K TEL INTERNATIONAL INC
Form 10-K
October 14, 2003

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(MARK ONE)

ý **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended June 30, 2003

OR

o **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 1-07115

K-TEL INTERNATIONAL, INC.

(Exact name of registrant as specified in its charter)

Minnesota (State or other jurisdiction of incorporation or organization)	**41-0946588** (I.R.S. Employer Identification No.)
2655 Cheshire Lane North, Suite 100, Plymouth, Minnesota (Address of principal executive offices)	**55447** (Zip Code)

Registrant s telephone number, including area code: **(763) 559-5566**

Securities registered pursuant to Section 12(b) of the Act:

None

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, par value $0.01

(Title of class)

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 ý   No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

Indicate by check mark whether or not the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2)

Yes o   No ý

As of December 31, 2002, the aggregate market value of voting stock held by non-affiliates of the registrant based on the last sale price as reported by the Over-the-Counter Bulletin Board on such date was $292,706.

As of September 22, 2003, the registrant had 13,653,738 shares of Common Stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

None.

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SAFE HARBOR STATEMENT UNDER THE
PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

Certain statements of a non-historical nature under the caption Management s Discussion and Analysis of Financial Condition and Results of Operations and elsewhere in this Form 10-K constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements may be identified by the use of terminology such as may, will, expect, anticipate, estimate, should, or continue or the negative thereof or other variations thereon or comparable terminology. Such forward-looking statements are subject to certain risks and uncertainties that could cause actual results to differ materially from historical results or from those results currently anticipated or projected. Such factors include, among other things, the following: changes in consumer purchasing; demand for and market acceptance of new and existing products; the impact from competition for recorded music; the outcome of legal proceedings; dependence on suppliers and distributors; the outcome of our subsidiaries bankruptcy and liquidation; success of marketing and promotion efforts; technological changes and difficulties; availability of financing; foreign currency variations; general economic, political and business conditions; and other matters. We undertake no obligation to release publicly the result of any revisions to these forward-looking statements, except as required by law.

PART I

ITEM 1: BUSINESS

K-tel International, Inc. (the Company, K-tel, or the registrant) was incorporated in 1968. Its corporate offices are located at 2655 Cheshire Lane North, Suite 100, Plymouth, Minnesota, and its phone number is (763) 559-5566. Through its operating subsidiaries, K-tel licenses its music catalog internationally and markets entertainment products mainly derived from its catalog through retail and direct response marketing channels in the United States and Europe. The Company has a focused method of distribution that targets the strengths of fewer individual retailers and supplies products suited to each retailer s needs. These new products are derived mainly from the Company s master recordings music catalog with the objective of realizing more competitive profit margins. K-tel purchases inventory from its duplicators to meet customer orders. Most customers purchase on a guaranteed sale basis where unsold merchandise can be returned for credit. Historically, K-tel subsidiaries had also distributed consumer products through operations that have been discontinued, and operated an Internet e-commerce site which has been suspended due to continuing losses. K-tel seeks to license its trademarks to other companies in businesses unrelated to K-tel s current operations. Licenses are granted for a royalty or fee, with no cost to the Company. The Company has licensed certain marks to K-tel Drug Mart Ltd., a Canadian direct marketer of prescription drugs beneficially owned by Philip Kives, the Chairman of the Board, President and Chief Executive Officer of K-tel. K-tel Drug Mart, which recently began operations, offers prescription drugs from its pharmacy in Canada to persons in the United States. K-tel is merely a licensor of its mark to K-tel Drug Mart. To date, K-tel Drug Mart s operations have not generated any significant licensing revenues for the Company.

Description of Current Businesses

Music Licensing and Sales

Currently K-tel s primary activity is the licensing of music to other record companies and to other segments of the entertainment industry. K-tel owns a proprietary master music catalog of approximately 6,000 titles consisting of original recordings and re-recordings of music from the 1950 s through today. Supplementing this major asset, K-tel has a non-exclusive worldwide license for a catalog of over 30,000 music titles. The Company also licenses the rights to master recordings to third parties worldwide for use in albums, films, television programs and commercials for either a flat fee or a royalty based on the number of units sold. K-tel continuously adds to its music master catalog to ensure growth and product diversity. Licensing of its proprietary music rights to third parties has historically been an important revenue source for K-tel.

The Company also markets and sells pre-recorded compact discs utilizing the master recordings in its music catalog, and DVD s from its developing catalog of musical performances. Customers include retailers, wholesalers and rack service distributors. These products are also sold through subsidiaries and licensees in the United Kingdom and elsewhere in Europe. The principal entertainment products that K-tel markets and sells consist primarily of pre-recorded thematic music packages in a compilation format featuring various artists. These thematic music selections, which cover nearly all music genres, are targeted to a variety of age groups. K-tel provides marketing support for its music sales through cooperative advertising with retailers, print media, radio and television advertising, and in-store promotions and displays.

For the year ended June 30, 2003, K-tel s net sales included $902,000 recovered from an audit of licensing income related to prior years. This is not expected to be a recurring source of income.

Two customers, Anderson Merchandising, Inc. and Handleman Company accounted for approximately 17.0% and 13.1% respectively of K-tel s revenue for the year ended June 30, 2003. The loss of, or a substantial reduction in, business from any of these customers would have a material adverse effect on the Company.

K-tel currently delivers music products (CDs and DVDs) through traditional wholesale and retail distribution channels. Prior to April 2001, the Company was distributing its music products in the United States to most major music retailers (Transworld Entertainment, Musicland, Best Buy, Circuit City, Tower Records) and to major distributors (Handelman, Anderson Merchandising, Valley Media). The Company now has a customer base that includes only a few selected retailers and distributors, and offers products that are of more interest to these individual customers. This focused approach is intended to improve product sell-through, minimize returns of unsold inventory and allow the Company to realize more competitive profit margins. This existing method of distributing music could be materially altered by new technologies that will enable users and customers of pre-recorded music to electronically download pre-recorded music at home to various personal computer media formats. The technology is developing and a number of competing companies are seeking to have the industry and the public embrace their technologies. Participants in this technology competition include Microsoft

Corporation, Liquid Audio, Inc., Apple Computer, Inc., MP3.com, Inc. and others. Digital music distribution provides both significant risks and opportunities for K-tel. The risks include K-tel s uncertain ability to compete with other music companies from a marketing and a technological standpoint. The Company believes there are opportunities to enhance its current distribution methods as well as increase opportunities to license its owned library of master recordings. K-tel s music sales and licensing subsidiaries are pursuing these alternative distribution channels.

In March 2001, the Company s music distribution subsidiary in the United States, K-tel International (USA), Inc. (K-tel (USA)) ceased operations and filed for protection under Chapter 7 of the United States bankruptcy code. This event ended the Company s traditional method of distributing music products through most retailers. The Company now distributes its music products through another subsidiary, K-tel Entertainment, Inc.

The Company s ability to continue its present operations and implement future expansion plans successfully is contingent mainly upon its ability to maintain its line of credit arrangements with K-5 Leisure Products, Inc., the Company s largest shareholder controlled by Philip Kives, the Chairman of the Board, President and Chief Executive Officer of K-tel. (See Note 3 to the consolidated financial statements), increase its revenues and profit margins, and ultimately attain and sustain profitable operations. Without increased revenues and sustained profitability, the cash generated from the Company s current operations will likely be inadequate to fund operations and service its indebtedness on an ongoing basis. Management is focusing its efforts on music licensing and limited music distribution. However, there can be no assurance that the Company will achieve profitable operations through these efforts or be able to continue operations. The financial statements do not include any adjustments that might result from the outcome of these uncertainties. The report of the Company s independent certified public accountants as of June 30, 2003 and 2002 and for the three years in the period ended June 30, 2003 included an explanatory paragraph expressing doubt about our ability to continue as a going concern.

E-Commerce

K-tel ceased operating its K-tel.com website, which marketed its own and other suppliers products to retail customers, in the fourth quarter of 2001 because this business segment was not cost effective. The web site has since been redeveloped to support the Company s sale of proprietary brand-name compilations and newly developed CD and DVD products to customers in the United States and United Kingdom.

Competition

The music business is highly competitive and dominated by major companies. K-tel faces competition for discretionary consumer purchases of its products from other record companies and other entertainment sources, such as film and video companies. Several major record companies in the United States including Bertelsmann AG, Sony Corp., Time Warner, Inc. and Universal Music Group dominate the market for pre-recorded music. K-tel does not have the financial resources, nor does it have the depth or breadth of catalog, distribution capabilities or current repertoire of these companies. Its ability to compete in this market depends upon:

the skill and creativity of its employees to expand and utilize its music catalog to create compilation packages;

its ability to distribute its products effectively and efficiently; and

its ability to build upon and maintain its reputation for producing, licensing, marketing and distributing high quality music.

The core of K-tel s music business involves the licensing of third party rights and the utilization of its own catalog to create music compilations for retail distribution. The major pre-recorded music companies, either directly or through subsidiaries, now manufacture or distribute pre-recorded music compilations in direct competition with K-tel s music compilation products. With this new competition, it is far more difficult for K-tel to access pre-recorded music from these major companies at acceptable rates. Therefore, the Company relies heavily on its own Dominion catalog and has accelerated the rate at which it produces new master recordings.

Another form of competition for the Company is the increasing ability for users and customers of pre-recorded music to download pre-recorded music electronically at home to various personal computer media formats. Although the technology and the related legal issues are still emerging, and although K-tel is pursuing opportunities offered by this technology, the Company is uncertain how this new technology will impact its current operations.

Intellectual Property

The Company believes that the K-tel® name and mark are well recognized and are therefore valuable assets of the Company. The Company pursues the registration of its trademarks and service marks in the U.S. and internationally. Effective trademark, service mark and copyright protection may not be available in every country in which its products and services are made available on-line. The Company has registered the trade mark K-tel®, variations of that mark and other marks relating to its products in the U.S. and internationally in various product and service categories. K-tel also claims rights in trademarks licensed by the Company in two pending U.S. trademark applications covering the marks K-TEL DRUG MART, and K-TEL MEDS. Federal and state trademark registrations continue indefinitely, so long as the trademarks are in use and periodic renewals and other required filings are made.

The Company regards its copyrights, service marks, trademarks, trade dress, trade secrets and similar intellectual property as critical to its success, and relies on trademark and copyright law, trade secret protection and confidentiality and/or license agreements with its employees, customers, partners and others to protect its proprietary rights. K-tel believes strongly in protecting its intellectual property and will seek protection for new products and marks whenever the Company believes it is advisable.K-tel cannot assure you that any trademarks held by it will be valid, enforceable or otherwise of value to the Company in relation to its competitors or the market in general, or that any trademark for which it has applied or may apply will be granted.

In addition to trademark protection, the Company generally obtains copyrights in music works, compilations and sound recordings.

Employees

On June 30, 2003, K-tel employed 21 full time people worldwide.

Financial and Geographic Information

For financial information about the Company s business segment and geographic area operations for each of the three fiscal years ended June 30, 2003 see Note 8 to the consolidated financial statements.

ITEM 2: PROPERTIES

K-tel s corporate offices and U.S. operations are located in leased facilities in Plymouth, a suburb of Minneapolis, Minnesota, consisting of approximately 4,000 square feet of office space and approximately 6,000 square feet of warehouse. K-tel s foreign subsidiaries lease a total of approximately 9,500 square feet of office and warehouse facilities. See Note 6 to the consolidated financial statements for a summary of the lease agreements. The Company believes that these facilities are adequate for its current needs.

ITEM 3: LEGAL PROCEEDINGS

Class Action Lawsuit

K-tel and certain of its current and former officers and directors were named as defendants in *In re K-tel International, Inc. Securities Litigation*, No. 98-CV-2480. This action consolidated twenty-three purported class actions that were initially filed in various United States District Courts in November 1998, and were subsequently transferred to, and consolidated in, the United States District Court for the District of Minnesota. On July 19, 1999, the plaintiffs filed an amended consolidated class action complaint that challenged the accuracy of certain public disclosures made by K-tel regarding its financial condition during the period from May 1998 through November 1998. The plaintiffs asserted claims under the federal securities laws and sought damages in an unspecified amount as well as costs, including attorneys fees and any other relief the Court deemed just and proper. K-tel moved to dismiss the complaint, and on July 31, 2000, the United States District Court granted the Company s motion to dismiss. The Court also barred further actions by the plaintiffs and denied plaintiffs request to amend the complaint in order to refile the complaint in the future. The plaintiffs appealed to the United States Court of Appeals for the Eighth Circuit, and the Court of Appeals heard the matter in October 2001. On August 7, 2002 the Court of Appeals, in a two to one decision, denied the plaintiffs appeal. On August 20, 2002, the plaintiffs applied for a rehearing by the full Court of Appeals. K-tel filed a response on September 15, 2002 to the plaintiffs petition for rehearing at the request of the Court. On October 2, 2002, the Court denied the petition for rehearing. The plaintiffs had until January 1, 2003 to seek a writ of certiorari (a petition asking the Court for a discretionary review of a lower court decision) from the United States Supreme Court, but did not seek this writ. There having been no appeal filed, the case has been dismissed with no further recourse available.

RTL Shopping S.A.

The Company has been named in a lawsuit filed in France brought by RTL9, a French cable TV station. The action seeks damages in the approximate amount of 20 million French Francs, or approximately $2.8 million. Initially, RTL9 was named as a defendant in a suit brought by a competitor of K-tel Marketing Ltd. alleging that RTL9 ran a commercial for K-tel Marketing which presented a product under brand names alleged to infringe on the competitor s own trademarks and also translated an English language script indicating that the product was just like or as good as others into better than in French, contrary to French law. The suit alleged trademark infringement, unfair competition, illicit comparative advertising and passing off. RTL9 then sued K-tel Marketing on October 4, 2000, pursuant to an indemnification provision the parties had entered into. Subsequently, K-tel Marketing went into liquidation and RTL9 filed a suit in December 2000 against K-tel International, Inc. under its agreement to guarantee payment for the commercial time. On May 28, 2001, RTL9 presented documents in court identifying K-tel International (USA), Inc. as a target of its claim. On September 3, 2001, the Company filed documents disputing the claim and advising the court of K-tel (USA) s Chapter 7 bankruptcy filing.

The Company believes that RTL9 has no basis for a complaint against the Company. As the result of information supplied by the parties to the Court, RTL9 has proposed to drop the lawsuit.

K-tel International, Inc. vs. Tristar Products, Inc.

On March 14, 2000, K-tel and its subsidiary in Germany commenced an action for breach of express and implied warranties against Defendant Tristar Products, Inc. This action is venued in the United States District Court for the District of Minnesota. This action arises out of Tristar s sale to K-tel of a defective home exercise product called the BunBlaster for resale in Germany, Austria and Switzerland. By written contract, Tristar has agreed to indemnify K-tel for injuries and damages arising out of the resale of those goods. K-tel is seeking approximately $2 million in consequential damages. Tristar is vigorously defending this claim. Discovery has been completed. Tristar has filed a Motion for Summary Judgment, to which the Company filed a Memorandum in Opposition. This motion was heard in U.S. District Court in Minneapolis on August 25, 2003. The Court has yet to rule on this motion.

On April 30, 2001, Tristar also asserted a patent and trademark/ trade-dress counterclaim against K-tel for allegedly passing off a product called the K-tel Hook and Hang while allegedly a distributor of the original patented Tristar Hook and Hang product. The Company denies the allegation because it never was a distributor of this or any similar product and intends to defend this action vigorously. Tristar has not identified the amount of damages it seeks with respect to this counterclaim. The United States District Court for the District of Minnesota issued an order on August 14, 2001 severing this action from the Company s action. This action is at an early stage and no discovery or other actions have occurred.

Other Litigation and Disputes

K-tel and its subsidiaries are also involved in other legal actions in the ordinary course of its business. With all litigation matters, management considers the likelihood of loss based on the facts and circumstances. If management determines that a loss is probable and the amount of loss can be reasonably estimated, such amount is recorded as a liability. Although the outcome of any such legal actions cannot be predicted, in the opinion of management there is currently no legal proceeding pending or asserted against or involving K-tel for which the outcome is likely to have a material adverse effect upon the consolidated financial position or results of operations of K-tel.

Subsidiaries   Bankruptcy and Liquidation

In March 2001, the Company s music distribution subsidiary in the United States, K-tel International (USA), Inc. ceased operations and filed for protection under Chapter 7 of the United States Bankruptcy Code. Pursuant to an agreement between the bankruptcy trustee and K-5 Leisure Products, Inc. (K-tel s secured creditor and controlling shareholder) entered into on March 3, 2003, the trustee released K-5 Leisure Products, Inc., K-tel and its subsidiaries and affiliates from any claims and actions with respect to the bankruptcy filing. The trustee filed a Limited Notice of Abandonment relative to K-5 s security interest in K-tel s assets. The Bankruptcy Court approved the abandonment as of June 13, 2003.

In November 2000, the Company s consumer products subsidiary in the United Kingdom, K-tel Marketing Ltd., ceased operations and began voluntary liquidation proceedings. At the initial meeting of the creditors on November 24, 2000, the creditors voted for the liquidation to become a creditors liquidation under English law. The Company has not been informed by the liquidators or their counsel of any plan to attempt to hold it or any of its subsidiaries liable for any of the commitments of K-tel Marketing Ltd. Management believes the Company will have no ongoing material liability related to K-tel Marketing Ltd. as a result of the liquidation proceeding.

ITEM 4: SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of K-tel s security holders during the fourth quarter of fiscal 2003.

ITEM 4A. EXECUTIVE OFFICERS OF THE REGISTRANT

The following table sets forth certain information with respect to the executive officers of K-tel at June 30, 2003.

Name of Officer	Age	Positions and Offices Held
Philip Kives	74	Chairman of the Board, Chief Executive Officer, President and Director
Dennis Ward	57	Chief Financial Officer, Secretary and Director

The officers of K-tel are elected annually and serve at the discretion of the Board of Directors.

Philip Kives has held various offices and/or managerial positions with K-tel for more than thirty-five years. Mr. Kives is currently the Company s Chairman, Chief Executive Officer and President.

Dennis W. Ward was appointed Chief Financial Officer and Secretary of K-tel on December 29, 2000 and has served as Controller of K-5 Leisure Products, Inc. (K-tel s largest shareholder) for more than twelve years.

PART II

ITEM 5: MARKET FOR REGISTRANT S COMMON STOCK AND RELATED STOCKHOLDER MATTERS

On September 22, 2003, there were 1,391 record holders of K-tel s common stock and 13,653,738 shares outstanding. The Company s common stock is traded on the Over-the-Counter Bulletin Board under the symbol KTEL .

The following table shows the range of high and low closing prices per share of K-tel s common stock for the fiscal year periods indicated. Such over-the-counter market quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission, and may not necessarily represent actual transactions.

	2003		2002	
	High	**Low**	**High**	**Low**
1st Quarter	$ .10	$ .05	$ .14	$ .10
2nd Quarter	$ .10	$ .04	$ .39	$ .12
3rd Quarter	$ .06	$ .04	$ .40	$ .13
4th Quarter	$ .18	$ .04	$ .15	$ .09

No cash dividends have been declared on K-tel s common stock during the past two fiscal years and K-tel does not expect to pay cash dividends in the foreseeable future. Management plans to use cash generated from operations for expansion of its business. The declaration or payment by K-tel of dividends, if any, on its common stock in the future is subject to the discretion of the Board of Directors and will depend on K-tel s earnings, financial condition, capital requirements and other relevant factors. The declaration or payment by K-tel of dividends is also subject to the terms of its credit facility.

Equity Compensation Plan Information

The following table provides information as of June 30, 2003 with respect to compensation plans under which the Company s equity securities are authorized for issuance.

	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	142,900(1)	$ 5.93	2,387,989(2)
Equity compensation plans not approved by security holders	300,000(3)	$ 0.05	NA
Total	442,900	$ 1.95	2,387,989

(1) Consists of 140,900 shares issuable pursuant to options granted under the Company s 1997 Stock Option Plan and 2,000 shares of common stock issuable pursuant to options granted under the Company s 1987 Stock Incentive Plan.

(2) Represents shares of common stock remaining available for future issuance under the Company s 1997 Stock Option Plan, as amended.

(3) Includes non-qualified stock options to purchase 95,000 shares of our common stock issued outside of the Company s 1997 Stock Option Plan to each of Jay William Smalley, Richard R. Marklund and Wesley C. Hayne in connection with such non-employee directors appointment to the Company s Compensation/ Stock Option Committee and a non-qualified stock option to purchase 15,000 shares of our common stock issued outside the Company s 1997 Stock Option Plan to Jay William Smalley in consideration of his past and continued service on the Company s board of directors. (See Director Compensation on page 18.) Does not include an aggregate of 2,137,939 shares of common stock issuable pursuant to a stock option exchange program approved on March 18, 2003 by a committee of the Company s board of directors comprised solely of independent directors. Under the program, four optionees agreed to cancellation of previously awarded options under the Company s 1997 Stock Option Plan and the Company agreed to issue options to purchase an equal number of shares outside the Company s stock option plan not earlier than six months and one day after the date of cancellation of the previously awarded options. The replacement options will be issued at an exercise price per share equal to the fair market value of the Company s common stock on the date of grant and will expire ten years after the date of grant. The options previously awarded were cancelled on March 18, 2003 and replacement options had not yet been granted as of the date of the table.

ITEM 6: SELECTED FINANCIAL DATA

The following summary of consolidated operations and certain balance sheet information includes the consolidated results of operations of K-tel and its subsidiaries as of and for the five years ended June 30, 2003. This summary should be read in conjunction with the consolidated financial statements and notes thereto appearing elsewhere in this filing. All share and per share amounts are based on the weighted average shares issued. All amounts are in thousands of dollars, except per share data.

	2003	2002	2001	2000	1999
Net sales	$ 7,234	$ 6,875	$ 17,514	$ 29,092	$ 44,650
Operating income (loss)	$ 53	$ (332)	$ (9,480)	$ (12,980)	$ (8,356)
Loss from discontinued operations	$ (581)				