

Bacterin International Holdings, Inc.
Form 10-Q
August 15, 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 June 30, 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 August 9, 2011: 39,645,561

BACTERIN INTERNATIONAL HOLDINGS, INC.
FORM 10-Q

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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

	June 30, 2011 (Unaudited)	As of December 31, 2010
ASSETS		
Current Assets:		
Cash and cash equivalents	\$ 1,402,407	\$ 327,481
Accounts receivable, net of allowance of \$79,684 and \$157,269, respectively	5,493,186	3,522,031
Accounts receivable - related party	666,173	613,034
Inventories, net	6,424,773	5,440,638
Prepaid and other current assets	480,249	572,015
	14,466,788	10,475,199
Non-current inventories	1,188,495	1,439,384
Property and equipment, net	3,394,241	3,397,320
Intangible assets, net	445,892	355,639
Note receivable - related party	82,398	82,398
Other assets	176,924	13,675
Total Assets	\$ 19,754,738	\$ 15,763,615
LIABILITIES & STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	\$ 2,479,491	\$ 2,260,237
Accounts payable - related party	-	573,036
Accrued liabilities	1,580,852	1,391,540
Warrant derivative liability	1,495,802	9,690,741
Current portion of capital lease obligations	22,779	30,105
Current portion of long-term debt	907,112	234,149
	6,486,036	14,179,808
Long-term Liabilities:		
Capital lease obligation, less current portion	23,430	13,185
Long-term debt, less current portion	4,278,442	2,189,866
Total Liabilities	10,787,908	16,382,859
Stockholders' Equity		
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; 38,858,894 shares issued and outstanding as of June 30, 2011 and 36,994,715 shares issued and outstanding on December 31, 2010	38	37
Additional paid-in capital	41,400,500	36,325,976

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Retained deficit	(32,433,708)	(36,945,257)
Total Stockholders' Equity	8,966,830	(619,244)
Total Liabilities & Stockholders' Equity	\$ 19,754,738	\$ 15,763,615

See notes to unaudited condensed consolidated financial statements.

BACTERIN INTERNATIONAL HOLDINGS, INC.
Condensed Consolidated Statements of Operations
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Revenue				
Tissue sales	\$ 7,370,048	\$ 3,185,772	13,238,972	\$ 5,890,747
Royalties and other	138,427	15,328	270,307	46,786
Total Revenue	7,508,475	3,201,100	13,509,279	5,937,533
Cost of tissue sales				
	1,742,144	519,082	2,729,443	1,123,704
Gross Profit	5,766,331	2,682,018	10,779,836	4,813,829
Operating Expenses				
General and administrative	1,410,679	1,940,807	3,708,054	3,406,945
Sales and marketing	4,331,145	1,683,853	8,595,426	3,126,570
Depreciation	157,019	151,661	304,177	304,162
Non-cash consulting expense	147,485	182,833	388,475	276,429
Total Operating Expenses	6,046,328	3,959,154	12,996,132	7,114,106
Loss from Operations	(279,997)	(1,277,136)	(2,216,296)	(2,300,277)
Other Income (Expense)				
Interest expense	(132,879)	(782,116)	(498,540)	(1,305,533)
Change in warrant derivative liability	7,579	7,719	7,226,385	(94,676)
Other income	-	531	-	6,455
Total Other Income (Expense)	(125,300)	(773,866)	6,727,845	(1,393,754)
Net Loss Before Benefit (Provision) for Income Taxes	(405,297)	(2,051,002)	4,511,549	(3,694,031)
Benefit (Provision) for Income Taxes				
Current	-	-	-	-
Deferred	-	-	-	-
Net Income (Loss)	\$ (405,297)	\$ (2,051,002)	4,511,549	\$ (3,694,031)
Net income (loss) per share:				
Basic	\$ (0.01)	\$ (0.07)	0.12	\$ (0.13)
Dilutive	(0.01)	(0.07)	0.10	(0.13)
Shares used in the computation:				
Basic	38,216,956	28,318,508	37,776,259	28,274,935
Dilutive	38,216,956	28,318,508	43,572,293	28,274,935

See notes to unaudited condensed consolidated financial statements.

BACTERIN INTERNATIONAL HOLDINGS, INC.
Condensed Consolidated Statements of Cash Flows
(Unaudited)

	Six Months Ended June 30,	
	2011	2010
Operating activities:		
Net income (loss)	\$4,511,549	\$(3,694,031)
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Depreciation and amortization	590,058	328,464
Non-cash consulting expense/stock option expense	671,004	356,427
Provision for losses on accounts receivable and inventory	72,415	51,902
Non-cash interest expense	-	586,534
Change in derivative warrant liability	(7,226,385)	94,676
Changes in operating assets and liabilities:		
Accounts receivable	(1,893,570)	(675,099)
Accounts receivable - related party	(53,139)	(206,063)
Inventories	(883,246)	(916,633)
Prepaid and other current assets	(71,483)	(271,082)
Accounts payable	(353,782)	118,282
Accrued liabilities	189,312	208,160
Net cash used in operating activities	(4,447,267)	(4,018,463)
Investing activities:		
Purchases of property and equipment	(269,413)	(40,903)
Notes receivable from stockholder	-	(82,255)
Intangible asset additions	(108,122)	(22,675)
Net cash used in investing activities	(377,535)	(145,833)
Financing activities:		
Proceeds from the issuance of long-term debt	2,579,688	-
Proceeds from the issuance of convertible notes	-	4,700,000
Payments on long-term debt	(86,157)	(204,272)
Payments on convertible debt	-	(340,000)
Payments on notes payable	-	(234,347)
Payments on capital leases	(28,769)	(50,349)
Payments on related party notes	-	(23,402)
Proceeds from issuance of stock	3,027,504	3,522,348
Proceeds from exercise of options	73,700	-
Proceeds from exercise of warrants	333,762	-
Purchase of treasury stock	-	(132,507)
Net cash provided by financing activities	5,899,728	7,237,471
Net change in cash and cash equivalents	1,074,926	3,073,175
Cash and cash equivalents at beginning of period	327,481	54,155
Cash and cash equivalents at end of period	\$1,402,407	\$3,127,330

See notes to unaudited condensed consolidated financial statements.

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Notes to Unaudited Condensed Consolidated Financial Statements (unaudited)

(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.

The accompanying interim condensed consolidated financial statements of Bacterin for the six months ended June 30, 2011 and 2010 are unaudited and are prepared in accordance with accounting principles generally accepted in the United States of America. They do not include all disclosures required by generally accepted accounting principles for annual financial statements, but in the opinion of management, include all adjustments, consisting only of normal recurring items, necessary for a fair presentation. Interim results are not necessarily indicative of results, which may be achieved in the future for the full year ending December 31, 2011.

These financial statements should be read in conjunction with the financial statements and notes thereto which are included in Bacterin’s Annual Report on Form 10-K for the year ended December 31, 2010. The accounting policies set forth in those annual financial statements are the same as the accounting policies utilized in the preparation of these financial statements, except as modified for appropriate interim financial statement presentation.

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 99% of sales in the United States for the first half of 2011. One customer accounted for approximately 17% and 7% of the Company’s revenue for the first half of 2011 and

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2010, respectively. One customer represented 23% and 6% of accounts receivable at June 30, 2011 and December 31, 2010, respectively.

Revenue by geographical region is as follows:

	Six months ended June 30,	
	2011	2010
United States	\$ 13,324,515	\$ 5,714,010
Rest of World	184,764	223,523
	\$ 13,509,279	\$ 5,937,533

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.

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 or 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.

The Company records a liability for all tax positions if it is not "more likely than not" that the position is sustainable based on its technical merits. The Company records interest and penalties related to tax positions with uncertainty in income tax expense. The Company had no such interest or penalties for the six months ended June 30, 2010 and June 30, 2011.

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	
	June 30,	
	2011	2010
Net Income (Loss)	\$ (405,297)	\$ (2,051,002)
Basic net income (loss) per share	\$ (0.01)	\$ (0.07)
Diluted net income (loss) per share	NA	NA
Weighted average common shares outstanding for basic net income (loss) per share	38,216,956	28,318,508
Weighted average common shares outstanding for diluted net income (loss) per share	NA	NA

Net Income (Loss) Per Share:	Six Months Ended	
	June 30,	
	2011	2010
Net Income (Loss)	\$ 4,511,549	\$ (3,694,031)
Basic net income (loss) per share	\$ 0.12	\$ (0.13)
Diluted net income (loss) per share	\$ 0.10	NA
Weighted average common shares outstanding for basic net income (loss) per share	37,776,259	28,274,935
Weighted average common shares outstanding for diluted net income (loss) per share	43,572,293	NA

Dilutive earnings per share are not reported for the three and six month periods ending June 30, 2010 and the three month period ending June 30, 2011 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 allowed the Company to draw down \$2.5 million initially. 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.

In the second quarter of 2011, the Company raised \$3,027,504 in a private placement transaction under Rule 506 of Regulation D. The transaction resulted in the issuance of 939,377 shares of the Company’s common stock and warrants to purchase 375,747 shares of the Company’s common stock.

On May 27, 2011, the Company entered into an equity purchase agreement with an asset management firm. Under the terms of the agreement, the Company received an initial investment of \$1 million as part of the Company’s private placement described above, through the sale of shares of its common stock to the asset management firm at \$3.06 per share, a price per share equal to the closing price on May 26th, 2011, together with warrants to purchase an additional 130,719 shares at the same price per share.

In addition, the asset management firm has committed to invest, up to an additional \$30 million through the purchase of shares of the Company's common stock from time to time. The transactions will be at the Company's sole option with no additional warrants granted.

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)

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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, other accrued expenses and long-term debt, approximate their fair values.

The Company follows a framework for measuring fair value. The framework provides a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). The three levels of the fair value hierarchy are described below:

Level 1: Inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets.

Level 2: Inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3: Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

A financial instrument's level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement.

The following tables set forth by level, within the fair value hierarchy, the Company's assets and liabilities as of June 30, 2011 and December 31, 2010 that are measured at fair value on a recurring basis:

Warrant derivative liability

	As of As of June 30, 2011	As of December 31, 2010
Level 1	-	-
Level 2	-	-
Level 3	\$ 1,495,802	\$ 9,690,741

The valuation technique used to measure fair value of the warrant liability is based on a lattice model and significant assumptions and inputs determined by the Company.

During the three and six months ended June 30, 2011, the Company did not change any valuation techniques used to measure financial assets and liabilities at fair value.

Level 3 Changes

The following is a reconciliation of the beginning and ending balances for liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during the period ending June 30, 2011:

Balance at January 1, 2011	\$9,690,741
Change in liability	8,194,939

Balance at June 30, 2011	\$1,495,802
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(2) Inventories

Inventories consist of the following:

	June 30, 2011	December 31, 2010
Current inventories		
Raw materials	\$ 966,000	\$ 709,800
Work in process	2,316,630	1,212,468
Finished goods	3,627,026	4,239,972
	6,909,656	6,162,240
Reserve	(484,883)	(721,602)
Current inventories, total	\$ 6,424,773	\$ 5,440,638
Non-current inventories		
Work in process	\$ -	\$ 588,295
Finished goods	1,188,495	851,089
Non-current inventories, total	\$ 1,188,495	\$ 1,439,384
Total inventories	\$ 7,613,268	\$ 6,880,022

(3) Property and Equipment, Net

Property and equipment, net are as follows:

	June 30, 2011	December 31, 2010
Buildings	\$ 1,613,628	\$ 1,613,628
Equipment	3,145,430	3,330,156
Computer equipment	276,260	255,170
Computer software	149,186	144,353
Furniture and fixtures	165,018	75,007
Leasehold improvements	1,272,806	902,916
Vehicles	68,306	68,306
Total cost	6,690,634	6,389,536
Less: accumulated depreciation	(3,296,393)	(2,992,216)
	\$ 3,394,241	\$ 3,397,320

Depreciation expense related to property, plant and equipment, including property under capital lease for the six months ended June 30, 2011 and 2010 was \$304,177 and \$304,162, respectively.

(4) 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:

	June 30, 2011	December 31, 2010
Intellectual Property		
Gross carrying value	\$ 563,605	\$ 455,483
Accumulated amortization	\$ (117,713)	\$ (99,844)
Net carrying value	\$ 445,892	\$ 355,639

Aggregate amortization expense for the period ended June 30, 2011 and 2010 was \$17,869 and \$24,302, respectively.

Estimated amortization expense:	
Remaining 2011	\$ 17,869
2012	\$ 35,738
2013	\$ 35,738
2014	\$ 35,738
2015	\$ 35,738
Thereafter	\$ 285,071

(5) Accrued Liabilities

Accrued liabilities consist of the following:

	June 30, 2011	December 31, 2010
Credit cards	\$ -	\$ 7,597
Accrued stock compensation	424,305	197,763
Wages payable	202,402	415,386
Accrued commissions	732,768	662,623
Other accrued expenses	221,377	108,171
	\$ 1,580,852	\$ 1,391,540

(6) 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:

	June 30, 2011	December 31, 2010
Revolving credit facility payable to Bridge Bank, interest of Prime plus 2.25%, secured by accounts receivable and personal property	\$ 2,575,000	\$ -
	1,485,850	1,500,000

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6.00% loan payable to Valley Bank of Belgrade, \$10,746 monthly payments including interest, maturing December 24, 2030; secured by building

12.553% loan payable to Venture Lending and Leasing, variable monthly payments, maturing in November, 2013, secured by equipment	1,216,339	1,250,000
12.553% loan payable to Venture Lending and Leasing, variable monthly payments, maturing in November, 2013, secured by equipment	1,216,339	1,250,000
	6,493,528	4,000,000
Less: Current portion	(907,112)	(234,149)
Debt discount	(1,307,974)	(1,575,985)
	\$ 4,278,442	\$ 2,189,866

The following is a summary of maturities due on the debt as of June 30, 2011:

Remainder 2011	\$ 440,143
2012	964,126
2013	3,713,939
2014	49,210
2015	52,245
Thereafter	1,273,867
Total	\$ 6,493,530

(7) Stock-Based Compensation

The Company's Equity Incentive Plan ("The 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 June 30, 2011, the Company had approximately 89,607 shares available for issuance under the equity plan. Subsequent to June 30, 2011, the shareholders approved an increase of 3,000,000 available shares under the Plan.

Stock compensation expense recognized in the statement of operations for the three months ended June 30, 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. The Company used a rate of 2.5% as of June 30, 2011.
- **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. The Company used an expected term of 6.3 years as of June 30, 2011.
- **Volatility:** The Company estimates expected volatility based on peer-companies as prescribed by ASC 718. The Company used a volatility rate of 46% as of June 30, 2011.
- **Dividend Yield:** The dividend yield assumption is based on the Company's history and expectation of dividend payouts and was 0% as of June 30, 2011 and 2010.

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

	Six months ended June 30, 2011			Six months ended June 30, 2010		
	Shares	Weighted Average Exercise Price	Weighted Average Fair Value at Grant Date	Shares	Weighted Average Exercise Price	Weighted Average Fair Value at Grant Date
Outstanding at Jan. 1,	3,850,743	\$ 1.38	\$0.83	3,353,493	\$ 1.33	\$0.61
Granted	757,250	4.10	1.91	1,082,880	1.67	0.77
Exercised	(55,000)	1.34	0.49	-	-	-
Cancelled or expired	(498,000)	3.27	1.75	(464,400)	1.56	0.69
Outstanding at June 30,	4,054,493	\$ 1.99	\$0.83	3,971,973	\$ 1.44	\$0.53
Exercisable at June 30,	1,508,243	\$ 1.75	\$0.57	1,448,352	\$ 1.17	\$0.53
						Weighted Average Fair Value at Grant Date
Unvested at January 1, 2011				2,330,750		0.71
Granted				757,250		1.91
Vested				(307,000)		0.65
Cancelled or Expired				(234,750)		3.27
Unvested at June 30, 2011				2,546,250		0.74

The total intrinsic value of options exercised in the first half of 2011 was \$93,600. The aggregate intrinsic value of options outstanding as of June 30, 2011 is \$6,040,385. The aggregate intrinsic value of exercisable options as of June 30, 2011 is \$4,006,465. As of June 30, 2011, the total compensation related to nonvested awards not yet recognized is \$2,033,920 and is expected to be recognized over 3.7 years.

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.

(8) Warrants

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.

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 WTI 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. As a result of the second quarter of 2011 private placement, WTI received an additional 133,474 warrants resulting in a total of 508,474 warrants owned by WTI and the strike price was reduced to \$2.95. 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.

Associated with the second quarter of 2011 private placement of common stock, 375,747 warrants with exercise prices ranging from \$2.95 to \$3.52 were issued to the participants. Warrants issued with common stock under this private placement were recorded as additional paid in capital at their estimated fair market value of \$312,285 during the second quarter of 2011.

The estimated fair value was derived using the Black Scholes model with the following assumptions:

Value of underlying common stock (per share)	\$2.84	
Risk free interest rate	1.76	%
Expected term	2.5	years
Dividend yield	0	%
Volatility	52	%

The following table summarizes our warrant activities for the period ended June 30, 2011:

	Shares	Weighted Average Exercise Price
Outstanding at January 1, 2011	7,291,560	\$ 2.08
Issued	375,747	3.22
Exercised	(581,808)	1.75
Cancelled or expired	-	-
Outstanding at June 30, 2011	7,085,499	2.17

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. The Company recorded an unrealized gain of \$7,579 and \$7,226,385 resulting from the change in the fair value of the warrant derivative liability for the three and six month periods ended June 30, 2011, respectively. 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.

Activity for the warrants included in the derivative liability is as follows:

Balance at January 1, 2011	\$ 1,595,473
Derivative warrants issued	\$ 133,474
Derivative warrants exercised	\$ (222,940)
Balance at June 30, 2011	\$ 1,506,007

(9) Commitments and Contingencies

Operating Leases

The Company leases two office facilities under non-cancelable operating lease agreements with expiration dates in 2013. For one facility, 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 June 30, 2011, under these leases, are as follows:

Remainder 2011	\$ 69,000
2012	\$ 174,700
2013	\$ 103,000
Thereafter	\$ -

Rent expense was \$85,053 and \$71,492 for the six months ended June 30, 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.

Litigation

From time to time, the Company is involved in legal proceedings arising in the ordinary course of business. 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.

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

In evaluating the realizability of the net deferred tax assets, the Company takes into account a number of factors, primarily relating to the ability to generate taxable income. Where it is determined that it is likely that the Company will be unable to realize deferred tax assets, a valuation allowance is established against the portion of the deferred tax asset. Because it cannot be accurately determined when or if the Company will become profitable, a valuation allowance was provided against the entire deferred income tax asset balance.

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 June 30, 2011 the federal and state 2010 income tax returns were not filed, however extensions were timely filed.

(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:

	Six months ended June 30,	
	2011	2010
Supplemental disclosure of cash flow information		
Cash paid during the period for:		
Interest	\$ 361,861	\$ 274,611
Income taxes	-	-
Non-cash investing and financing activities:		
Conversion of accounts payable into common stock	\$ 600,000	-
Decrease in warrant derivative liability due to warrant exercises	\$ 958,554	-
Conversion of convertible notes payable into common stock	-	\$ 3,482,324
Conversion of note payable into common stock	-	\$ 52,404

(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 and one of our directors, Mitchell Godfrey, also serve as Board members 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 \$1,327,876 to West Coast Tissue Services and \$1,887,329 to American Donor Services. At June 30, 2011 the Company had an accounts receivable-related party from West Coast Tissue Services of \$666,173. Accounts payable to American Donor Services of \$600,000 as of May 2, 2011 was converted to 170,454 shares of common stock. As of June 30, 2011, the Company had an accounts payable of \$300,034 to American Donor Services. No compensation is paid to our Chief Executive Officer, our VP – Biologics or our director for their services to those entities.

At June 30, 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 September 30, 2011.

(14) Subsequent Events

On July 11, 2011, the Company signed an Asset Purchase Agreement (“Agreement”) with Robinson MedSurg, LLC (“Seller”), a company engaged in the manufacture, distribution and sale of implantable medical devices for maxillofacial, craniofacial and orthopedic uses. Under the terms of the Agreement, the Company purchased certain assets from Seller, as described in the Agreement, for \$1 million in common stock of the Company. In addition, the Company agreed to pay Seller an additional \$500,000 in common stock when gross revenue from the sale of products resulting from the purchased assets (“Products”) equals or exceeds \$1 million, and an additional \$500,000 in common stock when gross revenue from the sale of Products equals or exceeds \$2 million, provided that such gross revenue thresholds are achieved within 2 years. The Company also engaged the sole member of Seller as a consultant. The Company will account for this business combination under the acquisition method in accordance with ASC 805, which requires the acquiring entity in a business combination to recognize all (and only) the assets acquired and liabilities assumed in the transaction; establishes the acquisition-date fair value as the measurement objective for all assets acquired and liabilities assumed; and requires the acquirer to disclose to investors and other users all of the

information they need to evaluate and understand the nature and financial effect of the business combination.

On July 29, 2011, the Company entered into Loan and Security Agreement with MidCap Funding III, LLC (“MidCap”), whereby MidCap and Silicon Valley Bank (“SVB”) agreed to provide a \$15 million credit facility which allows the Company to borrow \$7 million initially, and gives the Company the ability to borrow up to an additional \$8 million through December 31, 2011 in connection with a permitted acquisition. The credit facility is secured by substantially all of the Company’s assets and carries an interest rate of LIBOR plus 7.5%, subject to a LIBOR floor rate of 3%. Repayment will be interest only for the first nine months, with principal and interest for the subsequent 33 months.

In connection with the MidCap financing described above, MidCap and SVB received warrants to purchase shares of the Company’s common stock equal to 7% of the amount drawn on the credit facility divided by the exercise price of \$2.55 per share. The warrants have a seven year term. MidCap and SVB also have the right to receive additional warrants if additional amounts are drawn under the facility.

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, which was subsequently changed to BONE when it began trading on the NYSE on March 7, 2011.

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.

Results of Operations

Comparison of Three Months Ended June 30, 2011 and 2010

Revenue

Total revenue for the three months ended June 30, 2011 increased 135% to \$7,508,475 compared to \$3,201,100 in the comparable prior year period. The increase of \$4,307,375 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. In addition, as part of its ongoing strategy, the Company entered into an agreement for the sale to a US based distributor of biologics products to be sold in international countries.

Cost of tissue sales

Cost of tissue sales consist primarily of tissue and device manufacturing costs. Cost of tissue sales increased by 236% or \$1,223,062 to \$1,742,144 for the second quarter of 2011 from \$519,082 for the second 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 decreased to 77% from 84%, primarily due to lower margins resulting from discounts associated with the sale of biologic products to a US based distributor who will sell the Company's products in international countries.

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 53%, or \$2,087,174, for the three months ended June 30, 2011 compared to the three months ended June 30, 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 decreased 27%, or \$530,128, to \$1,410,679, for the three months ended June 30, 2011 compared to the same period of 2010. The decrease is largely due a decrease in legal fees resulting from higher expenses in 2010 leading up to the reverse merger as well as a decrease in stock option expense.

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 157%, or \$2,647,292, to \$4,331,145 for the three months ended June 30, 2011 from \$1,683,853 for the comparable prior year period. As a percentage of revenue, selling and marketing expenses increased to 58% in the second 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, increasing slightly to \$157,019 for the three months ended June 30, 2011 from \$151,661 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. Non-cash consulting expense decreased \$35,348 to \$147,485 for the second quarter of 2011 from \$182,833 for the second quarter of 2010. As a percentage of revenues, non-cash consulting expense for the three months ended June 30, 2011 was 2%, compared to 6% in the comparable prior year period.

Interest Expense

Interest expense is from our promissory notes. Interest expense for the three months ended June 30, 2011 decreased 83%, to \$132,879, as compared to the three months ended June 30, 2010. The decrease was the result of interest being incurred on convertible notes in the first half of 2010. Those notes were converted to common stock as of June 30, 2010 and therefore discontinued earning interest.

For the second quarter of 2011, the Company recorded an unrealized gain of \$7,579 associated with the change in the fair value of its warrant derivative liability.

Comparison of Six Months Ended June 30, 2011 and 2010

Revenue

Total revenue for the six months ended June 30, 2011 increased 128% to \$13,509,279 compared to \$5,937,533 in the comparable prior year period. The increase of \$7,571,746 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

Cost of tissue sales consist primarily of tissue and device manufacturing costs. Cost of tissue sales increased by 143% or \$1,605,739 to \$2,729,443 for the first half of 2011 from \$1,123,704 for the first half of 2010. The increase was the result of increased costs associated with our higher sales. As a percentage of revenues, our gross profit percentage

decreased slightly to 80% from 81%. The margin growth due to increased manufacturing efficiencies was offset by lower margins on a significant stocking order to a US based distributor of biologics products to international countries.

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 83%, or \$5,882,026, for the six months ended June 30, 2011 compared to the six months ended June 30, 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 9%, or \$301,109, to \$3,708,054, for the six months ended June 30, 2011 compared to the same period of 2010. The increase is largely associated with increased personnel costs which was partially offset by lower legal and stock option expense in 2011.

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 175%, or \$5,468,856, to \$8,595,426 for the six months ended June 30, 2011 from \$3,126,570 for the comparable prior year period. As a percentage of revenue, selling and marketing expenses increased to 64% in the first half 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 at \$304,177 for the six months ended June 30, 2011 from \$304,162 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. Non-cash consulting expense increased \$112,046 to \$388,475 for the first half of 2011 from \$276,429 in the first half of 2010. As a percentage of revenues, restricted stock expense for the six months ended June 30, 2011 was 3%, compared to 5% in the comparable prior year period.

Interest Expense

Interest expense is from our promissory notes. Interest expense for the six months ended June 30, 2011 decreased 62%, to \$498,540, as compared to the six months ended June 30, 2010. The decrease was the result of interest being incurred on convertible notes in the first half of 2010. Those notes were converted to warrants as of June 30, 2010 and therefore discontinued earning interest.

For the first half of 2011, the Company recorded an unrealized gain of \$7,226,385 associated with the change in fair value of its warrant derivative liability. The unrealized gain in 2011 is primarily due to the decrease in the Company's stock price from December 31, 2010 to the closing price on June 30, 2011.

Liquidity and Capital Resources

At June 30, 2011, we had approximately \$6,895,593 of cash and cash equivalents and accounts receivables. In addition, subsequent to June 30, 2011, we have secured access to a \$15 million credit facility which enabled the Company to borrow \$7 million initially, and gives the Company the ability to borrow up to an additional \$8 million through December 31, 2011 in connection with a permitted acquisition. In connection with the transaction, the Company repaid its outstanding loans and accrued interest to Bridge Bank and WTI resulting in net proceeds of approximately \$1.4 million to the Company.

Net cash used in operating activities for the first half of 2011 was \$4,447,267. This was primarily related to cash used to fund our operations as well as an increase of accounts receivable of \$1,893,570 and an increase in our inventory balance of approximately \$883,246 in the first six months of 2011. For the first half of 2010, net cash used in operating activities was \$4,018,463 due primarily to a net loss of \$3,694,031 for the period in addition to negative changes to working capital.

Net cash provided by financing activities was \$5,899,728 and \$7,237,471 for the first six months of 2011 and 2010, respectively. The net cash provided from financing activities during 2011 was primarily the result of \$3,027,504 in a private placement as well as the draw down of approximately \$2,579,688 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 June 30, 2011 cash on hand and accounts receivable balance of \$6,898,616, as well as our recently secured additional credit lines 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 June 30, 2011. Based upon that evaluation, we concluded that as of June 30, 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 June 30, 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 June 30, 2011 due to material weaknesses in our internal control over financial reporting that have not been fully remediated as of June 30, 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 has recently purchased an integrated accounting operating and inventory system. Currently, the Company expects to implement the system during the fourth quarter 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, tortuous interference with the sales contract. Plaintiff seeks \$300,000, 358,904 shares of our common stock, attorneys fees and costs.

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.

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 \$3,027,504 in a private placement transaction under Rule 506 of Regulation D, which resulted in the issuance of 939,377 shares of the Company's common stock and warrants to purchase 375,747 shares of the Company's common stock. The transaction was funded in three 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 used the proceeds from the private placement for working capital and general corporate purposes. 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

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
- 101.1 Interactive Data File

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: August 15, 2011

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

Date: August 15, 2011

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