assets:		
Land, Property and Equipment	11,748,063	4,186,9
Less Accumulated Depreciation	1,302,912	947,2
Total Fixed Assets	10,445,151	3,239,7
Other Assets	37,245	61,7
Total Assets	$ 17,374,641	$ 9,656,8

LIABILITIES AND SHAREHOLDERS' EQUITY

Current Liabilities:		
Current Installments on Capital Lease Obligations	$ 248,207	$ 233,0
Accounts Payable, Operating	5,694,445	2,100,2
Accrued Expenses	347,646	266,7
Total Current Liabilities	6,290,298	2,600,0
Long Term Liabilities:		
Capital Lease Obligations less Current Installments	554,920	677,7
Accounts Payable, Construction	1,784,467	
Notes Payable	7,000,000	2,500,0
Total Long Term Liabilities	9,339,387	3,177,7
Shareholders' Equity:		
Common Stock	264,249	264,2
Additional Paid-in Capital	12,097,881	12,097,8
Deficit	(10,355,517)	(8,169,1
Deferred Compensation	(261,657)	(313,9

Total Shareholders' Equity	1,744,956	3,879,0
Total Liabilities and Shareholders' Equity	$ 17,374,641	$ 9,656,8

See notes to condensed financial statements.

PENNEXX FOODS, INC.
Statements of Operations
(Unaudited)

	For the Three Month Period Ended June 30,		
	2002	2001	20
Sales	$ 13,600,172	$ 10,950,870	$ 24,5
Cost of Goods Sold			
Meat	9,839,926	8,068,446	16,8
Labor	1,829,765	1,854,553	3,0
Supplies	2,064,681	1,226,794	3,2
Total Cost of Goods Sold	13,734,372	11,149,793	23,1
Gross Profit (Loss)	(134,200)	(198,923)	1,3
Operating Expenses	2,016,244	744,241	3,4
Loss from Operations	(2,150,444)	(943,164)	(2,0
Interest (Net of Interest Income)	43,383	48,907	
Net Loss	$ (2,193,827)	$ (992,071)	$ (2,1
Loss Per Share			
Basic	$ (0.08)	$ (0.07)	$
Weighted Average Shares Outstanding			
Basic	26,424,822	13,575,076	26,4

See notes to condensed financial statements.

PENNEXX FOODS, INC.
Statements of Cash Flows
(Unaudited)

	Six Month Period Ended June 30	
	2002	2001
Cash flows from operating activities:		
Net Loss	$(2,186,377)	$(1,396,8
Adjustments:		
Depreciation and Amortization	355,680	293,0
Deferred Compensation	52,331	52,3
Provisions for Doubtful Accounts	154,141	
Common Stock issued for:		
Interest		23,8
Consulting		128,0
Changes in assets and liabilities		
Trade Receivables	(1,154,481)	(1,403,5
Other Receivables		95,4
Inventory	(796,567)	(384,9
Prepaid Expenses	13,511	10,2
Accounts Payable	3,594,191	1,438,3
Accrued Expenses	30,310	2,9
Net cash provided by (used for) operating activities	62,739	(1,141,0
Cash flows from investing activities:		
Purchase of land, property and equipment	(5,726,100)	(343,5
Other Assets	24,527	5,2
Net cash used for investing activities	(5,701,573)	(338,3
Cash flows from financing activities:		
Proceeds from issuance of stock, net		5,923,4
Proceeds from issuance of debt	4,500,000	
Repayments on capital lease obligations	(107,663)	(140,2
Net cash provided by financing activities	4,392,337	5,783,2
Net increase (decrease) in cash	(1,246,497)	4,303,7
Cash, beginning of year	2,415,785	

Cash, end of period	$ 1,169,288	$ 4,303,7
Supplemental disclosure of cash flow information:		
Interest paid during the period	$ 25,902	$ 51,0
Non-cash items:		
Purchase of equipment under capital lease agreements		$ 181,7
Debt converted into common stock		$ 100,0
Increase in land, property and equipment and accounts payable, construction	$ 1,784,467	
Interest expense capitalized	$ 50,552	

See notes to condensed financial statements.

Pennexx Foods, Inc.
Statement of Shareholders' Equity
Six Month Period ended June 30, 2002

(Unaudited)

	Common Stock $.01 par value 50,000,000 shares authorized			
	Shares issued or issuable	Amount	Additional paid-in capital	Deficit
Balance, January 1, 2002	26,424,822	$264,249	$12,097,881	$(8,169,140)
Net loss				(2,186,377)
Amortization of Compensatory Options				
Balance, June 30, 2002	26,424,822	$264,249	$12,097,881	$(10,355,517)

See notes to condensed financial statements.

Pennexx Foods, Inc.
Notes to Condensed Financial Statements
June 30, 2002

1. Basis of presentation.

The unaudited condensed financial statements have been prepared by Pennexx Foods, Inc. (the "Company") pursuant to the rules and regulations of the Securities and Exchange Commission (the "SEC"). Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been omitted pursuant to such rules and regulations; nevertheless, the Company believes that the disclosures are adequate to make the information presented not misleading. These financial statements and the notes hereto should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-KSB. In the opinion of the Company, all adjustments, including normal recurring adjustments necessary to present fairly the financial position of the Company as of June 30, 2002 and the results of its operations and cash flows for the three and six months then ended, have been included. The results of operations of the interim period are not necessarily indicative of the results for the full year.

2. Accounting policies.

There have been no changes in accounting policies used by the Company during the period ended June 30, 2002.

3. Summary of business.

The Company, incorporated on July 20, 1999 in the Commonwealth of Pennsylvania, prepares case-ready meat for distribution to food retailers in the Northeastern United States. It grants credit to its customers without requiring collateral.

4. Inventory.

The Company's inventories are valued at the lower of first-in, first-out cost or market. Inventories consist of the following:

	June 30, 2002	December 31, 2001
Unfinished beef, pork, veal, lamb	$ 642,000	$ 682,000
Packaging supplies	797,000	344,000
Finished Goods	499,790	116,000
	$1,938,790	$1,142,000

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5. Notes payable.

Notes payable consist of the following at June 30, 2002 and December 31, 2001:

	June 30, 2002	December 31, 2001
Revolving loan	$2,500,000	$2,500,000
Tabor Ave. Facility	4,500,000	0
	$7,000,000	$2,500,000

The Company has established a $30 million Credit Agreement, as amended, with its 50% shareholder, Smithfield Foods, Inc. ("Smithfield"). The Company's outstanding balance under the line of credit bears interest at 1% above prime and is secured by all of the Company's assets. The loan will mature in 2006. At June 30, 2002, the Company's outstanding principal balance under the line of credit, for the revolver, was $2.5 million and accrued interest was $35,839.

Smithfield has agreed to allow the Company to use up to $18.3 million of the $30 million credit line to allow the Company to purchase, renovate and equip the Tabor Avenue Facility. If the actual costs exceed this amount, the Company will have to get incremental funding approval from Smithfield, use internally generated funds, or secure additional commercial financing. As of June 30, 2002 the Company had been advanced $4.5 million for the plant renovations and new processing machinery. The outstanding balance bears interest at 1% above prime. It is anticipated that advances for the new plant will be repaid from the combined proceeds of industrial revenue bonds and other economic development loans. The industrial revenue bonds, if purchased, would bear interest rates appropriate for tax-exempt financings. Accrued and unpaid interest at June 30, 2002 was $50,552 all of which was capitalized.

6. Net loss per share.

Basic earnings per share ("EPS") is computed using the weighted average number of common shares outstanding during the period. Diluted EPS is computed using the weighted average number of common and dilutive common equivalent shares outstanding during the period. Dilutive common equivalent shares consist of common stock issuable upon exercise of stock options. For all periods presented there were no dilutive potential common shares because the assumed exercise of the options would be anti-dilutive.

Item 2. Management's Discussion and Analysis or Plan of Operation

Certain information contained in this Quarterly Report on Form 10-QSB represents "forward-looking" statements (as defined in Section 27A of the

Securities Act of 1933, as amended) that involve risks and uncertainties which may cause actual results to differ materially from those predicted in the forward-looking statements. If any of the Company's assumptions on which such statements are based prove incorrect, or should unanticipated circumstances arise, the Company's actual results could materially differ from those anticipated by such forward-looking statements. The differences could be caused by a number of factors or combination of factors, including, but not limited to, those listed under Item 6, "Note Regarding Forward-Looking Statements" filed

with the Securities and Exchange Commission on Form 10-KSB for the year ended December 31, 2001.

Results of Operations

Three Months Ended June 30, 2002 compared to Three Months Ended June 30, 2001

Sales for the three-month period ended June 30, 2002 were $13.6 million, representing an increase of approximately $2.7 million or 25% over sales of $10.9 million from the corresponding period of 2001. This increase was primarily the result of the increase in the volume of products handled (due in part to increasing sales to existing customers as well as sales to new customers) but was also partially due to a change in the mix of products sold in favor of higher priced items. As the diversity of services that the Company offers continues to grow, customers are increasing both the range of products as well as the quantity ordered.

Cost of goods sold for the three-month period ended June 30, 2002 was $13.7 million which resulted in a gross loss of approximately $0.1 million. By comparison, cost of goods sold for the three-month period ended June 30, 2001 was $11.1 million, which resulted in a gross loss of $0.2 million. The Company's cost of goods sold is comprised of three main components: meat, direct payroll, and supplies. These items accounted for approximately 72%, 14% and 15% of sales, respectively, in the three months ended June 30, 2002 as compared to 74%, 17% and 11% of sales for the corresponding period of the prior year. Although meat cost declined slightly as a percentage of sales in the current year as compared to the prior year, meat cost increased substantially as a percentage of sales in the most recent quarter as compared to the first quarter of 2002. This increase was due to in large part to the substantial increase in the amount of whole muscle beef processed by the Company, for which it was less able to obtain satisfactory yields than has historically been true of its prior mix of meats. Direct payroll declined as a percentage of sales in 2002 compared to 2001 due to increasing labor efficiencies. Supplies increased as a percentage of sales in 2002 as compared to 2001 due to increased freight costs and materials pricing. Freight costs increased in 2002, in part, due to the necessity for temporary off-site storage of goods resulting from the Company's having outgrown its Pottstown plant.

Operating expenses for the three months ended June 30, 2002 were $2.0 million (15% of sales) as compared to $.7 million (7% of sales) for the corresponding period of 2001. This increase of $1.3 million resulted from increased non-productive payroll expenses, increased depreciation expenses, increased maintenance expenses, increased insurance expenses, and increased commissions expenses due to sales volume and continued growth.

Interest expense (net of interest income) for the three-month period ended June 30, 2002 was approximately $.04 million compared to approximately $.05 million for the comparable period of 2001. This decrease in interest expense (net of interest income) is principally due to the increase in interest earned on investments as well as aging leases on equipment. The net loss for the three-month period of 2002 was approximately $2.2 million as compared to a net loss of $1.0 million for the second quarter of 2001.

Six Months Ended June 30, 2002 compared to Six Months Ended June 30, 2001

Sales for the six-month period ended June 30, 2002 were $24.5 million, representing an increase of approximately $5.5 million or 29% over sales of $19.0 million from the corresponding period of 2001. This increase was primarily the result of the increase in the volume of products handled (due in part to increasing sales to existing customers as well as sales to new customers) but was also partially due to a change in the mix of products sold in favor of higher priced items.

Cost of goods sold for the six-month period ended June 30, 2002 was $23.2 million which resulted in a gross profit of approximately $1.3 million or 6% of sales. By comparison, cost of goods sold for the six-month period ended June 30, 2001 was $18.7 million, which resulted in a gross profit of $.3 million or 2% of sales. The Company's cost of goods sold is comprised of three main components: meat, direct payroll, and supplies. These items accounted for approximately 69%, 12% and 13% of sales, respectively, in the six months ended June 30, 2002 as compared to 70%, 18% and 11% of sales for the corresponding period of the prior year. Direct payroll declined as a percentage of sales in 2002 as compared to 2001 due to increasing labor efficiencies. Supplies increased as a percentage of sales in 2002 as compared to 2001 due to increased material costs as well as increased freight charges.

Operating expenses for the six months ended June 30, 2002 were $3.4 million (14% of sales) as compared to $1.6 million (9% of sales) for the corresponding period of 2001. This increase of $1.8 million resulted from increased non-productive payroll expenses, increased depreciation expenses, increased maintenance expenses, increased insurance expenses, and increased commissions expenses due to sales volume and continued growth.

Interest expense (net of interest income) for the six-month period ended June 30, 2002 was approximately $.1 million compared to approximately $.1 million for the comparable period of 2001. The net loss for the six-month period of 2002 was approximately $2.2 million as compared to a net loss of $1.4 million for the second quarter of 2001.

Tabor Avenue Facility

On April 2, 2002 the Company purchased a 145,000 square foot facility on ten acres of land located at 5501 Tabor Avenue in Philadelphia, Pennsylvania (the "Tabor Avenue Facility") from QF Acquisition Corp., the equitable owner, and PIDC Financing Corp., the legal owner. The purchase price of the Tabor Avenue Facility was $2 million which was negotiated at arms length by the parties.

The Company is consolidating all operations in the new plant at the

same time it is renovating and equipping the plant. The Company's current estimate to renovate and equip the Tabor Avenue Facility is as follows:

Renovation Costs	$3.1 million
Equipment Costs	$12.9 million
Other Costs	$0.5 million
Total	$16.5 million

In addition to these expenses, the Company will incur moving expenses and other costs associated with the move to the new plant. Although employment has been offered to the existing work force and the Company is running vans from the former facility to the new plant, the Company believes that it will have to replace at least a portion of the work force which chooses not to relocate from Pottstown. As a result, the Company will probably experience, at least temporarily, certain lost efficiencies among workers, and will incur additional costs to train new employees.

The Company expects to amortize the acquisition, renovation and related construction interest and transaction costs of the Tabor Avenue Facility over 39 years. The costs of moving and installing equipment in the new plant will be capitalized and depreciated over three years.

In the third quarter, the Company will write off all remaining unamortized leasehold improvements located at the Pottstown plant in the amount of $162,000. As described below, the Company is in litigation with the landlord of the Pottstown plant.

The new facility is intended to address space and automation issues. Management believes that the new facility will allow the Company to accommodate a substantial increase in production orders and, after accounting for the increased costs associated with the move (such as higher debt service expense), management expects that such increased volume, if achieved, will lead to higher gross profits. In addition, the new plant offers the physical layout to improve the Company's automation which, after accounting for the costs of equipment acquisition, installation, and training, should also increase gross profits. These projected increases in gross profit, in turn, are expected to help cover Company overheads.

Liquidity and Capital Resources

At June 30, 2002, the Company had $1.2 million of cash (and cash equivalents), slightly less than half of the amount it had at December 31, 2001. The Company's ratio of current assets to current liabilities at June 30, 2002 was 1.1, down from 2.44 at December 31, 2001. Both decreases are primarily the result of the Company's net loss in the six months ended June 30, 2002.

Generally, the Company maintains an unfinished inventory of meat supplies equal to approximately 60-75% of estimated weekly sales volume. Purchases are made using the trade credit programs of suppliers, which allow the Company to purchase meat supplies with payment due within seven days. Inventory

is purchased generally on a daily basis and in advance (i.e., in anticipation) of customer orders.

The Company's working capital decreased from $3.8 million at December 31, 2001 to $0.6 million at June 30, 2002, principally as a result of the net

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loss in the six months ended June 30, 2002 and also partially as a result of the purchase of property and equipment. Management believes that, due to the move from the Pottstown plant to the Tabor Avenue plant in July, 2002, the Company experienced an additional loss in that month. If the Company's losses continue, it will shortly deplete its remaining cash resources. Accounts payable, operating increased from $2.1 million at December 31, 2001 to $5.7 million at June 30, 2002 as a result of the Company's increasing the amount of time taken to pay some outstanding invoices. The Company estimates that as a result of this increase in time of payment, approximately 50%-60% of accounts payable at June 30, 2002 were within suppliers' terms. Finally, accrued expenses were unusually high at June 30, 2002 as a result of the timing of payroll dates in relation to the quarter ending June 30, 2002.

Smithfield has agreed to allow the Company to use up to $18.3 million of the $30 million credit line (see note 5 to financial statements) to allow the Company to purchase, renovate and equip the Tabor Avenue Facility. If the actual costs exceed this amount, the Company will have to get incremental funding approval from Smithfield, use internally generated funds, or secure additional commercial financing. The amount outstanding on the Smithfield line of credit was as follows on the dates indicated:

Description	June 30, 2002	Decemb
Principal Advances	$7,000,000	$
Accrued Interest	86,391	
Total	$ 7,086,391	$

The Company has also applied for certain economic development related financing for the new facility in an aggregate amount of $16 million. To the extent received, these amounts would be used to repay advances made by Smithfield on the line of credit. The economic development loans, if obtained, would bear below market interest rates.

For a discussion of the potential financial effect on the Company's liquidity of an adverse ruling in litigation to which the Company is a party, see, Part II. Other Information, Item 1. Legal Proceedings.

PART II -- OTHER INFORMATION

Item 1. Legal Proceedings

The Company is the defendant in a lawsuit brought by its former landlord at the Pottstown plant. Proceedings began almost two years ago in the Montgomery County Court of Common Pleas. Since the commencement of the litigation, the landlord filed a voluntary petition for protection from its creditors under Chapter 11 of the Bankruptcy Code, and the case has been moved to the Bankruptcy Court for the Eastern District of Pennsylvania. In the lawsuit, the landlord has alleged that the Company failed to make timely rental payments and is seeking damages. In addition, the landlord claims that it is entitled to retain certain equipment purchased and installed by the Company as trade fixtures at the plant, or alternatively, to be paid the value of such equipment if removed. The Company's defense to the claim is that the unpaid rent

has been withheld because of the landlord's failure to honor its obligations to make certain improvements at the property.

Approximately $145,000, representing all rents due under the lease from the commencement of the dispute to May 31, 2002, have been deposited into escrow. However, the landlord contends that the Company owes rent at a rate higher than the contract rent set forth in the lease from November 2000 to the present. The contract rent is approximately $96,000 per year. The landlord has demanded approximately $750,000 in rent in excess of the amount in escrow, approximately $50,000 of interest due on such demanded additional rent, $35,000 on account of property of a company related to the landlord and allegedly taken and used by the Company, and approximately $125,000 in counsel fees and other miscellaneous expenses. The Company vigorously disputes all of such claims. As a result, the Company has not provided any loss contingency on account of the pending claim because of management's belief that any award to the plaintiff will not materially exceed the amount in escrow.

In addition to the foregoing items, there is also a dispute in the pending litigation over the Company's right to remove certain refrigeration equipment which it installed at the Pottstown plant. The value of such refrigeration equipment is estimated at $150,000. The landlord contends that such equipment must be abandoned by the Company at the plant.

On April 25, 2002, the landlord filed a motion for partial summary judgment to evict, eject and dispossess the Company from the Pottstown plant. On June 21, 2002, the Bankruptcy Court ruled in favor of the landlord. Consequently, the Company accelerated its relocation to the Tabor Avenue Facility. The acceleration of the timing of the move from Pottstown to Tabor Avenue means that new equipment intended to automate the new plant will have to be installed around the work schedule of the new plant after such new equipment arrives. Moreover, the Company will be required to subcontract a portion of its pork processing work for a time through a transition period until the new plant is completely configured and the new equipment is completely installed.

These events will have an adverse financial effect on the Company. Revenues and margins will be reduced until full operations are established at the Tabor Avenue plant. The Company estimates that this time period will extend until at least September, 2002 and perhaps until October, 2002. The Company will be incurring key employees' salaries and fixed operating costs despite the reduction of revenues and margins during such time period. The Company estimates that these expenses will approximate $175,000 to $225,000 per month.

The Company's cash and cash equivalents on June 30, 2002 were $1.2 million. The Company's line of credit with Smithfield is based primarily on

inventories and accounts receivable. If inventories and accounts receivable decline as a result of these events (which is likely), the Company will be required to begin paying down the balance of the line of credit, which it may not be able to do.

Item 5. Other Information

The Company and Smithfield are among the parties to a Standstill Agreement dated June 27, 2001 (the "Standstill Agreement") which was filed as an exhibit to the Company's registration statement on Form 10-SB filed July 9, 2001. Under the Standstill Agreement, the parties thereto have agreed, during the Limitation Period (as defined in the Standstill Agreement), among other things, (1) not to change the number of directors on the Company's Board of Directors and (2) to vote their shares in order to ensure that the Company's Board of Directors will remain composed of five directors: two nominees of Smithfield, two nominees of Ellis M. Shore, and one nominee of Michael D. Queen. The Limitation Period ends when any one of four events set forth in the Standstill Agreement occurs. One such event is the net worth of the Company first falling below $2 million. The net worth of the Company at June 30, 2002 was approximately $1.7 million, and accordingly the Limitation Period has ended.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

99.1 Certificate Pursuant to 18 U.S.C.ss.1350.

(b) The Company filed a Current Report on Form 8-K dated April 2, 2002 in connection with its purchase of the Tabor Avenue facility.

SIGNATURES

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

PENNEXX FOODS, INC.

By: /s/ Michael D. Queen

Michael D. Queen

President

Date: August 19, 2002