

Bacterin International Holdings, Inc.  
Form 10-Q  
May 12, 2011

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-Q

(Mark one)

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

For the quarterly period ended March 31, 2011

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 001-34951

BACTERIN INTERNATIONAL HOLDINGS, INC.  
(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction  
of incorporation or organization)

20-5313323  
(I.R.S. Employer  
Identification No.)

600 CRUISER LANE  
BELGRADE, MONTANA 59714  
(Address of principal executive offices) (Zip code)

(406) 388-0480  
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§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  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

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Large accelerated filer

Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company)

Smaller reporting company

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

Number of shares of common stock, \$0.000001 par value, of registrant outstanding at May 11, 2011: 38,076,859

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BACTERIN INTERNATIONAL HOLDINGS, INC.  
FORM 10-Q

TABLE OF CONTENTS

|                 |  |    |
|-----------------|--|----|
| <b>PART I.</b>  | <b>FINANCIAL INFORMATION</b>   |    |
| Item 1.         | Financial Statements   |    |
|                 | Condensed Consolidated Balance Sheets as of March 31, 2011 (unaudited) and December 31, 2010                   | 5  |
|                 | Condensed Consolidated Statements of Operations for the three-months ended March 31, 2011 and 2010 (unaudited) | 6  |
|                 | Condensed Consolidated Statements of Cash Flows for the three-months ended March 31, 2011 and 2010 (unaudited) | 7  |
|                 | Notes to Consolidated Financial Statements   | 8  |
| Item 2.         | Management's Discussion and Analysis of Financial Condition and Results of Operations                          | 24 |
| Item 3.         | Quantitative and Qualitative Disclosures About Market Risk   | 29 |
| Item 4.         | Controls and Procedures  | 29 |
| <b>PART II.</b> | <b>OTHER INFORMATION</b>   |    |
| Item 1.         | Legal Proceedings  | 30 |
| Item 1A.        | Risk Factors   | 31 |
| Item 2.         | Unregistered Sales of Equity Securities and Use of Proceeds  | 31 |
| Item 3.         | Defaults Upon Senior Securities  | 31 |
| Item 4.         | (Removed and Reserved)   | 31 |
| Item 5.         | Other Information  | 31 |
| Item 6.         | Exhibits   | 31 |

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

The statements contained in this Form 10-Q that are not purely historical are forward-looking statements within the meaning of applicable securities laws. Our forward-looking statements include, but are not limited to, statements regarding our “expectations,” “hopes,” “beliefs,” “intentions,” “plans,” or “strategies” regarding the future. In addition, statements that refer to projections, forecasts, or other characterizations of future events or circumstances, including any underlying assumptions, are forward-looking statements. The words “anticipate,” “believe,” “continue,” “could,” “estimate,” “expect,” “intend,” “may,” “might,” “plan,” “possible,” “potential,” “predict,” “project,” “should” and “would,” as well as similar words, may identify forward-looking statements, but the absence of these words does not mean that a statement is not forward looking. Forward-looking statements in this Form 10-Q may include, for example, statements about:

- the future performance and market acceptance of our products;
- our ability to maintain our competitive position;
- negative media publicity;
- our ability to obtain donor cadavers for our products;
- our efforts to innovate and develop new products;
- our ability to engage and retain qualified technical personnel and members of our management team;
- our reliance on our current facilities;
- our ability to generate funds or raise capital to finance our growth;
- our efforts to expand our sales force;
- government regulations;
- fluctuations in our operating results;
- government and third-party coverage and reimbursement for our products;
- our ability to manage our growth;
- our ability to successfully integrate future business combinations or acquisitions;
- product liability claims and other litigation to which we may be subjected;
- product recalls and defects;
- timing and results of clinical trials;
- our ability to obtain and protect our intellectual property and proprietary rights;
- infringement and ownership of intellectual property;



our ability to attract broker coverage;

the trading market, market prices, dilution, and dividends of our common stock;

influence by our management; and

our ability to issue preferred stock.

The forward-looking statements contained in this Form 10-Q are based on our current expectations and beliefs concerning future developments and their potential effects on us. There can be no assurance that future developments affecting us will be those that we have anticipated. These forward-looking statements involve a number of risks, uncertainties, or assumptions, many of which are beyond our control, which may cause actual results or performance to be materially different from those expressed or implied by these forward-looking statements. These risks and uncertainties include, but are not limited to, those factors described in the "Risk Factors" section of our Annual Report on Form 10-K filed April 11, 2011. Should one or more of these risks or uncertainties materialize, or should any of our assumptions prove incorrect, actual results may vary in material respects from those projected in these forward-looking statements. We undertake no obligation to update or revise any forward-looking statements, whether as a result of new information, future events, or otherwise, except as may be required under applicable securities laws.

## PART I – FINANCIAL INFORMATION

## Item 1. Financial Statements

**BACTERIN INTERNATIONAL HOLDINGS, INC.**  
Condensed Consolidated Balance Sheets as of March 31, 2011 and December 31, 2010

|  | As of             |                      |
|--|-------------------|----------------------|
|  | March 31,<br>2011 | December 31,<br>2010 |
|  | (Unaudited)       |                      |
| <b>ASSETS</b>  |                   |                      |
| Current Assets:  |                   |                      |
| Cash and cash equivalents  | \$ 375,413        | \$ 327,481           |
| Accounts receivable, net of allowance of \$125,603 and \$157,269, respectively   | 4,238,645         | 3,522,031            |
| Accounts receivable - related party  | 654,461           | 613,034              |
| Inventories, net   | 6,233,091         | 5,440,638            |
| Prepaid and other current assets   | 517,311           | 572,015              |
|  | 12,018,921        | 10,475,199           |
| Non-current inventories  |                   |                      |
|  | 1,118,170         | 1,439,384            |
| Property and equipment, net  | 3,406,559         | 3,397,320            |
| Intangible assets, net   | 417,151           | 355,639              |
| Note receivable - related party  | 82,398            | 82,398               |
| Other assets   | 17,281            | 13,675               |
| Total Assets   | \$ 17,060,480     | \$ 15,763,615        |
| <b>LIABILITIES &amp; STOCKHOLDERS' EQUITY (DEFICIT)</b>  |                   |                      |
| Current Liabilities:   |                   |                      |
| Accounts payable   | \$ 2,439,021      | \$ 2,260,237         |
| Accounts payable - related party   | 789,935           | 573,036              |
| Accrued liabilities  | 1,924,909         | 1,391,540            |
| Warrant derivative liability   | 1,654,750         | 9,690,741            |
| Current portion of capital lease obligations   | 15,817            | 30,105               |
| Current portion of long-term debt  | 991,520           | 234,149              |
|  | 7,815,952         | 14,179,808           |
| Long-term Liabilities:   |                   |                      |
| Capital lease obligation, less current portion   | 16,965            | 13,185               |
| Long-term debt, less current portion   | 3,390,434         | 2,189,866            |
| Total Liabilities  | 11,223,351        | 16,382,859           |
| Stockholders' Equity (Deficit)   |                   |                      |
| Preferred stock, \$.000001 par value; 5,000,000 shares authorized; no shares issued and outstanding  | -                 | -                    |
| Common stock, \$.000001 par value; 95,000,000 shares authorized; 37,677,334 shares issued and outstanding as of March 31, 2011 and 36,994,715 shares issued and outstanding on December 31, 2010 | 38                | 37                   |
| Additional paid-in capital   | 37,865,562        | 36,325,976           |
| Retained deficit   | (32,028,471)      | (36,945,257)         |

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|  |               |               |
|--|---------------|---------------|
| Total Stockholders' Equity (Deficit)               | 5,837,129     | (619,244 )    |
| Total Liabilities & Stockholders' Equity (Deficit) | \$ 17,060,480 | \$ 15,763,615 |

See notes to unaudited condensed consolidated financial statements.



## BACTERIN INTERNATIONAL HOLDINGS, INC.

Condensed Consolidated Statements of Operations  
For the Three Months Ended March 31, 2011 and 2010  
(Unaudited)

|   | Quarter Ended March 31, |                       |
|---|-------------------------|-----------------------|
|   | 2011                    | 2010                  |
| <b>Revenue</b>  |                         |                       |
| Tissue sales  | \$5,868,924             | \$2,704,975           |
| Royalties and other   | 131,880                 | 31,458                |
| <b>Total Revenue</b>  | <b>6,000,804</b>        | <b>2,736,433</b>      |
| <b>Cost of tissue sales</b>                                 | <b>987,356</b>          | <b>604,622</b>        |
| <b>Gross Profit</b>   | <b>5,013,448</b>        | <b>2,131,811</b>      |
| <b>Operating Expenses</b>                                   |                         |                       |
| General and administrative                                  | 2,297,375               | 1,466,138             |
| Sales and marketing   | 4,264,282               | 1,442,717             |
| Depreciation  | 147,159                 | 152,501               |
| Non-cash consulting expense                                 | 240,991                 | 93,596                |
| <b>Total Operating Expenses</b>                             | <b>6,949,807</b>        | <b>3,154,952</b>      |
| <b>Loss from Operations</b>                                 | <b>(1,936,359 )</b>     | <b>(1,023,141 )</b>   |
| <b>Other Income (Expense)</b>                               |                         |                       |
| Interest expense  | (372,433 )              | (523,417 )            |
| Change in warrant derivative liability                      | 7,218,806               | (102,395 )            |
| Other income  | 6,772                   | 5,924                 |
| <b>Total Other Income (Expense)</b>                         | <b>6,853,145</b>        | <b>(619,888 )</b>     |
| <b>Net Loss Before Benefit (Provision) for Income Taxes</b> | <b>4,916,786</b>        | <b>(1,643,029 )</b>   |
| <b>Benefit (Provision) for Income Taxes</b>                 |                         |                       |
| Current   | -                       | -                     |
| Deferred  | -                       | -                     |
| <b>Net Income (Loss)</b>                                    | <b>\$4,916,786</b>      | <b>\$(1,643,029 )</b> |
| <b>Net income (loss) per share:</b>                         |                         |                       |
| Basic   | \$0.13                  | \$(0.05 )             |
| Dilutive  | \$0.11                  | NA                    |
| <b>Shares used in the computation:</b>                      |                         |                       |
| Basic   | 37,330,665              | 36,468,563            |
| Dilutive  | 44,419,879              | NA                    |



BACTERIN INTERNATIONAL HOLDINGS, INC.  
Condensed Consolidated Statements of Cash Flows  
For the Three Months Ended March 31, 2011 and 2010  
(Unaudited)

|   | Quarter Ended March 31, |               |
|---|-------------------------|---------------|
|   | 2011                    | 2010          |
| <b>Operating activities:</b>                              |                         |               |
| Net income (loss)   | \$4,916,786             | \$(1,643,029) |
| <b>Noncash adjustments:</b>                               |                         |               |
| Depreciation and amortization                             | 291,429                 | 164,578       |
| Non-cash consulting expense/stock option expense          | 665,199                 | 93,596        |
| Provision for losses on accounts receivable and inventory | 118,334                 | 17,117        |
| Increase in debt discount                                 | -                       | (315,121 )    |
| Non-cash interest expense                                 | -                       | 52,404        |
| Change in derivative warrant liability                    | (7,213,037)             | 515,227       |
| <b>Changes in operating assets and liabilities:</b>       |                         |               |
| Accounts receivable                                       | (684,948 )              | (250,887 )    |
| Notes receivable  | (41,427 )               | (156,000 )    |
| Inventories   | (621,239 )              | (566,421 )    |
| Prepaid and other current assets                          | 51,098                  | (10,000 )     |
| Accounts payable  | 395,683                 | (151,255 )    |
| Accrued liabilities                                       | 533,369                 | 108,120       |
| Net cash used in operating activities                     | (1,588,753)             | (2,141,671)   |
| <b>Investing activities:</b>                              |                         |               |
| Purchases of property and equipment                       | (156,398 )              | (40,903 )     |
| Notes receivable from stockholder                         | -                       | (22,178 )     |
| Intangible asset additions                                | (69,103 )               | (15,436 )     |
| Net cash (used in) investing activities                   | (225,501 )              | (78,517 )     |
| <b>Financing activities:</b>                              |                         |               |
| Proceeds from the issuance of long-term debt              | 1,825,000               | 3,275,000     |
| Payments on long-term debt                                | (3,740 )                | (87,980 )     |
| Payments on convertible debt                              | -                       | (340,000 )    |
| Payments on notes payable                                 | -                       | (386,078 )    |
| Payments on capital leases                                | (10,508 )               | (25,087 )     |
| Proceeds from issuance of stock                           | -                       | 10,000        |
| Proceeds from exercise of warrants                        | 51,434                  | -             |
| Net cash provided by financing activities                 | 1,862,186               | 2,445,855     |
| Net change in cash and cash equivalents                   | 47,932                  | 225,667       |
| Cash and cash equivalents at beginning of period          | 327,481                 | 54,155        |
| Cash and cash equivalents at end of period                | \$ 375,413              | \$ 279,822    |

See notes to unaudited condensed consolidated financial statements.



## Notes to Unaudited Condensed Consolidated Financial Statements

## (1) Business Description and Summary of Significant Accounting Policies

## Business Description

Bacterin International Holdings, Inc. (the “Company” or “Bacterin”) develops, manufactures and markets biologics products to domestic and international markets. Bacterin’s proprietary methods are used in human allografts to create stem cell scaffolds and promote bone and other tissue growth. These products are used in a variety of applications including enhancing fusion in spine surgery, relief of back pain with a facet joint stabilization, promotion of bone growth in foot and ankle surgery, promotion of skull healing following neurosurgery and cartilage regeneration in knee and other joint surgeries.

Bacterin’s device division develops anti-microbial coatings to inhibit infection based upon proprietary knowledge of the phenotypical changes made by microbes as they sense and adapt to changes in their environment. Bacterin develops, employs, and licenses bioactive coatings for various medical device applications. Bacterin’s strategic coating initiatives include the inhibition of biofilm formation, local (as opposed to systemic) drug delivery, local (as opposed to systemic) pain management, and anti-thrombotic factors for medical device applications.

## Certain Risks and Concentrations

The Company's revenue is derived principally from the sale or license of its medical products, coatings and device implants. The markets in which the Company competes are highly competitive and rapidly changing. Significant technological advances, changes in customer requirements, or the emergence of competitive products with new capabilities or technologies could adversely affect the Company's operating results. The Company's business could be harmed by a decline in demand for, or in the prices of, its products or as a result of, among other factors, any change in pricing or distribution model, increased price competition, changes in government regulations or a failure by the Company to keep up with technological change. Further, a decline in available tissue donors could have an adverse impact on the business.

Financial instruments subjecting the Company to concentrations of credit risk are accounts and notes receivable. The Company maintains cash, cash equivalents, and short-term investments with various domestic financial institutions. From time to time, the Company's cash balances with its financial institutions may exceed federal deposit insurance limits.

The Company's customers are worldwide with approximately 98% of sales in the United States for the first quarter of 2011. One customer accounted for approximately 4% and 13% of the Company’s revenue for the first quarter of 2011 and 2010, respectively. One customer represented 6% of accounts receivable at March 31, 2011 and December 31, 2010.

Revenue by geographical region is as follows:

|               | Three months ended<br>March 31, |             |
|---------------|---------------------------------|-------------|
|               | 2011                            | 2010        |
| United States | \$5,894,215                     | \$2,543,639 |
| Rest of World | 106,589                         | 192,794     |
|               | \$6,000,804                     | \$2,736,433 |



#### Use of Estimates

The preparation of the financial statements requires management of the Company to make a number of estimates and assumptions relating to the reported amount of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the period; the carrying amount of property and equipment and intangible assets; valuation allowances for receivables and deferred income tax assets; and estimates of expected term and volatility in determining stock-based compensation expense. Actual results could differ from those estimates.

#### Cash and Cash Equivalents

The Company considers all highly liquid investments purchased with an original maturity date of three months or less to be cash equivalents. Cash equivalents are recorded at cost, which approximates market value.

#### Accounts Receivable and Accounts Receivable – Related Party

Accounts receivable represents amounts due from customers for which revenue has been recognized. Normal terms on trade accounts receivable are net 30 days and some customers are offered discounts for quick pay. Accounts receivable – related party include amounts due from West Coast Tissue Service, a supplier of donors to the Company. The Company performs credit evaluations when considered necessary, but generally does not require collateral to extend credit.

The allowance for doubtful accounts is the Company's best estimate of the amount of probable credit losses in the Company's existing receivables. The Company determines the allowance based on factors such as historical collection experience, customer's current creditworthiness, customer concentration, age of accounts receivable balance and general economic conditions that may affect a customer's ability to pay. Actual customer collections could differ from estimates. Account balances are charged to the allowance after all means of collection have been exhausted and the potential for recovery is considered remote. Provisions to the allowance for doubtful accounts are charged to expense. The Company does not have any off-balance sheet credit exposure related to its customers.

#### Inventories

Inventories are stated at the lower of cost or market. Cost is determined using the specific identification method and includes materials, labor and overhead.

#### Property and Equipment

Property and equipment are stated at cost less accumulated depreciation and amortization. Depreciation and amortization is computed using the straight-line method over the estimated useful lives of the assets, generally three to seven years for computers and equipment, and 30 years for buildings. Repairs and maintenance are expensed as incurred.

#### Intangible Assets

Intangible assets include costs to acquire and protect Company patents and are carried at cost less accumulated amortization. The Company amortizes these assets on a straight-line basis over their estimated useful lives of 15 years.





## Grants

As part of the Company's efforts to build the development of new technologies, tissue donation and expansion of tissue supply, the Company, may, from time-to-time either provide or receive grants. These grant receipts are used for research and development efforts.

## Revenue Recognition

Revenue is recognized when all of the following criteria are met: a) the Company has entered into a legally binding agreement with the customer; b) the products or services have been delivered; c) the Company's fee for providing the products and services is fixed and determinable; and d) collection of the Company's fee is probable.

The Company's policy is to record revenue net of any applicable sales, use, or excise taxes. If an arrangement includes a right of acceptance or a right to cancel, revenue is recognized when acceptance is received or the right to cancel has expired.

The Company sells to certain customers under consignment arrangements whereby the Company ships product to be stored by the customer. The customer is required to report the use to the Company and upon such notice, the Company invoices the customer.

Research and development services revenue is recognized as performed, based on the incurrence of qualifying costs or achievement of milestones as prescribed in the arrangement.

## Non Cash Consulting Expense

Non cash consulting expense consists of the fair market value of restricted stock awards to consultants and advisors to the Company.

## Research and Development

Research and development costs, which are principally related to internal costs for the development of new technologies and processes for tissue and coatings, are expensed as incurred.

## Income Taxes

The Company records income taxes under the asset and liability method as prescribed under FASB Accounting Standards Codification ("ASC") 740, Accounting for Income Taxes. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. When applicable, a valuation allowance is established to reduce any deferred tax asset when it is determined that it is more likely than not that some portion of the deferred tax asset will not be realized.

## Impairment of Long-Lived Assets

Long-lived assets, including intangible assets, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held

and used is measured by a comparison of the carrying amount of an asset to future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the estimated fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell.

## Net Income (Loss) Per Share

A reconciliation of the denominator used in the calculation of basic and diluted net income (loss) per share is as follows:

| Net Income (Loss) Per Share:   | Three Months Ended |                |
|--|--------------------|----------------|
|  | March 31,          |                |
|  | 2011               | 2010           |
| Net Income (Loss)  | \$4,916,786        | \$(1,643,029 ) |
| Basic net income (loss) per share  | \$0.13             | \$(0.05 )      |
| Diluted net income (loss) per share  | \$0.11             | NA             |
| Weighted average common shares outstanding for basic net income (loss) per share   | 37,330,665         | 36,468,563     |
| Weighted average common shares outstanding for diluted net income (loss) per share | 44,419,879         | NA             |

Dilutive earnings per share are not reported for the period ending March 31, 2010 as their effects of including outstanding stock options and warrants are anti-dilutive.

## Reverse Merger/Financing Transactions

On June 30, 2010, the Company completed a reverse merger transaction (the “Reverse Merger”), in which we caused Bacterin International, Inc., a Nevada corporation (“Bacterin”), to be merged with and into a wholly-owned Nevada subsidiary created for purposes of effecting the Reverse Merger, and the stockholders of Bacterin obtained control of the Company. The Reverse Merger was consummated under Nevada corporate law pursuant to an Agreement and Plan of Merger, dated as of June 30, 2010. As a result of the Reverse Merger, Bacterin became our wholly-owned subsidiary and we are now engaged, through Bacterin, in the business of biomaterials research, development, and commercialization. K-Kitz ceased operations on June 30, 2010 in connection with the Reverse Merger transaction.

Pursuant to the terms of the Reverse Merger, the stockholders of Bacterin immediately preceding the Reverse Merger received one share of the Company’s common stock for each two shares of Bacterin common stock such stockholder held prior to the Reverse Merger (effectively resulting in a de facto one-for-two reverse stock split of the then outstanding Bacterin shares). The aggregate number of the Company’s shares of common stock so issued to the Bacterin stockholders, being 28,257,133 shares, represented approximately 96% of our outstanding common stock as of the closing of the Reverse Merger on June 30, 2010, prior to taking into account the issuance of any shares of our common stock pursuant to the private placement described below.

All share amounts, including those for which any securities are exercisable or convertible, have been adjusted to reflect the conversion ratio used in the Reverse Merger. In addition, stockholders equity and earnings per share have been retroactively restated to reflect the number of shares of Company common stock received by Bacterin stockholders in the Reverse Merger or the number of shares of Company common stock receivable by former Bacterin stockholders upon exercise or conversion of other securities held by them, as applicable.

Bacterin was deemed to be the acquiring company for accounting purposes and, accordingly, the Reverse Merger has been accounted for as a recapitalization. The consolidated financial statements of the Company after the Reverse Merger reflect the historical financial results of Bacterin before the consummation of the Reverse Merger and do not include the historical financial results of the Company before the consummation of the Reverse Merger.

#### Private Placement

Concurrently with the closing of the Reverse Merger on June 30, 2010, we also completed an initial closing of a private placement to selected qualified investors of shares of our common stock at a purchase price of \$1.60 per share and detachable warrants to purchase one-quarter share of our common stock (at an exercise price of \$2.50 per share) for each share of common stock purchased in the private placement.

In the initial closing on June 30, 2010, we sold 4,934,533 shares of our common stock and warrants to purchase 1,233,646 shares of common stock as part of this initial closing. We received gross proceeds of \$7,508,329 in consideration for the sale of the shares of common stock and warrants, which consisted of (i) \$4,026,000 in net cash from investors in the private placement and (ii) \$3,482,329 from note holders in two earlier Bacterin bridge financings (conducted to fund working capital and capital expenditures during the months prior to the Reverse Merger) who converted their outstanding principal and interest into the private placement at a 10% discount to the purchase price, being \$1.44 per share, and received identical warrant coverage as the cash investors except that the exercise price of the converting note holders' warrants is \$2.25 per share, a 10% discount to the exercise price of the warrants received by the cash investors. The note holders in the bridge financings also received warrants to purchase 1,482,256 shares of our common stock and our placement agent received warrants to purchase 328,125 shares of our common stock as part of the bridge financings.

In the second and final closing of this private placement on July 30, 2010, we sold a total of 1,102,500 additional shares of our common stock together with additional warrants to purchase an aggregate of 275,625 shares of our common stock for total gross cash proceeds of \$1,764,000.

Our placement agents received an aggregate of \$463,200 in cash fees in connection with the private placement (\$322,080 from the initial closing and \$141,120 from the second and final closing) and were reimbursed for their out-of-pocket-expenses. In addition, the placement agents received an aggregate of 106,217 shares of our common stock (84,167 shares from the initial closing and 22,050 shares from the second and final closing) and warrants to purchase 361,875 shares of our common stock (251,625 shares from the initial closing and 110,250 shares from the second and final closing) at an exercise price of \$1.60 per share.

Following the private placement transaction, the Company has permitted an additional \$450,000 in principal amount outstanding under the bridge financing to convert into 316,823 shares of the Company's common stock and warrants to purchase 88,309 shares of the Company's common stock on the same terms as if such debt had actually converted in the private placement transaction.

On August 6, 2010, we paid certain of Bacterin's former stockholders, who held approximately 371,970 shares of Bacterin common stock in the aggregate, the fair value for such shares in connection with the exercise of their dissenters' rights. As a result, and pursuant to the terms of the agreement governing the Reverse Merger, the former Bacterin stockholders (excluding the dissenting shareholders) were issued 371,970 shares of our common stock (i.e., the same number of shares that the dissenting stockholders would have received had they not exercised their dissenters' rights) in proportion to such stockholders' pre-Reverse Merger share holding percentages in Bacterin.



On November 19, 2010, the Company entered into financing arrangement with two subsidiaries of Western Technology Investment (“WTI”), whereby WTI, through its subsidiaries, agreed to provide a credit facility which allows the Company to draw down \$2.5 million initially, and gives the Company the ability to draw down an additional \$2.5 million through April 30, 2011 provided the Company has achieved 90% of performance based milestones for the next two quarters. In addition, upon the mutual agreement of Bacterin and WTI, WTI has agreed to an additional commitment through December 31, 2011 of up to 25% of the next new round of equity financing or up to \$3.0 million. The credit facility is secured by the Company’s personal property and carries an all-in interest rate of 12.5%. Repayment of the initial \$2.5 million will be interest only for the first six months, with principal and interest for the subsequent 30 months. The WTI facility also allows the Company to obtain separate accounts receivable financing. In connection with the financing, WTI also received warrants to purchase up to 375,000 shares of the Company’s common stock. The warrants have an exercise price of the lower of \$4.00 per share or the price at which shares of the Company’s stock are sold in the next qualified financing, if applicable prior to the date of exercise. The WTI warrants expire on April 30, 2018. WTI also has the right to receive additional warrants to purchase 125,000 shares of the Company’s common stock at the same exercise price if the Company draws down the second \$2.5 million tranche of the facility. In January 2011, Middlebury Securities LLC also received warrants to purchase 25,000 shares of our common stock for placement agent service in connection with the WTI transaction.

The Company also issued warrants to purchase a total of 489,710 shares of the Company’s common stock to a limited group of existing investors who exercised existing warrants. The new warrants have an exercise price of \$4.00 per share and expire November 15, 2015. The Company received a total of \$1,172,696 from the cash payments of the exercise price of the existing warrants.

#### Stock-Based Compensation

The Company records stock-compensation expense according to the provisions of ASC 718. Under ASC 718, stock-based compensation costs are recognized based on the estimated fair value at the grant date for all stock-based awards. The Company estimates grant date fair values using the Black-Scholes-Merton option pricing model, which requires assumptions of the life of the award and the stock price volatility over the term of the award. The Company records compensation cost of stock-based awards using the straight line method, which is recorded into earnings over the vesting period of the award. Pursuant to the income tax provisions included in ASC 718-740, the Company has elected the “short cut method” of computing its hypothetical pool of additional paid-in capital that is available to absorb future tax benefit shortfalls.

#### Comprehensive Income (Loss)

Comprehensive loss includes net income or loss, as well as other changes in stockholders’ equity that result from transactions and economic events other than those with stockholders. The Company currently does not have any transactions that qualify for accounting and inclusion as other comprehensive income (loss).

#### Fair Value of Financial Instruments

The carrying values of financial instruments, including accounts receivable, notes receivable, accounts payable and other accrued expenses, approximate their fair values.

#### (2) Accounts Receivable – related party

Accounts receivable – related party consist of the following:

March 31,      December 31,

|                                 | 2011      | 2010       |
|---------------------------------|-----------|------------|
| West Coast Tissue Service, Inc. | \$654,461 | \$ 613,034 |

West Coast Tissue Service, Inc. is a non-profit corporation organized under Section 501C(3) of the Internal Revenue Code. The Company has contracted with West Coast Tissue Service to acquire its donor tissue for use in the Company's production. If the Company were unable to continue to receive donor tissue, it may have a material effect on its financial statements and results of operations. The notes are non-interest bearing.

(3) Inventories

Inventories consist of the following:

|                                | March 31,<br>2011 | December 31,<br>2010 |
|--------------------------------|-------------------|----------------------|
| Current inventories            |                   |                      |
| Raw materials                  | \$920,183         | \$ 709,800           |
| Work in process                | 1,472,428         | 1,212,468            |
| Finished goods                 | 4,325,363         | 4,239,972            |
|                                | 6,717,974         | 6,162,240            |
| Reserve                        | (484,883 )        | (721,602 )           |
| Current inventories, total     | \$6,233,091       | \$ 5,440,638         |
| Non-current inventories        |                   |                      |
| Work in process                | \$396,778         | \$ 588,295           |
| Finished goods                 | 721,392           | 851,089              |
| Non-current inventories, total | \$1,118,170       | \$ 1,439,384         |
| Total inventories              | \$7,351,261       | \$ 6,880,022         |



## (4) Property and Equipment, Net

Property and equipment, net are as follows:

|                                | March 31,<br>2011 | December 31,<br>2010 |
|--------------------------------|-------------------|----------------------|
| Buildings                      | \$ 1,613,628      | \$ 1,613,628         |
| Equipment                      | 3,053,038         | 3,330,156            |
| Computer equipment             | 263,188           | 255,170              |
| Computer software              | 146,192           | 144,353              |
| Furniture and fixtures         | 133,327           | 75,007               |
| Leasehold improvements         | 1,268,255         | 902,916              |
| Vehicles                       | 68,306            | 68,306               |
| Total cost                     | 6,545,934         | 6,389,536            |
| Less: accumulated depreciation | (3,139,375)       | (2,992,216)          |
|                                | \$3,406,559       | \$ 3,397,320         |

Maintenance and repairs expense for the three months ended March 31, 2011 and 2010, was \$15,824 and \$25,661, respectively. Depreciation expense related to property, plant and equipment, including property under capital lease for the three months ended March 31, 2011 and 2010 was \$147,159 and \$152,501, respectively.

## (5) Intangible Assets

Bacterin has been issued various patents with regards to processes for its products. Costs to apply for and maintain patents are capitalized as intangible assets.

The following table sets forth information regarding intangible assets:

|                          | March 31,<br>2011 | December 31,<br>2010 |
|--------------------------|-------------------|----------------------|
| Intellectual Property    |                   |                      |
| Gross carrying value     | \$524,586         | \$ 455,483           |
| Accumulated amortization | \$(107,435)       | \$ (99,844)          |
| Net carrying value       | \$417,151         | \$ 355,639           |

Aggregate amortization expense for the period ended March 31, 2011 and 2010 was \$7,591 and \$12,077, respectively.

Estimated amortization expense:

|                |           |
|----------------|-----------|
| Remaining 2011 | \$ 21,847 |
| 2012           | \$ 30,366 |
| 2013           | \$ 30,366 |
| 2014           | \$ 30,366 |
| 2015           | \$ 30,366 |

## (6) Accrued Liabilities

Accrued liabilities consist of the following:

|                            | March 31,<br>2011 | December 31,<br>2010 |
|----------------------------|-------------------|----------------------|
| Credit cards               | \$7,520           | \$ 7,597             |
| Accrued stock compensation | 276,820           | 197,763              |
| Wages payable              | 315,443           | 415,386              |
| Accrued commissions        | 816,782           | 662,623              |
| Other accrued expenses     | 508,344           | 108,171              |
|                            | \$1,924,909       | \$ 1,391,540         |

## (7) Long-Term Debt

Effective January 14, 2011, the Company entered into a Loan and Security Agreement with Bridge Bank, National Association ("Bridge Bank") whereby Bridge Bank agreed to provide a two year revolving credit facility which allows the Company to borrow, subject to borrowing base limitations, up to the lesser of (i) 80% of the Company's eligible accounts receivable, or (ii) \$3 million, increasing to \$5 million if the Company achieves two consecutive quarters of profitability of at least \$4 million in the aggregate. Amounts advanced will carry interest at the Bridge Bank prime rate plus 2.25% (subject to a minimum prime rate of 4%) and will be secured by the Company's accounts receivable and other personal property.

Long-term debt consists of the following:

|  | March 31,<br>2011 | December 31,<br>2010 |
|--|-------------------|----------------------|
| Revolving credit facility payable to Bridge Bank, interest of Prime plus 2.25%, secured by accounts receivable and personal property         | \$ 1,825,000      | \$ -                 |
| 6.00% loan payable to Valley Bank of Belgrade, \$10,746 monthly payments including interest, maturing December 24, 2030; secured by building | 1,496,260         | 1,500,000            |
| 12.553% loan payable to Venture Lending and Leasing, variable monthly payments, maturing in November, 2013, secured by equipment             | 1,250,000         | 1,250,000            |
| 12.553% loan payable to Venture Lending and Leasing, variable monthly payments, maturing in November, 2013, secured by equipment             | 1,250,000         | 1,250,000            |
|  | 5,821,260         | 4,000,000            |
| Less: Current portion  | (991,520)         | (234,149)            |
| Debt discount  | (1,439,306)       | (1,575,985)          |
|  | \$ 3,390,434      | \$ 2,189,866         |

The following is a summary of maturities due on the debt as of March 31, 2011:

|                |              |
|----------------|--------------|
| Remainder 2011 | \$ 525,550   |
| 2012           | 966,896      |
| 2013           | 2,929,703    |
| 2014           | 47,912       |
| 2015           | 50,868       |
| Thereafter     | 1,300,331    |
| Total          | \$ 5,821,260 |

#### (8) Stock-Based Compensation

The Company's Equity Incentive Plan provides for stock awards, including options and performance stock awards, to be granted to employees, consultants, independent contractors, officers and directors. The purpose of the incentive compensation plan is to enable us to attract, retain and motivate key employees, directors and, on occasion, independent consultants, by providing them with stock options and restricted stock grants. Stock options granted under the incentive compensation plan may be either incentive stock options to employees, as defined in Section 422A of the Internal Revenue Code of 1986, or non-qualified stock options. The plan is currently administered by the compensation committee of our Board of Directors. The administrator of the plan has the power to determine the terms of any stock options granted under the incentive plan, including the exercise price, the number of shares subject to the stock option and conditions of exercise. Stock options granted under the incentive plan are generally not transferable, vest in installments and are exercisable during the lifetime of the optionee only by such optionee. The exercise price of all incentive stock options granted under the incentive plan must be at least equal to the fair market value of the shares of common stock on the date of the grant. The specific terms of each stock option grant will be reflected in a written stock option agreement. At March 31, 2011, the Company had approximately 772,007 shares available for issuance under the equity plan.

Stock compensation expense recognized in the statement of operations for the three months ended March 31, 2011 and 2010 is based on awards ultimately expected to vest and reflects an estimate of awards that will be forfeited. ASC 718 requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

The estimated fair value of stock options granted is done using the Black-Sholes-Merton method applied to individual grants. Key assumptions used to estimate the fair value of stock awards are as follows:

**Risk-Free Rate:** The risk-free rate is determined by reference to U.S. Treasury yields at or near the time of grant for time periods similar to the expected term of the award.

**Expected Term:** The Company does not have adequate history to estimate an expected term of stock-based awards, and accordingly, uses the short-cut method as prescribed by Staff Accounting Bulletin 107 to determine an expected term.

**Volatility:** The Company estimates expected volatility based on peer-companies as prescribed by ASC 718.

**Dividend Yield:** The dividend yield assumption is based on the Company's history and expectation of dividend payouts and was 0% as of March 31, 2011 and 2010.

Activity under the Company's stock option plans was as follows:

|                          | Three months ended<br>March 31, 2011 |  | Three months ended<br>March 31, 2010 |  |
|--------------------------|--------------------------------------|--|--------------------------------------|--|
|                          | Shares                               | Weighted<br>Average<br>Exercise<br>Price | Shares                               | Weighted<br>Average<br>Exercise<br>Price |
| Outstanding at Jan. 1,   | 3,850,743                            | \$ 1.38                                  | 3,353,493                            | \$ 1.33                                  |
| Granted                  | 530,250                              | 4.74                                     | 72,500                               | 1.60                                     |
| Exercised                | -                                    | -  | -                                    | -  |
| Cancelled or expired     | (251,250)                            | 3.22                                     | (76,250)                             | 1.47                                     |
| Outstanding at March 31, | 4,129,743                            | \$ 1.70                                  | 3,349,743                            | \$ 1.33                                  |
| Exercisable at March 31, | 1,522,448                            | \$ 1.13                                  | 1,556,201                            | \$ 1.13                                  |

From time to time the Company may grant stock options to consultants. The Company accounts for consultant stock options in accordance with ASC 505-50. Compensation expense for the grant of stock options to consultants is determined based on the estimated fair value of the stock options at the measurement date as defined in ASC 505-50 and is recognized over the vesting period.

In connection with private placements of convertible debt, short-term debt, and common stock, the Company issued warrants to purchase shares of common stock at an exercise price of between \$1.16 and \$2.50 per share. During 2009, 38,400 warrants were issued with private placements of common stock, 86,400 warrants were issued with the placement of short-term debt and 105,600 warrants were issued with the placement of convertible notes. Warrants issued with common stock were recorded as additional paid in capital at the estimated fair market value of \$13,601 in 2009. The warrants issued with convertible debt and short-term loans were recorded as interest expense at the estimated fair value of \$137,415 in 2009 using the following assumptions:

|  | March 31,<br>2011 |   | March 31,<br>2010 |   |
|--|-------------------|---|-------------------|---|
| Value of underlying common stock (per share) | \$1.60            |   | \$1.60            |   |
| Risk free rate                               | 0.82              | % | 2.20              | % |
| Expected term                                | 2.5 years         |   | 2.5-5 years       |   |
| Dividend yield                               | 0                 | % | 0                 | % |
| Volatility                                   | 52                | % | 44-61             | % |

From January 1, 2010, through December 31, 2010, we issued warrants to purchase 1,570,565 shares of our common stock at an exercise price between \$2.16 and \$2.50 per share in connection with Bacterin's two prior bridge financings and warrants to purchase 1,509,271 shares of our common stock in connection with the closing of our private placement on June 30, 2010 and July 30, 2010 described above. Warrants to purchase 904,688 shares of our common stock which were issued to investors who purchased shares for cash in the private placement have an exercise price of \$2.50 per share and warrants to purchase 604,583 shares of our common stock which were issued to note holders who converted debt they acquired in Bacterin's two prior bridge financings into the private placement have an exercise price of \$2.25 per share, a 10% discount to the exercise price of the investors for cash.

Additionally, we issued warrants to our placement agents to purchase 328,125 shares of our common stock at an exercise price of \$1.66 per share in connection with Bacterin's two prior bridge financings and 361,875 shares of our common stock at an exercise price of \$1.60 per share in connection with the private placements which closed on June 30, 2010 and July 30, 2010.

In November 2010, the Company issued warrants to purchase 375,000 shares of common stock to Western Technology, Inc. in connection with a financing transaction. The warrants have an exercise price of the lower of \$4.00 per share or the price at which shares of the Company's stock are sold in the next qualified financing, if applicable, prior to the date of exercise. The warrants expire on April 30, 2018. WTI also has the right to receive additional warrants to purchase 125,000 shares of the Company's common stock at the same exercise price if the Company draws down the second \$2.5 million tranche of the facility.

The Company also issued warrants to purchase 489,710 shares of the Company's common stock to a limited group of investors at an exercise price of \$4.00 per share in exchange for those investors exercising their existing 489,710 warrants at exercise price ranging from \$2.16 to \$2.50 per share.

The following table summarizes our warrant activities for the period ended March 31, 2011:

|                                | Shares    | Weighted<br>Average<br>Exercise<br>Price |
|--------------------------------|-----------|--|
| Outstanding at January 1, 2011 | 7,291,560 | \$ 2.08                                  |
| Issued                         | -         | -  |
| Exercised                      | (413,978) | 1.63                                     |
| Cancelled or expired           | -         | -  |
| Outstanding at March 31, 2011  | 6,877,582 | 2.11                                     |

The Company utilizes a lattice model to determine the fair market value of the warrants. The 1,570,565 warrants issued in connection with the bridge financings and the 375,000 warrants issued in connection with the WTI financing were accounted for as derivative liabilities in connection with the price protection provisions of the warrants in compliance with ASC 815. The lattice model accommodates the probability of exercise price adjustment features as outlined in the warrant agreements. Under the terms of the warrant agreement, at any time while the warrant is outstanding, the exercise price per share can be reduced to the price per share of future subsequent equity sales of the Company's common stock or common stock equivalents that is lower than the exercise price per share as stated in the warrant agreement.

#### (9) Commitments and Contingencies

##### Operating Leases

The Company leases office facilities under a non-cancelable operating lease agreement with an expiration date in 2013. The Company has the option to extend the lease for another ten year term and has right of first refusal on any sale. The Company leases additional office facilities under month-to-month arrangements. Future minimum payments for the next five years and thereafter as of March 31, 2011, under these leases, are as follows:

|            |            |
|------------|------------|
| 2011       | \$ 97,808  |
| 2012       | \$ 145,369 |
| 2013       | \$ 72,258  |
| Thereafter | \$ -       |

Rent expense was \$39,600 and \$38,620 for the three months ended March 31, 2011 and 2010, respectively. Rent expense is determined using the straight-line method of the minimum expected rent paid over the term of the agreement. The Company has no contingent rent agreements.

#### Warranties and Indemnification

The Company's arrangements generally include certain provisions for indemnifying customers against liabilities if its products or services infringe a third-party's intellectual property rights. To date, the Company has not incurred any material costs as a result of such indemnifications and has not accrued any liabilities related to such obligations in the accompanying financial statements.

The Company has also agreed to indemnify its directors and executive officers for costs associated with any fees, expenses, judgments, fines and settlement amounts incurred by any of these persons in any action or proceeding to which any of those persons is, or is threatened to be, made a party by reason of the person's service as a director or officer, including any action by the Company, arising out of that person's services as the Company's director or officer or that person's services provided to any other company or enterprise at the Company's request.

#### Acquisition

On March 18, 2011, the Company announced that it has executed a preliminary letter of intent to acquire Robinson MedSurg LLC ("RMS"), a medical device distribution company focused primarily on maxillofacial and craniofacial surgery devices. The proposed transaction will involve an initial exchange of Bacterin common stock valued at \$1,000,000 at the closing date, in exchange for all the assets of RMS, including approximately \$500,000 of inventory, existing commercial agreements and intellectual property. In addition, upon achievement of certain revenue goals by RMS over a two year period, additional Bacterin common stock valued at \$1,000,000 may be remitted to RMS.

#### Litigation

From time to time, the Company is involved in legal proceedings arising in the ordinary course of business. The Company believes that the resolution of these matters will not have a material effect on the Company's financial position, results of operations or liquidity. Legal fees are charged to expense as incurred, unless the probability of incurring a loss is high and the amount can be reasonably estimated, in which case the estimated loss is accrued.

#### (10) Income Taxes

The Company's provision for income taxes differs from applying the statutory U.S. federal income tax rate to income before taxes. The primary difference results from providing for state income taxes and from deducting certain expenses for financial statement purposes but not for federal income tax purposes.

The components of income (loss) before provision for income taxes consist of the following:

|               | Three months ended<br>March 31, |               |
|---------------|---------------------------------|---------------|
|               | 2011                            | 2010          |
| United States | \$4,916,786                     | \$(1,643,029) |

The reconciliation of income tax attributable to operations computed at the U.S. Federal statutory income tax rate of 35% to income tax expense is as follows:

|   | Three months ended<br>March 31, |              |
|---|---------------------------------|--------------|
|   | 2011                            | 2010         |
| Statutory Federal tax rate                  | \$ 1,720,554                    | \$ (575,055) |
| Valuation allowance                         | (2,058,172)                     | 676,261      |
| State income taxes, net of Federal benefit  | 282,466                         | (113,368)    |
| Nondeductible meals & entertainment expense | 55,152                          | 12,162       |
|   | \$ -                            | \$ -         |

Deferred tax components are as follows:

|                                   | March 31,<br>2011 | December 31,<br>2010 |
|-----------------------------------|-------------------|----------------------|
| <b>Deferred tax assets:</b>       |                   |                      |
| Accrued liability for vacation    | \$ 85,734         | \$ 85,734            |
| Accrued commission expense        | 73,684            | 48,318               |
| Bad debt reserve                  | 36,941            | 34,275               |
| Inventory reserve                 | 29,647            | 25,140               |
| Net operating loss carryovers     | 3,833,439         | 3,654,421            |
| Non-cash warrant/interest expense | 843,321           | 843,321              |
| Debt issuance expense             | 1,216,559         | 846,341              |
| Stock compensation                | 700,513           | 661,296              |
| Total deferred tax assets         | 6,819,838         | 6,198,846            |
| Valuation allowance               | (6,704,404)       | (6,057,142)          |
| Net deferred tax assets           | 115,434           | 141,704              |
| <b>Deferred tax liabilities:</b>  |                   |                      |
| Depreciation                      | (152,891)         | (179,774)            |
| Amortization                      | 37,457            | 38,070               |
| Total deferred tax liabilities    | (115,434)         | (141,704)            |
| Net deferred tax assets           | \$ -              | \$ -                 |



The ultimate realization of deferred tax assets is dependent upon the existence, or generation, of taxable income in the periods when those temporary differences and net operating loss carryovers are deductible. Management considers the scheduled reversal of deferred tax liabilities, taxes paid in carryover years, projected future taxable income, available tax planning strategies, and other factors in making this assessment. Based on available evidence, management does not believe it is more likely than not that all of the deferred tax assets will be realized. Accordingly, the Company has established a valuation allowance equal to the net realizable deferred tax assets. The valuation allowance decreased by \$2,058,172 and increased by \$676,262 for the three months ended March 31, 2011 and year ended December 31, 2010, respectively.

At March 31, 2011 and December 31, 2010, the Company had total domestic Federal and state net operating loss carryovers of approximately \$16,261,062 and \$14,581,241, respectively. Federal net operating loss carryovers expire at various dates between 2027 and 2029, while state net operating loss carryovers expire between 2024 and 2029.

Under the Tax Reform Act of 1986, as amended, the amounts of and benefits from net operating loss carryovers and research and development credits may be impaired or limited in certain circumstances. Events which cause limitations in the amount of net operating losses that the Company may utilize in any one year include, but are not limited to, a cumulative ownership change of more than 50%, as defined, over a three year period. The Company does not believe that such an ownership change has occurred in 2011 or 2010.

The 2007 through 2009 tax years remain open to examination by the Internal Revenue Service and the 2005 to 2009 tax years remain open to the Montana Department of Revenue. These taxing authorities have the authority to examine those tax years until the applicable statute of limitations expire. As of March 31, 2011 the federal and state 2010 income tax returns were not filed, however extensions were timely filed.

The Company did not recognize any interest or penalties related to income taxes for the years ended December 31, 2010 and 2009.

#### (11) Employee Benefit Plans

As of January 1, 2011, the Company switched from a SIMPLE IRA to a 401(k) retirement plan. Qualified employees may defer their salary and the deferrals are matched up to 2%. The 2% matching will be paid by December 31, 2011 for the year ended December 31, 2011. Employees who make contributions in 2011 must be employed as of December 31, 2011 to be eligible for the matching contribution. The plan covers substantially all full-time employees. Under the terms of the plan, participants may contribute up to the lower of \$16,500 of their salary or the statutorily prescribed limit to the plan. Employees are eligible after six months of employment and may enroll twice a year in January and July.

## (12) Supplemental Disclosure of Cash Flow Information

Supplemental cash flow information is as follows:

|   | Three months ended |            |
|---|--------------------|------------|
|   | March 31,          |            |
|   | 2011               | 2010       |
| <b>Supplemental disclosure of cash flow information</b> |                    |            |
| Cash paid during the period for:                        |                    |            |
| Interest  | \$ 372,433         | \$ 523,417 |
| Income taxes  | -                  | -          |

## (13) Related Party Transactions

Our Chief Executive Officer serves as a Board member of West Coast Tissue Services and is Chairman of the Board of American Donor Services. In addition, our Vice President – Biologics serves as a Board member of American Donor Services. Both of these entities recover tissues from donors and we reimburse them for recovery fees including labor costs. These relationships benefit the Company, thus insuring we have a pipeline of current and future donors which is necessary for our success. The aggregate amount of all payments made to these entities since January 1, 2008 is \$1,136,314 to West Coast Tissue Services and \$1,708,633 to American Donor Services. At March 31, 2011 the Company had an accounts receivable-related party from West Coast Tissue Services of \$654,461 and accounts payable to American Donor Services of \$789,935. No compensation is paid to our Chief Executive Officer or VP – Biologics for their services to those entities.

At March 31, 2011, the Company has a note receivable from its Chief Executive Officer of \$82,398 which existed prior to the reverse merger transaction in June, 2010, before we became a public corporation. The Company expects to collect the note and accrued interest by June 30, 2011.

## (14) Subsequent Events

On May 3, 2011, the Company announced that it has raised \$1,874,502 in a private placement transaction under Rule 506 of Regulation D, subject to NYSE Amex approval. The transaction will result in the issuance of 562,579 shares of the Company's common stock and warrants to purchase 225,031 shares of the Company's common stock.

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This Management's Discussion and Analysis of Financial Condition and Results of Operations contains "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements include statements relating to the intended usage and markets for our products and services, the market for our common stock, and our liquidity, results of operations, and ability to meet our anticipated cash requirements. Actual results could differ materially from those currently anticipated as a result of a number of factors, including those set forth under "Risk Factors" in our Annual Report on Form 10-K filed with the SEC on April 11, 2011.

You should read the following discussion of our financial condition and results of operations in conjunction with our financial statements and related notes set forth in this report. Unless the context otherwise requires, "we," "our," "us" and similar expressions used in this Management's Discussion and Analysis of Financial Condition and Results of Operation section refer to Bacterin International, Inc., a Nevada corporation ("Bacterin") prior to the closing of the Reverse Merger, as defined below, on June 30, 2010, and Bacterin International Holdings, Inc., f/k/a K-Kitz, Inc., as successor to the business of Bacterin, following the closing of the Reverse Merger transaction.

### Background

On June 30, 2010, the Company completed a reverse merger transaction (the "Reverse Merger"), in which we caused Bacterin to be merged with and into a wholly-owned Nevada subsidiary created for purposes of effecting the Reverse Merger, and the stockholders of Bacterin obtained control of the Company. The Reverse Merger was consummated under Nevada corporate law pursuant to an Agreement and Plan of Merger, dated as of June 30, 2010. As a result of the Reverse Merger, Bacterin became our wholly-owned subsidiary and we are now engaged, through Bacterin, in the business of biomaterials research, development, and commercialization.

Pursuant to the terms of the Reverse Merger, the stockholders of Bacterin immediately preceding the Reverse Merger received one share of the Company's common stock for each two shares of Bacterin common stock such stockholder held prior to the Reverse Merger (effectively resulting in a de facto one-for-two reverse stock split of the then outstanding Bacterin shares) with the aggregate number of the Company's shares of common stock so issued to the Bacterin stockholders, being 28,257,070 shares, representing approximately 96% of our outstanding common stock as of the closing of the Reverse Merger on June 30, 2010, prior to taking into account the issuance of any shares of our common stock pursuant to the private placement described below.

Before the Reverse Merger, our corporate name was K-Kitz, Inc., and our trading symbol was KKTZ.OB. On June 29, 2010, we changed our corporate name to "Bacterin International Holdings, Inc." which name change became effective for trading purposes on July 1, 2010. Effective July 21, 2010, our trading symbol was changed from KKTZ.OB to BIHI.OB.

Concurrently with the closing of the Reverse Merger, we completed an initial closing of a private placement to selected qualified investors of shares of our common stock at a purchase price of \$1.60 per share and detachable warrants to purchase one-quarter share of our common stock (at an exercise price of \$2.50 per share). In total, we sold 4,934,534 shares of our common stock and warrants to purchase 1,233,634 shares of common stock as part of this initial closing. We received gross proceeds of \$7,508,329 in consideration for the sale of the shares of common stock and warrants, which consisted of (i) \$4,026,000 in cash from investors in the private placement and (ii) \$3,482,329 from note holders in two earlier Bacterin bridge financings (conducted to fund working capital and capital expenditures during the months prior to the Reverse Merger) who converted their outstanding principal and interest into the private placement at a 10% discount to the purchase price, being \$1.44 per share, and received identical

warrant coverage as the cash investors except that the exercise price of the converting note holders' warrants is \$2.25 per share, a 10% discount to the exercise price of the warrants received by the cash investors.

In the second and final closing of this private placement on July 30, 2010, we sold a total of 1,102,500 additional shares of our common stock together with additional warrants to purchase an aggregate of 275,625 shares of our common stock for total gross cash proceeds of \$1,764,000.

Our placement agents received an aggregate of \$463,200 in cash fees in connection with the private placement (\$322,080 from the initial closing and \$141,120 from the second and final closing) and were reimbursed for their out-of-pocket-expenses. In addition, the placement agents received an aggregate of 106,217 shares of our common stock (84,167 shares from the initial closing and 22,050 shares from the second and final closing) and warrants to purchase 361,875 shares of our common stock (251,625 shares from the initial closing and 110,250 shares from the second and final closing) at an exercise price of \$1.60 per share.

Following the private placement transaction, the Company has permitted an additional \$450,000 in principal amount outstanding under the bridge financing to convert into 316,823 shares of the Company's common stock and warrants to purchase 88,309 shares of the Company's common stock on the same terms as if such debt had actually converted in the private placement transaction.

Concurrently with the closing of the Reverse Merger, the Company repurchased 4,319,404 shares of its common stock from one of its stockholders for aggregate consideration of \$100, as well as certain other good and valuable consideration, and Bacterin repurchased 82,817 shares of its common stock from a few of its stockholders for aggregate consideration of \$132,507. Immediately after these repurchases, all of these shares were cancelled in connection with the Reverse Merger.

#### Overview

We develop, manufacture and market biologics products to domestic and international markets through our biologics division and are a leader in the field of biomaterials research, device development and commercialization. Our proprietary methods optimize the growth factors in human allografts to create the ideal stem cell scaffold and promote bone and other tissue growth. These products are used in a variety of applications including enhancing fusion in spine surgery, relief of back pain with a facet joint stabilization, promotion of bone growth in foot and ankle surgery, promotion of skull healing following neurosurgery and cartilage regeneration in knee and other joint surgeries.

Our medical devices division develops medical devices intended for use in several diverse clinical areas including orthopedic, plastic, and cardiovascular surgery. Our background and expertise is in the research, testing, and development of coatings for medical devices, particularly antimicrobial-based coatings. Such coatings contain active agents and provide our products with several potential advantages over traditional medical devices. They offer a means of protecting the surface of a medical device from contamination by pathogenic organisms, thereby minimizing the potential for infection. Other coatings can serve as a reserve for local delivery of active agents, enhancing a variety of biological functions such as bone growth and pain management.

The manufacturing and operations of the biologics and device divisions are organized separately while products from both are marketed through several channels including private label arrangements, independent distributors, joint development projects and our direct sales network which we began to implement in the last half of 2009. To date, we have established 13 regions with a regional vice-president in charge of all activities within the region and have hired and trained 52 sales representatives. Our customers are located worldwide, with approximately 97% of our first quarter 2011 sales being derived from customers located in the United States. Our headquarters, laboratory and manufacturing facilities are located in Belgrade, Montana.

#### Revenue Model

We generate revenue from a variety of sources, including the following: license fees and royalties from collaborative product development efforts with medical device manufacturers; sales from products developed and manufactured by us under our own label; products manufactured by us under private labels for other device distributing companies; and contract revenue from analytical testing and development services provided to medical device manufacturer clients, which tailor our coating process to the client's specific product/medical application. In order for us to recognize revenue from these sources, the following criteria generally must be met:

- we have entered into a legally binding agreement with the customer for the product or services;
- the products or services have been delivered by us;
- our fee for providing the products or services is fixed and determinable; and
- our fee is actually collectible.

We record revenue net of any applicable sales, use, or excise taxes. If our arrangement with the customer includes a right of acceptance or a right to cancel, revenue is recognized when our products or services are accepted or when the right to cancel has expired. We sell to certain customers under consignment arrangements. Under these arrangements, revenue is recorded on the date of sale. Revenue for research and development services provided by us is recognized based upon our meeting certain performance standards, such as incurring qualifying costs, as set forth in the specific arrangement governing the provision of such services.

## Revenue

Total revenue for the three months ended March 31, 2011 increased 119% to \$6,000,804 compared to \$2,736,433 in the comparable prior year period. The increase of \$3,264,371 was largely the result of our products' continuing penetration into the market due in part to the benefits our products provide to both the patient and the medical care provider, combined with the continued expansion of our direct sales force which moved from a distributor based model in the second half of 2009.

## Cost of tissue sales

Costs of tissue sales consist primarily of tissue and device manufacturing costs. Costs of tissue sales increased by 63% or \$382,734 to \$987,356 for the first quarter of 2011 from \$604,622 for the first quarter of 2010. The increase was the result of increased costs associated with our higher sales. As a percentage of revenues, our gross profit percentage increased from 78% to 84% due to improved manufacturing efficiencies associated with a higher utilization of our manufacturing capacity.

## Operating Expenses

Operating expenses include general and administrative expenses, selling and marketing expenses, depreciation, research and development expenses, and compensation costs, including incentive compensation. Operating expenses increased 120%, or \$3,794,855, for the three months ended March 31, 2011 compared to the three months ended March 31, 2010, primarily due to the reasons set forth below.

## General and Administrative

General and administrative expenses consist principally of corporate personnel cash based and stock option compensation related costs and corporate expenses for legal, accounting and other professional fees as well as occupancy costs. General and administrative expenses increased 57%, or \$831,237, to \$2,297,375, for the three months ended March 31, 2011 compared to the same period of 2010. The increase is largely associated with increased personnel costs as well as legal and professional fees incurred between the two periods.

## Sales and Marketing

Sales and marketing expenses include sales expenses, cash based and stock option compensation expense and primarily consist of costs for trade shows, sales conventions and meetings, travel expenses, advertising and other sales and marketing related costs. Selling and marketing expenses increased 196%, or \$2,821,565, to \$4,264,282 for the three months ended March 31, 2011 from \$1,442,717 for the comparable prior year period. As a percentage of revenue, selling and marketing expenses increased to 71% in the first quarter of 2011 from 53% in the same period of the prior year. The increases were primarily the result of increased commissions and travel costs associated with the larger sales force as well as a substantial increase in marketing and advertising activities in 2011 as part of our continued conversion to a direct sales force model from a distributor based model.

## Depreciation

Depreciation expense consists of depreciation of long-lived property and equipment. Depreciation expense remained relatively unchanged, decreasing slightly to \$147,159 for the three months ended March 31, 2011 from \$152,501 in the comparable prior year period.





#### Non-cash Consulting Expense

Non-cash consulting expense consists of non-cash expense associated with granting restricted stock to consultants. Stock options/restricted stock compensation expense increased \$147,395 to \$240,991 for the first quarter of 2011 from \$93,596 in the first quarter of 2010. As a percentage of revenues, restricted stock expense for the three months ended March 31, 2011 was 4%, compared to 3% in the comparable prior year period.

#### Interest Expense

Interest expense is from our promissory notes. Interest expense for the three months ended March 31, 2011 decreased 29%, to \$372,433, as compared to the three months ended March 31, 2010. The decrease was the result of refinancing that occurred in the second half of 2010 with preferable interest rates. In addition, the Company incurred debt discount expenses associated with its financing transactions in the first quarter of 2010.

For the first quarter of 2011, the Company recorded a non-cash income of \$7,218,806 associated with the issuance of warrants as part of its convertible debt financing. The income in 2011 is primarily due to the decrease in the Company's stock price from December 31, 2010 to the closing price on March 31, 2011.

#### Liquidity and Capital Resources

Since our inception, we have historically financed our operations through operating cash flows, as well as the private placement of equity securities and debt, and other debt transactions. On June 30 and July 30, 2010, we raised approximately \$9,272,000 through a private placement of equity securities and conversion of a portion of a bridge loan financing. In addition, during November 2010, we finalized a debt transaction with WTI which resulted in gross proceeds to the Company of \$2,500,000. At March 31, 2011, we had approximately \$4,614,000 of cash and cash equivalents and accounts receivables. In addition, we have access to credit lines secured by certain of our accounts receivable balances through a credit facility for up to \$5 million with Bridge Bank which closed in January 2011. At March 31, 2011, the Company has drawn down \$1,825,000 on its credit facility.

Net cash used in operating activities for the first quarter of 2011 was \$1,588,753. This was primarily related to cash used to fund our operations as well as an increase of accounts receivable of \$684,948 and an increase in our inventory balance of approximately \$621,239. For the first quarter of 2010, net cash used in operating activities was \$2,141,671 due primarily to a net loss of \$1,643,029 for the period in addition to negative changes to working capital.

Net cash provided by financing activities was \$1,862,185 and \$2,445,855 for the first quarter of 2011 and 2010, respectively. The net cash provided from financing activities during 2011 was primarily the result of the draw down of approximately \$1,825,000 proceeds from the revolving credit facility entered into in early 2011.

#### Off Balance Sheet Arrangements

We do not have any off balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity or capital expenditures or capital resources that are material to an investor in our shares.

## Cash Requirements

We believe that our March 31, 2011 cash on hand and accounts receivable balance of \$4,238,645, as well as proceeds from our recent private placement, additional credit lines available through our accounts receivable credit facility with Bridge Bank and anticipated cash receipts from sales expected from operations will be sufficient to meet our anticipated cash requirements through June 30, 2012. We incurred approximately \$9 million in sales and marketing expenses in 2010 and expect to incur \$20 million in 2011. The increased sales and marketing expenses are anticipated to be funded from operating cash flow. The incurrence of these additional expenses may impact our operating results and there can be no assurance of their effectiveness. If we do not meet our revenue objectives over that period, we may need to sell additional equity securities, which could result in dilution to our stockholders, or seek additional loans. The incurrence of indebtedness would result in increased debt service obligations and could require us to agree to operating and financial covenants that would restrict our operations. Financing may not be available in amounts or on terms acceptable to us, if at all. Any failure by us to raise additional funds on terms favorable to us, or at all, could limit our ability to expand our business operations and could harm our overall business prospects.

In addition, we currently anticipate that we will need to spend between \$4 and \$5 million over the next 5 years in order to increase, expand or update our existing facilities to meet our expected growth over that period.

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

As a smaller reporting company, we are not required to provide the information required by this Item.

## Item 4. Controls and Procedures

### Evaluation of Disclosure Controls and Procedures

Our senior management with the participation of our chief executive officer and chief financial officer evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a – 15(e) under the Exchange Act) as of March 31, 2011. Based upon that evaluation, we concluded that as of March 31, 2011, our disclosure controls and procedures were ineffective due to the material weakness in our internal controls over financial reporting detailed below that have not been fully remediated as of March 31, 2011.

### Management's Report on Internal Control over Financial Reporting

Management is responsible for maintaining adequate internal control over financial reporting as such term is defined in Rule 13a-15 (f) under the Securities and Exchange Act of 1934 as amended. Under the supervision and with the participation of senior and executive management, we conducted an evaluation of our internal controls over financial reporting based upon the framework Internal Control – Integrated Framework as outlined by COSO, the Committee of Sponsoring Organizations of the Treadway Commission. Our internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of an evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.

Based on our evaluation under the framework Internal Control – Integrated Framework, management concluded that our internal control over financial reporting was ineffective as of March 31, 2011 due to material weaknesses in our internal control over financial reporting that have not been fully remediated as of March 31, 2011 as detailed below:

1) Insufficient number of personnel with the appropriate level of experience and technical expertise to appropriately resolve non-routine and complex accounting matters while completing the financial statement close process. This weakness resulted in the identification of adjustments during the financial statement close process that have been recorded in 2010 consolidated financial statements. Until this design deficiency in our internal control over financial reporting is remediated, there is a reasonable possibility that a material misstatement in our annual or interim financial statements could occur and not be corrected or prevented by our internal control system in a timely manner.

Our efforts to remediate this weakness include the following:

-The hiring of an SEC Reporting Manager in February 2011 with experience preparing SEC reports for publicly traded companies required to comply with Section 404 of the Sarbanes Oxley act of 2002.

-We will further expand the hiring of qualified accounting and finance personnel throughout 2011.

-Expand the training and education of our accounting and finance department, including Sarbanes Oxley compliance training.

2) The Company currently keeps its inventory records under a separate operating system than its accounting system. Accordingly, duplicate input is required for both systems increasing the risk of errors in recording inventory transactions while requiring numerous reconciliations to be performed by Company personnel.

In addition, the inventory system does not have the capability to generate historical detailed inventory reports which limits the ability to reconcile discrepancies between the accounting system and the inventory system.

Our efforts to remediate the weakness include the following:

-The Company is currently evaluating the purchase of an integrated accounting operating and inventory system. Currently, the Company expects to implement the system during the second half of 2011.

-In the interim periods, the Company will perform a detailed inventory reconciliation and cost analysis on a quarterly basis.

3) The documentation surrounding equity transactions for employees and consultants needs to be strengthened to comply with procedures outlined by the Company to ensure that all equity related transactions are properly recorded in the appropriate periods.

Our efforts to remediate the weakness include the following:

-Development of a standard operating procedure for the grant of all equity securities including the approval process by the Compensation Committee and the Board of Directors.

## PART II – OTHER INFORMATION

### Item 1. Legal Proceedings

In November 2009, we were served a complaint in connection with the following court action filed in Utah state court: Yanaki and Activatek v. Cook and Bacterin International, Inc., case number 090912772. This action involves the plaintiff's attempt to sell shares of our common stock to a third party in a private sale and claims, as its primary allegation, tortious interference with the sales contract. Plaintiff seeks \$300,000, 358,904 shares of our common stock, attorneys fees and costs. Discovery is proceeding and a mediation has been scheduled for May 2011.

We have been served a complaint in connection with Civil Action No. 8:10-cv-01589-VMC-EAJ filed by minSURG International, Inc., or minSURG, in the United States District Court in the Middle District of Florida. In this action, minSURG alleges infringement of U.S. Patent No. 7,708,761, entitled "Spinal Plug for a Minimally Invasive Facet Joint Fusion System" by many companies in our industry. minSURG seeks an injunction against alleged patent infringement plus unspecified commercial monetary damages. We have entered into a joint defense agreement with many of the other defendants in this action and plan a vigorous defense. Regardless of the outcome of this case, we do not anticipate this notice to have a material impact on our overall sales or operating results. Plaintiff's request for a preliminary injunction was denied and a Markman hearing has been scheduled by the Court.

On February 18, 2011 the Company received pleadings in litigation commenced in Federal District Court in New Jersey by Musculoskeletal Transplant Foundation against the Company, Lori Kmet and Carey Bauer. Plaintiff alleges that Ms. Kmet and Ms. Bauer, former employees of Plaintiff, violated certain non-compete, non-solicit and nondisclosure commitments when they joined the Company's sales force. The Company is alleged to have interfered with these commitments in engaging these employees. The parties arrived at an amicable settlement in April 2011 that allows Ms. Bauer and Ms. Kmet to continue their work with the Company.

#### Item 1A Risk Factors

As a smaller reporting company, we are not required to provide the information required by this Item.

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

The Company raised \$1,874,502 in a private placement transaction under Rule 506 of Regulation D, which resulted in the issuance of 562,579 shares of the Company's common stock and warrants to purchase 225,031 shares of the Company's common stock. The transaction was funded in two tranches and priced at market value on the date each tranche was submitted to NYSE Amex for approval. The warrants have a market value exercise price and are exercisable over the next five years, subject to a six month holding period. The Company plans to use the proceeds from the private placement for working capital and to increase production capacity. Middlebury Securities LLC received \$20,000 in connection with the participation of certain investors

#### Item 3. Defaults Upon Senior Securities

None

#### Item 4 (Removed and Reserved)

#### Item 5. Other Information

None

#### Item 6. Exhibits

- 3.1 Certificate of Incorporation (filed as Exhibit 3.1 to Form 8-K filed June 30, 2010, incorporated by reference herein)
- 3.2 Amended and Restated Bylaws (filed as Exhibit 3.2 to Form 8-K filed January 12, 2011, incorporated by reference herein)
- 31.1 Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer

31.2 Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer

32.1 Section 1350 Certification of Chief Executive Officer

32.2 Section 1350 Certification of Chief Financial Officer

31

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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.

BACTERIN INTERNATIONAL HOLDINGS, INC.

Date: May 12, 2011

By: /s/ Guy Cook  
Name: Guy Cook  
Title: President and Chief Executive Officer

Date: May 12, 2011

By: /s/ John P, Gandolfo  
Name: John P, Gandolfo  
Title: Chief Financial Officer