



**CANDELA**

*Delivering Aesthetic Laser Solutions Worldwide*

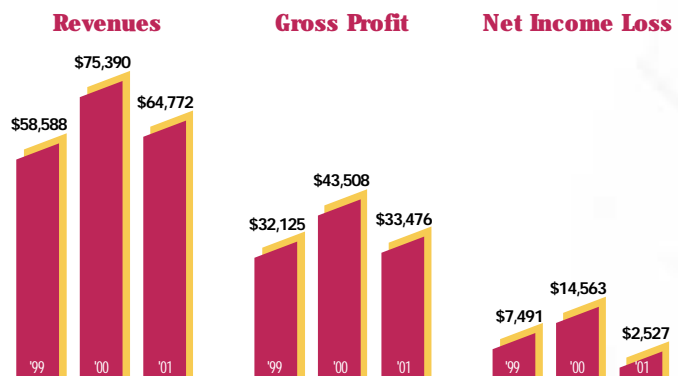
Annual Report 2001

Candela Corporation  
 Candela Deutschland GmbH  
 Candela France SARL  
 Candela Iberica, S.A.  
 Candela KK

*All over the world, people share a common desire to look and feel their best. As demand for cosmetic and medical laser procedures grows, Candela Corporation delivers faster, smaller, more affordable laser systems that give growing numbers of physicians and other practitioners a wider range of treatments in order to enhance their practice.*

*Candela's continued success and growing global presence are the result of a simple formula: combine efficacy and economics to help our customers succeed.*

## Financial Highlights



	Fourth Quarter Ended		Fiscal Year Ended	
	June 30, 2001	July 1, 2000	June 30, 2001	July 1, 2000
Revenues	\$18,177	\$22,364	\$64,772	\$75,390
Gross Profit	9,658	12,837	33,476	43,508
Net Income (Loss)	(44)	4,946	2,527	14,563
Earnings (Loss) Per Share – Diluted	\$0.00	\$0.40	\$0.22	\$1.19
Adjusted Weighted Average Shares Outstanding	10,752	12,225	11,521	12,190

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## About Candela

Founded in 1970, Candela Corporation develops, manufactures, and distributes advanced aesthetic laser systems that enable physicians and personal care practitioners to treat a wide range of cosmetic and medical conditions. Today, Candela has an installed base of over 5,000 systems in 55 countries.

Candela's extensive line of laser systems is used by dermatologists, plastic surgeons, family practitioners, obstetricians, gynecologists, and general and vascular surgeons for removal of unwanted hair and vascular lesions, as well as the treatment of pigmented lesions and tattoos and other skin treatments.

## To Our Stockholders

Fiscal year 2001 tested our resolve and commitment.

While profitable, revenues fell \$11 million this year over last year. The primary shortfall came from our domestic operations where intense and growing competition in our direct markets and internal disruption at Physician Sales & Service, Inc. (PS&S) in our opportunity markets combined for greater than \$8 million of the shortfall. The remaining shortfall was in our international markets where a strong U.S. dollar effectively and dramatically increased local prices, driving down demand.

While revenues in the second half of the fiscal year were decidedly better than the first half, we believe it may not be until the second half of calendar year 2002 before we can return to a sustainable pattern of growth.

Despite a disappointing sales performance, there were some noteworthy events during the year, including:



- The appointment of Dr. Kathleen McMillan as Vice President of Research. Dr. McMillan was employed by Candela for many years before taking a three-year stay within the research hierarchy of New England Medical Center/Tufts University School of Medicine. We are delighted she has returned to steer and accelerate our research programs toward additional commercial products.
- The receipt of FDA clearance for the treatment of psoriasis.
- The receipt of FDA clearance for permanent hair reduction using the GentleLASE®.
- The receipt of FDA clearance for the treatment of rosacea.
- The introduction of the Smoothbeam™, a diode laser incorporating the Dynamic Cooling Device™, (DCD™), for incision, ablation, and vaporization with hemostasis of soft tissue.
- The introduction of the GentleYAG™ high-energy, long-pulse Nd:YAG laser designed for the removal of unwanted hair and large leg veins for darker skin types V and VI.

Also, during the fiscal year, Mr. Ted Johnson retired from our Board of Directors after more than a decade of service. Over the years, Ted provided counsel to me and the senior management team. He was always a steady hand at times when such was most needed. I personally want to thank him for his contributions to the Company, and wish him all the best.

As we head into the coming fiscal year, we have not, and will not, lose sight of the fact that shareholder value is Job #1. We believe our new product introductions, as well as a stabilization of our distribution channels, will allow us to return to a pattern of growth. Furthermore, we will look at acquisition opportunities that, through operating synergies, are accretive to our organic growth plan. Given the current slowdown in general business conditions, the Company is confident that its strong cash reserves will allow it to continue to make the investments necessary for the future of the Company.

I look forward to communicating further with you as our plans unfold.

Best regards,

A handwritten signature in black ink, appearing to read "Gerard E. Puorro". The signature is fluid and cursive.

Gerard E. Puorro

President & Chief Executive Officer



# Introducing New “Gentle” Innovations

*A pioneer in laser technology, Candela was the first to introduce the pulsed dye laser, with its patented Dynamic Cooling Device (DCD), and an affordable hair removal laser. In 2001, Candela once again demonstrated its ability to take laser technology to new levels of innovation. The Company introduced the Smoothbeam, a diode laser for incision, excision, ablation, and vaporization with hemostasis of soft tissue, and the GentleYAG hair removal laser for darker skin types, including V and VI and tanned skin.*

## Smoothbeam Launches

Candela released its diode-based laser system, Smoothbeam which includes Candela's proprietary Dynamic Cooling Device with a unique 1450 nm wavelength.



### Hair Removal for Every Need

#### GentleLASE Plus

- Permanent hair reduction and large leg vein removal

#### GentleYAG

- Hair and large leg vein removal for darker and tanned skin

#### GentleLASE LE

- Laser hair removal

### More Aesthetic Solutions

Candela enables practices to offer a wide array of aesthetic services.

Other products include:

#### GentlePeel™

- Microdermabrasion

#### ALEXLAZR™

- Removal of pigmented lesions and tattoos



## GentleYAG Broadens the Candela Hair Removal Family

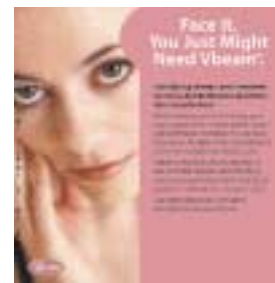
Removal of unwanted hair is big business the world over and growing. In the U.S. alone, women spend over \$2 billion annually on hair removal procedures. Such demand makes the growing GentleLASE family of lasers key drivers for Candela's success.

The newest addition to the GentleLASE family is the GentleYAG, an Nd:YAG long-pulse laser that provides safe, effective hair and large leg vein removal for darker skin. GentleYAG joins the GentleLASE Plus, the best-selling hair removal laser in the world today, and GentleLASE LE (Limited Edition), a laser affordably priced for the electrology practice. Together, these lasers provide the market with safe, effective, fast, versatile, and affordable hair removal lasers for a wide variety of patient skin types and practitioner needs.

## Vbeam™ Delivers Purpura-Free Treatment Capability

Success continued in 2001 for Candela's Vbeam, the first pulsed dye laser capable of purpura-free treatment for a wide variety of vascular lesions. Physicians worldwide have discovered Vbeam's versatility in treating facial spider veins, rosacea, scars, stretch marks, warts, leg veins, port wine stains, and hemangiomas.

Candela also began offering Vbeam users a best-of-class marketing tool kit, complete with promotional materials, print advertisements, and a direct mail campaign to help customers generate greater procedure volumes. Easily customized for any size practice, Candela's marketing tool kit signals the Company's commitment to make a Candela laser purchase the most value-added in the industry.



**Practice Builder**  
*In 2001, Candela began supporting customers with marketing tool kits to help physicians and other practitioners maximize the value of their Candela lasers.*



# Reaching Out to Customers and the Community

*Nationally and internationally, Candela turned up the volume in sales and education efforts in 2001. The Company opened a third Japan office in Nagoya City to reach an important Asian market. The sales force fanned out across the U.S. to present hands-on laser workshops. Overall, Candela's installed product base continued to expand at an impressive rate to approximately 5,000 laser systems in 55 countries.*

## Laser Symposia Launch in U.S.

Candela took to the road in 2001 to present nearly 100 laser symposia in key geographic centers. The symposia featured lectures by thought leaders, live patient demonstrations, and hands-on experience under the tutelage of renowned physicians and practitioners. Symposium participants included physicians, nurses, electrologists, technicians, and laser practitioners.

Encouraged by heavy participation, the Company plans to roll out this successful format to international markets as well in the coming year.



*"Laser technology is so much smaller, faster and more affordable that we practitioners can now have ultra-sophisticated tools right in our offices. Our patients appreciate how little discomfort there is, and how easy it is to just come to the office rather than the hospital."*

*Steve J. Ugent, M.D.  
Dermatology Associates P.C., Mass.*

## Leadership Initiatives Expand

Candela's commitment to community service grew in 2001. The Company became a corporate sponsor of the National Psoriasis Foundation, and Candela President and CEO Gerard E. Puorro was appointed to the Board of Directors for the Sturge-Weber Foundation. The Company also supports the Foundation annually with a 5K Fun Run/Walk. Candela employees volunteered for the WGBH-TV Telethon in Boston, a major fundraising event for one of the Public Broadcasting System's premier educational affiliates.



# Broadening Our Horizons



What does the future hold for Candela? Continued growth, led in the coming year by the introduction of an exciting new FDA-cleared laser for the treatment of psoriasis, a debilitating condition that affects 80 million people worldwide. Candela has also increased R&D and engineering capacity to support expanding applications for its technologies. Candela also plans to launch a global marketing campaign in 2001 to capture a greater share of the growing world market for aesthetic laser procedures.

Together with a strong product line that continues to grow and laser-like focus on the needs of Candela customers, these efforts should leave no doubt as to the rewarding market position Candela occupies today: a worldwide leader in delivering aesthetic laser solutions.



## Candela

*Light-Years Ahead of the Rest*



### Sturge-Weber Foundation

The Sturge-Weber Foundation is a nonprofit organization for parents, professionals, and others concerned with Sturge-Weber Syndrome (SWS). SWS is a debilitating disease that causes glaucoma, seizures, and developmental disabilities, along with its most identifying characteristic, the port wine stain.

Success also followed Candela to the print and broadcast media. Candela and Candela lasers appeared in national consumer magazines, including *Elle*, *Glamour*, and *Ladies Home Journal*, and on regional and national television, including a segment on the popular ABC morning show, *The View*, touting Vbeam as a “medical breakthrough.”

## Market for the Registrant's Common Stock and Related Stockholder Matters

Candela's common stock trades on the NASDAQ stock market under the symbol CLZR.

At September 24, 2001, there were 369 holders of record of the Company's common stock, and the closing sale price of the Company's common stock was \$5.15.

The following table sets forth quarterly high and low closing sales prices of the common stock for the indicated fiscal periods:

	FISCAL 2001		FISCAL 2000	
	HIGH	LOW	HIGH	LOW
First Quarter	\$13.4380	\$9.2500	\$11.7500	\$6.7087
Second Quarter	10.6880	5.2500	12.7500	6.7087
Third Quarter	9.1250	5.3750	18.1250	11.5420
Fourth Quarter	7.9800	6.5000	14.0000	9.0000

### Dividend Policy

The Company has never paid a cash dividend and has no present intention to pay cash dividends in the foreseeable future. The Board of Directors currently intends to retain any future earnings for use in the Company's business.

*All statements, trend analysis, and other information contained in the following discussion relative to markets for our products and trends in revenue, gross margins, and anticipated expense levels, as well as other statements including words such as "anticipate," "believe," "plan," "estimate," "expect," and "intend" and other similar expressions constitute forward-looking statements. These forward-looking statements are subject to business and economic risks and uncertainties, and our actual results of operations may differ materially from those contained in the forward-looking statements. Factors that could cause or contribute to such differences include but are not limited to those discussed in "Cautionary Statements" as well as other risks and uncertainties referenced in this annual report.*

## Selected Consolidated Financial Data

The table set forth below contains certain consolidated financial data for each of the last five fiscal years of the Company. This data should be read in conjunction with the detailed information, financial statements and related notes, as well as Management's Discussion and Analysis of Financial Condition and Results of Operations included elsewhere herein.

	For the Year Ended				
(in thousands, except per share data)	June 30 2001	July 1 2000	July 3 1999	June 27 1998	June 28 1997
<b>Consolidated Statement of Operations Data:</b>					
<b>Revenue:</b>					
Lasers and other products	\$48,375	\$60,340	\$46,708	\$25,917	\$25,601
Product-related service	12,498	11,320	8,801	8,405	7,660
Skin care centers	3,899	3,730	3,079	2,703	2,244
Total revenue	64,772	75,390	58,588	37,025	35,505
<b>Cost of sales:</b>					
Lasers and other products	21,208	22,703	18,623	11,272	11,195
Product-related service	7,676	6,802	5,715	6,954	5,563
Skin care centers	2,412	2,377	2,125	2,481	1,892
Total cost of sales	31,296	31,882	26,463	20,707	18,650
<b>Gross profit:</b>					
Lasers and other products	27,167	37,637	28,085	14,645	14,406
Product-related service	4,822	4,518	3,086	1,451	2,097
Skin care centers	1,487	1,353	954	222	352
Total gross profit	33,476	43,508	32,125	16,318	16,855
<b>Operating expenses:</b>					
Research and development	5,575	4,822	3,998	2,399	2,488
Selling, general & administrative (3)	24,076	21,669	17,891	15,271	13,680
Restructuring charges (1)(2)	1,113	-	-	2,609	-
Total operating expenses	30,764	26,491	21,889	20,279	16,168
Income (loss) from operations	2,712	17,017	10,236	(3,961)	687
<b>Other income (expense):</b>					
Interest income	1,652	1,427	115	42	84
Interest expense	(437)	(482)	(492)	(235)	(107)
Other income (expense), net	33	242	(3)	(123)	(26)
Total other income (expense)	1,248	1,187	(380)	(316)	(49)
<b>Income (loss) before income taxes</b>	3,960	18,204	9,856	(4,277)	638
Provision for income taxes	1,433	3,641	2,365	175	400
<b>Net income (loss)</b>	<b>\$2,527</b>	<b>\$14,563</b>	<b>\$7,491</b>	<b>\$(4,452)</b>	<b>\$238</b>
Basic earnings (loss) per share	\$0.23	\$1.33	\$0.91	\$(0.54)	\$0.03
Diluted earnings (loss) per share	\$0.22	\$1.19	\$0.82	\$(0.54)	\$0.03
Weighted average shares outstanding	10,928	10,932	8,250	8,219	8,097
Adjusted weighted average shares outstanding	11,521	12,190	9,179	8,219	8,510

## Selected Consolidated Financial Data

	For the Year Ended				
	June 30 2001	July 1 2000	July 3 1999	June 27 1998	June 28 1997
<small>(in thousands, except per share data)</small>					
<b>Consolidated Balance Sheet Data:</b>					
Cash and cash equivalents	\$32,318	\$34,863	\$10,055	\$ 1,615	\$ 2,674
Working capital	42,310	44,255	13,186	2,639	7,032
Total assets	74,018	73,164	36,451	22,604	24,837
Long-term debt	2,815	3,034	3,181	887	1,519
Total stockholders' equity	46,974	48,563	14,023	5,395	10,246
Total liabilities and stockholders' equity	74,018	73,164	36,451	22,604	24,837

- (1) During the quarter ended December 27, 1997, a restructuring charge was recorded and a reserve established in the amount of \$2.6 million resulting from the closure of the skin care center located in Scottsdale, Arizona.
- (2) During the quarter ended June 30, 2001, an additional restructuring charge of \$1.1 million was recorded resulting from the change in estimate of future sublease payments regarding the skin care center located in Scottsdale, Arizona.
- (3) During the quarter ended June 30, 2001, an asset impairment charge of \$640,000 was recorded for the long-lived assets, principally, leasehold improvements, located at the skin care center located in Boston, Massachusetts.

## Management's Discussion and Analysis of Financial Condition and Results of Operations

### Results of Operations

The following tables set forth selected financial data for the periods indicated, expressed as percentages.

	For the Year Ended		
	June 30 2001	July 1 2000	July 3 1999
<b>Revenue Mix:</b>			
Lasers and other products	74.7 %	80.0 %	79.7 %
Product-related service	19.3 %	15.0 %	15.0 %
Skin care centers	6.0 %	5.0 %	5.3 %
Total revenue	100.0 %	100.0 %	100.0 %
<b>Operating Ratios:</b>			
<b>Gross profit:</b>			
Lasers and other products	56.2 %	62.4 %	60.1 %
Product-related service	38.6 %	39.9 %	35.1 %
Skin care centers	38.1 %	36.3 %	31.0 %
Total gross profit	51.7 %	57.7 %	54.8 %
<b>Operating expenses:</b>			
Research and development	8.6 %	6.4 %	6.8 %
Selling, general, and administrative	37.2 %	28.7 %	30.5 %
Restructuring charge	1.7 %	0.0 %	0.0 %
Total operating expenses	47.5 %	35.1 %	37.3 %
Income from operations	4.2 %	22.6 %	17.5 %
Total other income (expense)	1.9 %	1.5 %	(0.6)%
<b>Income before income taxes</b>	<b>6.1 %</b>	<b>24.1 %</b>	<b>16.9 %</b>
Provision for income taxes	2.2 %	4.8 %	4.0 %
<b>Net income</b>	<b>3.9 %</b>	<b>19.3 %</b>	<b>12.8 %</b>

## *Management's Discussion and Analysis of Financial Condition and Results of Operations*

### **Fiscal Year Ended June 30, 2001 Compared to Fiscal Year Ended July 1, 2000**

**Revenue.** Total revenue declined 14% to \$64.8 million in fiscal 2001 from \$75.4 million in fiscal 2000. International revenue, consisting of sales from our subsidiaries in Germany, Spain, France, and Japan, and sales shipped directly to international locations from the U.S., was 55% of total revenue for fiscal 2001 in comparison to 52% for fiscal 2000. Laser and product revenue decreased 19.8% to \$48.4 million in fiscal 2001 from \$60.3 million in fiscal 2000. This decrease was due to a shortfall in the second quarter of fiscal 2001, caused by a lack of orders from a major US distributor, combined with a decline in the average selling price of the GentleLASE, our highest volume selling laser. Product-related service revenue increased 10.6% to \$12.5 million in fiscal 2001 from \$11.3 million in fiscal 2000. This increase was attributable to increased shipments of consumables used with our Vbeam, GentleLASE, and Smoothbeam products as well as an increase in the sale of extended service contracts. Skin care center revenue increased 5.4% to \$3.9 million in fiscal 2001 compared to \$3.7 million in 2000, due to increased marketing and promotional activities for our Boston Spa.

**Gross Profit.** Gross profit decreased to \$33.5 million or 51.7% of revenue in fiscal 2001 from \$43.5 million or 57.7% of revenue in fiscal 2000 mainly as a result of an increase in sales discounts, effects of a fluctuating foreign currency market, and sales of lower margin systems, in comparison to sales of higher margin GentleLASE and Vbeam systems during fiscal 2000. Gross profit on lasers and other products decreased to \$27.2 million or 56% in fiscal 2001 compared to \$37.6 million or 62% in fiscal 2000. Gross profit for product-related service revenue in fiscal 2001 slightly increased to \$4.8 million or 39% of revenue compared to \$4.5 million or 40% of revenue for fiscal 2000. Skin care center gross profit for fiscal year 2001 increased to \$1.5 million or 38% of revenue in comparison to \$1.4 million or 36% of revenue for fiscal year 2000 resulting from a combination of an increased number of services and emphasis placed on cost control within the center.

**Research and Development Expense.** Research and development spending for fiscal 2001 increased 16% to \$5.6 million, from \$4.8 million for fiscal 2000. The increase in research and development expense reflects efforts to develop new products such as the Smoothbeam, our newest laser, and the Clearbeam™, to be released in fiscal 2002.

**Selling, General, and Administrative Expense.** Selling, general, and administrative expense increased 11.0% to \$24.1 million in fiscal 2001, from \$21.7 million in fiscal 2000. This increase reflects substantial marketing expenditures incurred to support the launches of new lasers, combined with legal expenses due to litigation settlements throughout the first half of the year. Selling costs increased due to sponsoring preceptorships for future clientele. Selling, general, and administrative expenses were 37% of revenue in fiscal 2001 compared to 29% for fiscal 2000.

**Impairment Charge.** During the quarter ended June 30, 2001, the Company determined that impairment indicators existed relating to its skin care/health spa services. In accordance with SFAS No. 121, "Accounting for the Impairment of Long-lived Assets and for Long-lived Assets to Be Disposed Of," the Company evaluated the recoverability of its spa-related long-lived assets. The Company determined that the estimated future undiscounted cash flows were below the carrying value of the spa-related long-lived assets at June 30, 2001. Accordingly, the Company has charged off as selling, general, and administrative expense all remaining undepreciated long-lived, principally, leasehold improvements, assets of \$640,000.

## *Management's Discussion and Analysis of Financial Condition and Results of Operations*

**Restructuring Charge.** During the quarter ended December 27, 1997, a restructuring charge was recorded and a reserve established in the amount of \$2.6 million, which assumed a sublease of the premises, resulting from the closure of the skin care center located in Scottsdale, Arizona. During fiscal 2001, we incurred an additional charge of \$1.1 million due to a change in future sublease payments.

**Other Income/Expense.** For the fiscal years ended June 30, 2001 and July 1, 2000, total other income remained constant at \$1.2 million. Interest income increased due to high levels of cash invested and was offset by losses arising from the effects of currency fluctuations, in particular, the Japanese yen.

**Income Taxes.** The provision for income taxes results from a combination of activities of both the domestic and foreign subsidiaries of the Company. The Company recorded a 36% effective tax rate for the year ended June 30, 2001, compared to the year ended July 1, 2000, in which the Company recorded a 20% tax rate due to reductions in the valuation allowance against the deferred tax asset.

### **Fiscal Year Ended July 1, 2000 Compared to Fiscal Year Ended July 3, 1999**

**Revenue.** Total revenue increased 29% to \$75.4 million in fiscal 2000 from \$58.6 million in fiscal 1999. International revenue, consisting of sales from our subsidiaries in Germany, Spain, and Japan, and sales shipped directly to international locations from the U.S., was 52% of total revenue for both fiscal 2000 and fiscal 1999. Laser and product revenue increased 29% to \$60.3 million in fiscal 2000 from \$46.7 million in fiscal 1999. This was due to our initial shipments of our new Vbeam laser system for the treatment of vascular lesions and continued strong sales of our GentleLASE hair removal system. Product-related service revenue increased 29% to \$11.3 million in fiscal 2000 from \$8.8 million in fiscal 1999. This increase was attributable to increased shipments of consumables used with our Vbeam, GentleLASE, and Sclero products as well as an increase in the sale of service contracts. Skin care center revenue increased 21% to \$3.7 million in fiscal 2000 compared to \$3.1 million in 1999, due to increased marketing and promotional activities for our Boston spa.

**Gross Profit.** Gross profit increased to \$43.5 million or 58% of revenue in fiscal 2000 from \$32.1 million or 55% of revenue in fiscal 1999 mainly as a result of increased sales of higher margin GentleLASE and Vbeam systems. Gross profit on lasers and other products increased to \$37.6 million or 62% in fiscal 2000 compared to \$28.1 million or 60% in fiscal 1999. Gross profit for service revenue in fiscal 2000 increased to \$4.5 million or 40% of revenue compared to \$3.1 million or 35% of revenue for fiscal 1999 resulting from the increase in the number of units in service. Skin care center gross profit for fiscal year 2000 increased to \$1.35 million or 36% of revenue in comparison to \$0.95 million or 31% of revenue for fiscal year 1999 resulting from a combination of increased number of services and emphasis placed on cost control within the center.

**Research and Development Expense.** Research and development spending for fiscal 2000 increased 21% to \$4.8 million, from \$4.0 million for fiscal 1999. The increase in research and development expense reflects efforts to develop new products and product improvements designed to enhance, augment, and expand our existing product lines.

## *Management's Discussion and Analysis of Financial Condition and Results of Operations*

**Selling, General, and Administrative Expense.** Selling, general, and administrative expense increased 21% to \$21.7 million in fiscal 2000, from \$17.9 million in fiscal 1999. This reflects additional expenditures incurred to support our increased sales volume. This includes increased commission and travel costs as well as expenditures relating to our offices in Frankfurt, Paris, and Osaka. These offices were opened during the course of fiscal 1999 and 2000 and did not have a full year of expenses in fiscal 1999. Selling, general, and administrative expenses were 29% of revenue in fiscal 2000 compared to 31% for fiscal 1999.

**Restructuring Charge.** During the quarter ended December 27, 1997, a restructuring charge was recorded and a reserve established in the amount of \$2.6 million resulting from the closure of the skin care center located in Scottsdale, Arizona. During fiscal 2000, a total of \$476,000 was charged against this reserve, representing costs associated with the closure of the Scottsdale facility leaving a reserve balance of \$1.0 million.

**Other Income/Expense.** For the fiscal year ended July 1, 2000, total other income was \$1.2 million in comparison to other expense of \$0.4 million for the same period a year earlier. This increase was a result of increased interest income due to our substantially higher cash balances in fiscal 2000 in comparison to fiscal 1999. Operating margins for future periods will be impacted by a modified royalty formulation with respect to our DCD license from the Regents negotiated in August of 2000, since the same royalty rate will now apply to more components sold.

**Income Taxes.** The provision for income taxes results from a combination of activities of both the domestic and foreign subsidiaries. The provision for income taxes for the year ended July 1, 2000, reflects the utilization of tax credits generated in the current year and tax provisions calculated in Japan and Spain at a rate in excess of the U.S. statutory tax rate. We released \$3.1 million of the valuation allowance against our deferred tax asset in fiscal 2000. The effective tax rate for fiscal 2000 and 1999 are approximately 20% and 24%, respectively.

During fiscal 2000, Candela believed it was more likely than not that a portion of the deferred tax asset would be utilized during the current year. Therefore, the Company, in accordance with the Statement of Financial Accounting Standards Board No. 109 "Accounting for Income Taxes," decreased its valuation allowance against current year taxable income, resulting in a decrease to its effective rate.

### **Liquidity and Capital Resources**

Cash provided by operating activities amounted to \$3.1 million for fiscal 2001 compared to \$8.5 million in fiscal 2000, reflecting a substantial decline in net income for the fiscal year ended 2001, marginally offset by collections in accounts receivable. The continued sales of the Vbeam impacted cash by way of an increased amount of deferred income, due to its associated three year service contract. Cash used in investing activities totaled \$1.6 million for fiscal 2001 compared to \$554,000 for the same period a year earlier resulting from capital expenditures made in renovating the manufacturing portion of our facilities and purchasing more computer equipment to support Oracle software, a new ERP system which is currently in implementation. Cash used in financing activities amounted to \$3.2 million in 2001 in comparison to cash provided by financing activities of \$18.1 million for 2000. This is due to the cost of repurchasing shares in the open market during the first half of the fiscal year, whereas in the previous year, the proceeds were due to the completion of our secondary offering.

## *Management's Discussion and Analysis of Financial Condition and Results of Operations*

On October 15, 1998, we issued eight-year, 9.75% subordinated term notes to three investors in the aggregate amount of \$3.7 million, secured by the Company's assets. The notes become due in October 2006, and require quarterly interest payments. In addition, we issued warrants to purchase 555,000 shares of common stock to the note holders that have an exercise price of \$4.00 per warrant, which yield 1.5 shares of common stock. The relative fair value ascribed to the warrants is \$836,000 and has been recorded as a component of Additional Paid-In Capital in Stockholders' Equity. The relative fair value of the debt was recorded as \$2,864,000. The debt will be accreted to face value using the interest method over eight years, which will result in interest expense of \$836,000 over the eight-year period in addition to the 9.75% face interest. As of June 30, 2001, a total of \$259,500 has been accreted to the notes, resulting in a long-term liability balance of \$2.8 million and a short-term balance of \$318,000; furthermore, a total of \$98,500 of interest expense has been recorded in fiscal year 2001.

The Company also maintains a renewable \$5,000,000 revolving credit agreement with a major bank with interest at the bank's base rate. Any borrowings outstanding under the line of credit are due on demand or according to a payment schedule established at the time funds are borrowed. The line of credit is unsecured. The agreement contains restrictive covenants limiting the establishment of new liens, and the purchase of margin stock. No amounts were outstanding under the line of credit as of June 30, 2001.

We believe that cash balances will be sufficient to meet anticipated cash requirements. However, we cannot be sure that we will not require additional capital beyond the amounts currently forecasted by us, nor that any such required additional capital will be available on reasonable terms, if at all, as it becomes required.

## Report of Independent Auditors

### To the Board of Directors and Stockholders of Candela Corporation

We have audited the accompanying consolidated balance sheets of Candela Corporation and subsidiaries as of June 30, 2001 and July 1, 2000, and the related consolidated statements of operations and comprehensive income, stockholders' equity, and cash flows for each of the two years in the period ended June 30, 2001. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Candela Corporation and subsidiaries at June 30, 2001, and July 1, 2000, and the consolidated results of their operations and their cash flows for each of the two years in the period ended June 30, 2001, in conformity with accounting principles generally accepted in the United States.



ERNST & YOUNG LLP

Boston, Massachusetts  
August 10, 2001

### To the Board of Directors and Stockholders of Candela Corporation:

In our opinion, the accompanying consolidated statement of operations and comprehensive income, of stockholders' equity and cash flows, present fairly, in all material respects, the financial position of Candela Corporation and its Subsidiaries at July 3, 1999, and the results of their operations and their cash flows for the year ended July 3, 1999, in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audit of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.



PRICEWATERHOUSECOOPERS LLP

Boston, Massachusetts  
August 23, 1999

## Consolidated Balance Sheets

(in thousands)	June 30 2001	July 1 2000
<b>Assets:</b>		
<b>Current assets:</b>		
Cash and cash equivalents	\$32,318	\$34,863
Accounts receivable (net of allowance of \$901 and \$1,207 in 2001 and 2000, respectively)	19,648	19,875
Notes receivable	1,205	1,813
Inventories, net	10,071	8,386
Other current assets	980	885
Total current assets	64,222	65,822
Property and equipment, net	2,678	2,462
Deferred tax assets	5,327	4,643
Prepaid licenses	1,595	-
Other assets	196	237
Total assets	\$74,018	\$73,164
<b>Liabilities and Stockholders' Equity:</b>		
<b>Current liabilities:</b>		
Accounts payable	\$ 5,781	\$ 4,654
Accrued payroll and related expenses	1,832	2,351
Accrued warranty costs	3,629	3,295
Income taxes payable	2,549	3,332
Restructuring reserve	1,689	1,043
Other accrued liabilities	1,909	1,467
Current portion of long-term debt	318	15
Deferred income	4,205	3,182
Total current liabilities	21,912	19,339
Long-term portion of deferred income	2,317	2,228
Long-term debt	2,815	3,034
Total long-term liabilities	5,132	5,262
Commitments and contingencies	-	-
<b>Stockholders' equity:</b>		
Common stock, \$.01 par value: 30,000,000 shares authorized 11,783,736 and 11,501,241 shares issued and outstanding in 2001 and 2000, respectively	118	115
Treasury stock, at cost: 1,000,000 shares and 280,000 shares in 2001 and 2000, respectively	(7,782)	(3,046)
Additional paid-in capital	43,475	41,924
Accumulated earnings	13,244	10,717
Accumulated other comprehensive loss	(2,081)	(1,147)
Total stockholders' equity	46,974	48,563
Total liabilities and stockholders' equity	\$74,018	\$73,164

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

## Consolidated Statements of Operations and Comprehensive Income

(in thousands, except per share data)	June 30 2001	July 1 2000	July 3 1999
<b>Revenue:</b>			
Lasers and other products	\$48,375	\$60,340	\$46,708
Product-related service	12,498	11,320	8,801
Skin care centers	3,899	3,730	3,079
Total revenue	64,772	75,390	58,588
<b>Cost of sales:</b>			
Lasers and other products	21,208	22,703	18,623
Product-related service	7,676	6,802	5,715
Skin care centers	2,412	2,377	2,125
Total cost of sales	31,296	31,882	26,463
<b>Gross profit</b>	33,476	43,508	32,125
<b>Operating expenses:</b>			
Research and development	5,575	4,822	3,998
Selling, general, and administrative	24,076	21,669	17,891
Restructuring charge	1,113	-	-
Total operating expenses	30,764	26,491	21,889
Income from operations	2,712	17,017	10,236
<b>Other income (expense):</b>			
Interest income	1,652	1,427	115
Interest expense	(437)	(482)	(492)
Other income (expense), net	33	242	(3)
Total other income (expense)	1,248	1,187	(380)
Income before income taxes	3,960	18,204	9,856
Provision for income taxes	1,433	3,641	2,365
<b>Net income</b>	<b>\$2,527</b>	<b>\$14,563</b>	<b>\$7,491</b>
Basic earnings per share	\$0.23	\$1.33	\$0.91
Diluted earnings per share	\$0.22	\$1.19	\$0.82
Weighted average shares outstanding	10,928	10,932	8,250
Adjusted weighted average shares outstanding	11,521	12,190	9,179
Net income	\$2,527	\$14,563	\$7,491
Other comprehensive loss net of tax:			
Foreign currency translation adjustment	(598)	(318)	(14)
<b>Comprehensive income</b>	<b>\$1,929</b>	<b>\$14,245</b>	<b>\$7,477</b>

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

## Consolidated Statements of Stockholders' Equity

(in thousands)

For the years ended June 30, 2001; July 1, 2000; and July 3, 1999

	<u>Common Stock</u>		<u>Additional</u>	<u>Treasury Stock</u>		<u>Accumulated</u>	<u>Accumulated</u>	<u>Total</u>
	<u>Shares</u>	<u>Amount</u>	<u>Paid-in</u> <u>Capital</u>	<u>Shares</u>	<u>Amount</u>	<u>Earnings</u> <u>(Deficit)</u>	<u>Other</u> <u>Comprehensive</u> <u>(Loss)</u>	
<b>Balance June 27, 1998</b>	8,219	\$82	\$17,380	-	-	\$(11,337)	\$(730)	\$5,395
Sale of common stock under stock plans	126	1	309					310
Exercise of stock warrants	3		10					10
Issuance of stock warrants			836					836
Net income						7,491		7,491
Currency translation adjustment			-			-	(19)	(19)
<b>Balance July 3, 1999</b>	8,348	83	18,535	-	-	(3,846)	(749)	14,023
Sale of common stock under stock plans	693	7	1,856					1,863
Exercise of stock warrants	210	2	788					790
Secondary offering	2,250	23	19,101					19,124
Treasury stock purchases				(280)	(3,046)			(3,046)
Disqualifying dispositions of options			1,644					1,644
Net income						14,563		14,563
Currency translation adjustment							(398)	(398)
<b>Balance July 1, 2000</b>	11,501	115	41,924	(280)	(3,046)	10,717	(1,147)	48,563
Sale of common stock under stock plans	123	1	454					455
Exercise of stock warrants	160	2	1097					1,099
Treasury stock purchases				(720)	(4,736)			(4,736)
Net income						2,527		2,527
Currency translation adjustment							(934)	(934)
<b>Balance June 30, 2001</b>	11,784	\$118	\$43,475	(1,000)	\$(7,782)	\$13,244	\$(2,081)	\$46,974

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

## Consolidated Statements of Cash Flows

(in thousands)	For the years ended		
	June 30 2001	July 1 2000	July 3 1999
<b>Cash flows from operating activities:</b>			
Net income	\$2,527	\$14,563	\$7,491
<b>Adjustments to reconcile net income to net cash provided by operating activities:</b>			
Depreciation and amortization	751	715	751
Accretion of imputed interest on stock warrants	98	96	66
Provision for bad debts	60	312	268
Provision for restructuring charges	1,113	-	-
Provision for impairment of long-lived assets	640	-	-
Provision for deferred taxes	(683)	(3,542)	(1,100)
Effect of exchange rate changes on income	(110)	(190)	20
<b>Changes in assets and liabilities:</b>			
Accounts receivable	713	(7,984)	(3,905)
Notes receivable	414	629	(488)
Inventories	(2,217)	(1,247)	362
Other current assets	135	91	(762)
Other assets	(1,624)	-	(4)
Accounts payable	1,034	443	361
Accrued payroll and related expenses	(630)	(1,278)	2,415
Deferred income	1,095	3,499	78
Accrued warranty costs	334	793	488
Income tax payable	(774)	1,646	2,849
Accrued restructuring charges	(467)	(476)	(289)
Other accrued liabilities	625	265	213
Net cash provided by operating activities	3,034	8,335	8,814
<b>Cash flows from investing activities:</b>			
Purchase of property, plant, and equipment	(1,612)	(554)	(524)
Proceeds from sale of property, plant, and equipment	-	-	363
Net cash used in investing activities	(1,612)	(554)	(161)
<b>Cash flows from financing activities:</b>			
Proceeds from issuance of common stock	1,554	21,777	321
Repurchases of Treasury stock	(4,736)	(3,046)	-
Borrowings from (repayment of) long-term debt	-	(78)	332
Payment of capital lease obligations	(14)	(574)	(638)
Net cash provided by (used in) financing activities	(3,196)	18,079	15
Effect of exchange rate changes on cash and cash equivalents	(771)	(1,052)	(228)
Net increase (decrease) on cash and cash equivalents	(2,545)	24,808	8,440
Cash and cash equivalents, beginning of period	34,863	10,055	1,615
Cash and cash equivalents, end of period	\$32,318	\$34,863	\$10,055
Cash paid during the year for:			
Interest	\$361	\$387	\$366
Income taxes	\$2,287	\$3,099	\$615
Non-Cash Activity			
Capital lease financing	-	-	\$42

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

## *Notes to Consolidated Financial Statements*

### *1 • Summary of Significant Accounting Policies*

#### **Business**

The Company researches, develops, manufactures, markets, and services lasers and other devices used to perform aesthetic and cosmetic procedures.

#### **Basis of Presentation**

The consolidated financial statements include the accounts of Candela Corporation and its wholly owned subsidiaries. All intercompany accounts and transactions have been eliminated.

The Company's fiscal year ends on the Saturday nearest June 30. The years ended June 30, 2001; July 1, 2000; and July 3, 1999 contain 52, 52, and 53 weeks, respectively.

#### **Use of Estimates**

The presentation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. It is the belief of the Company's management that all necessary adjustments have been made for an accurate presentation of results. Actual results could differ from those estimates and impact future results of operations and cash flows.

#### **Cash and Cash Equivalents**

The Company classifies investments purchased with a maturity at the date of acquisition of three months or less as cash equivalents. These are valued at cash plus accrued interest, which approximates market value. At June 30, 2001, and July 1, 2000, substantially all cash equivalents were invested in overnight Repurchase Agreements, U.S. Treasury Bills with a major bank, or commercial paper issued by a major bank. The Company had letters of credit outstanding at June 1, 2001, amounting to \$2.1 million with expiration dates varying between July 1, 2001 and September 30, 2001.

#### **Accounts Receivable and Notes Receivable**

The Company's trade accounts receivables and notes receivables are primarily from sales to end users and distributors servicing the dermatology market, and reflect a broad domestic and international customer base. The Company does not require collateral and has not historically experienced significant credit losses related to receivables from individual customers or groups of customers in any particular industry or geographic area.

#### **Inventories**

Inventory is stated at the lower of cost (first-in, first-out method) or market, using a standard costing system.

#### **Property and Equipment**

Purchased property and equipment is recorded at cost. Property and equipment purchased under capital lease arrangements is recorded at the lesser of cost or the present value of the minimum lease payments required during the lease period. Laser systems used for testing are capitalized at cost. Depreciation and amortization are provided using the straight-line method over the estimated useful lives as follows:

## Notes to Consolidated Financial Statements

	<b>Number of Years</b>
Leasehold improvements and assets under capital lease	2 to 13
Office furniture	3
Computers, software, and other equipment	5

### **Income Taxes**

The Company accounts for income taxes using an asset and liability approach that requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been recognized in the financial statements or tax returns. In estimating future tax consequences, all expected future events are considered other than enactments of changes in tax laws or rates. Valuation allowances are established as necessary to reduce deferred tax assets in the event that realization of the assets is considered unlikely.

### **Research and Development Expense**

Research and development costs are expensed as incurred.

### **Repairs and Maintenance**

Repairs and maintenance costs are expensed as incurred.

### **Advertising Costs**

Advertising costs are expensed as incurred. Advertising costs were \$783,000, \$782,000, and \$604,000 for the years ending June 30, 2001; July 1, 2000; and July 3, 1999, respectively.

### **Foreign Currency Translation**

The activity of the Company's foreign subsidiaries is translated into U.S. dollars in accordance with Statement of Financial Accounting Standards (SFAS) No. 52, "Foreign Currency Translation." Assets and liabilities are translated into U.S. dollars at current exchange rates, while income and expense items are translated at average rates of exchange prevailing during the year. Exchange gains and losses arising from translation of the Japanese, Spanish, German, and French subsidiary balance sheets are accumulated as a separate component of stockholders' equity. Net exchange gain or (loss) resulting from foreign currency transactions amounted to \$111,000, \$190,000, and (\$20,000) for fiscal 2001, 2000, and 1999, respectively, and is included in other expense.

### **Financial Instruments**

The Company operates internationally, with sales offices, customers, and vendors in several countries outside of the United States. The Company may reduce its exposure to fluctuations in foreign exchange rates by creating offsetting positions through the use of foreign currency forward contracts, a type of derivative financial instrument. These foreign currency forward contracts may involve elements of credit and market risk in excess of the amounts recognized in the financial statements. The Company monitors its positions and the credit quality of counter-parties, consisting primarily of major financial institutions, and does not anticipate nonperformance by any counter-party. The Company does not use derivative financial instruments for trading or speculative purposes, nor is the Company a party to leveraged derivatives.

Effective July 2, 2000, we adopted the Statement of Financial Accounting Standard ("SFAS") No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended. SFAS No. 133 requires that an entity recognize all derivatives as either assets or liabilities measured at fair value. Changes in the fair value of derivatives are recorded each period in current earnings or in other comprehensive income, depending on whether a derivative is designated as part of a hedging

## Notes to Consolidated Financial Statements

relationship and, if it is, depending on the type of hedging relationship. Adoption of this new accounting standard had a negligible impact on our financial position and results of operations. At June 30, 2001, the Company held foreign currency forward contracts with notional values totaling approximately \$5.7 million, which have maturities prior to October 4, 2001. These foreign currency forward contracts do not qualify for hedge accounting and, therefore, are adjusted to fair value through income as a component of other income and expense and offset the change in fair value of the foreign currency intercompany receivables. The aggregate fair value of our forward foreign exchange contracts outstanding was \$101,175 as of June 30, 2001. The net fair value is computed by subtracting the value of the contracts using the year-end exchange rate (the notional value) from the value of the forward contracts computed at the contracted exchange rates.

The Company's financial instruments also include cash, cash equivalents, accounts receivable, accounts payable, accrued liabilities, and debt. Excluding long-term debt, these financial instruments are carried at cost, which approximates fair value due to their relative short term to maturity. The fair value of the Company's long-term debt is estimated to be \$1,614,545 using discounted cash flow analysis based on the Company's incremental borrowing rates for similar types of borrowing arrangements.

### Revenue Recognition

*Product sales* – Revenue from product sales, except sales to certain distributors, is recognized at the time of shipment. Shipments made to distributors, for which payment to the Company is dependent on resale of the system, are not recognized as revenue unless the distributor demonstrates that the system is sold.

*Grants* – Revenue from U.S. government contracts is granted under the Small Business Innovation Research program. Government contracts limit reimbursement to 100% of allowable direct costs and a negotiated rate for indirect costs. The revenue is recognized as reimbursable costs are incurred.

*Service* – Revenue from the sale of service contracts is deferred and recognized on a straight-line basis over the contract period. Revenue from service administered by Candela is recognized as the services are provided. Amounts received from the sale of gift certificates by Candela Skin Care Centers (“CSCC”) are deferred and recognized as revenue when the services are provided.

### Product Warranty Costs

The length of the Company's warranty on end user sales of medical devices is generally one year on parts and labor except on our Vbeam system, which carries a standard three-year service contract. An extended warranty is also available for purchase on all of our systems. Distributor sales generally include a parts warranty only. Estimated future costs for initial product warranties are provided for at the time of sale.

### Research and Development Expense

Research and development costs are expensed as incurred.

### Treasury Stock

The Board of Directors approved an open market stock repurchase program that enables the Company to purchase up to 1,250,000 shares of its common stock. The program is in effect until December 12, 2001, and may be suspended or discontinued by the Company at any time. All such purchases are transacted on the NASDAQ stock market at prevailing open market prices and are paid for with general corporate funds. Such purchases are accounted for at cost and held as Treasury stock. As of June 30, 2001, the Company had repurchased 1,000,000 shares.

## Notes to Consolidated Financial Statements

### Comprehensive Income

Comprehensive income is comprised of two components, net income and other comprehensive income. Other comprehensive income consists of translation adjustments, which represent the effect of translating assets and liabilities of the Company's foreign subsidiaries.

### Earnings (Loss) per Share

	For the Years Ended		
	June 30 2001	July 1 2000	July 3 1999
<small>(in thousands, except per share amounts)</small>			
<b>Numerator</b>			
Net Income	\$2,527	\$14,563	\$7,491
<b>Denominator</b>			
Basic Earnings per Share			
Weighted average share outstanding	10,928	10,932	8,250
Earnings per Share	\$0.23	\$1.33	\$0.91
Diluted Earnings per Share			
Weighted average share outstanding	10,928	10,932	8,250
Effect of dilutive securities:			
Stock options	331	702	317
Stock warrants	262	556	612
Adjusted weighted average shares outstanding	11,521	12,190	9,179
Earnings per Share	\$0.22	\$1.19	\$0.82

During the years ended June 30, 2001; July 1, 2000; and July 3, 1999, options and warrants to purchase 207,811; 157,500; and 6,884 shares of common stock, respectively, were not included in the computation of diluted earnings loss per share because they would have had an antidilutive effect.

### Dividends

The Company currently intends to retain future earnings for use in its business and, therefore, does not expect to pay dividends in the foreseeable future.

### Accounting for Stock-Based Compensation

The Company has elected the disclosure-only alternative permitted under SFAS No. 123, "Accounting for Stock-Based Compensation." The Company has disclosed herein pro forma net income and pro forma earnings per share in the footnotes using the fair value based method for fiscal 2001, 2000, and 1999.

### New Accounting Pronouncements

In December 1999, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 101 ("SAB 101"), "Revenue Recognition in Financial Statements." SAB 101 provides guidance on applying generally accepted accounting principles to revenue recognition issues in financial statements. The adoption of SAB 101 in the fourth quarter of fiscal year 2001 did not materially affect the Company's results of operations or financial position.

## Notes to Consolidated Financial Statements

In June 2001, the Financial Accounting Standards Board (FASB) issued SFAS No. 141, "Business Combinations." SFAS No. 141 revises the standards of business combinations by eliminating the use of the pooling-of-interests ("pooling") method and requiring that all business combinations be accounted for using the purchase method of accounting. SFAS No. 141 also changes the criteria to recognize intangible assets apart from goodwill. The provisions of SFAS No. 141 are effective for all business combinations initiated after June 30, 2001. The adoption of this statement had no impact on the Company's financial position and results of operations.

In June 2001, the FASB issued SFAS No. 142, "Goodwill and Other Intangible Assets." SFAS No. 142 revises the standards of accounting for goodwill and indefinite lived intangible assets by replacing the regular amortization of these assets with the requirement that they are reviewed annually, or more frequently if impairment indicators arise, for impairment. Separable intangible assets that have finite lives will continue to be amortized over their useful lives. The accounting standards of SFAS No. 142 are effective for fiscal years beginning after December 15, 2001. The Company does not believe the adoption of this statement will have any impact on the earnings and financial position of the Company.

### Uncertainties

The Company is subject to risks common to companies in the aesthetic laser industry, including (i) the Company's ability to successfully complete preclinical and clinical development and obtain timely regulatory approval and adequate patent and other proprietary rights protection of its products and services, (ii) the content and timing of decisions made by the Food & Drug Administration and other agencies regarding the procedures for which the Company's products may be approved, (iii) the ability of the Company to manufacture adequate supplies of its products for development and commercialization activities, (iv) the accuracy of the Company's estimates of the size and characteristics of markets to be addressed by the Company's products and services, (v) market acceptance of the Company's products and services, (vi) the Company's ability to obtain reimbursement for its products from third-party payers, where appropriate, and (vii) the accuracy of the Company's information concerning the products and resources of competitors and potential competitors.

The Company depends on a single vendor for alexandrite rods used to manufacture the GentleLASE. This product accounts for a significant portion of our total revenues.

### Reclassifications

Certain prior year balances have been reclassified to conform with the current year presentation.

## 2 • Inventories

Inventories consist of the following (in thousands):

	June 30 2001	July 1 2000
Raw materials	\$3,723	\$2,750
Work in process	951	602
Finished goods	5,397	5,034
	<u>\$10,071</u>	<u>\$8,386</u>

## Notes to Consolidated Financial Statements

### 3 • Property and Equipment

Property and equipment consist of the following (in thousands):

	June 30 2001	July 1 2000
Leasehold improvements	\$3,653	\$2,268
Office furniture	892	977
Computers, software, and other equipment	4,803	4,969
	9,348	8,214
Less accumulated depreciation and amortization	(6,670)	(5,752)
Property and equipment, net	\$2,678	\$2,462

### 4 • Deferred Income

Deferred income consists of the following (in thousands):

	June 30 2001	July 1 2000
Service contract revenue	\$5,051	\$4,269
Gift certificate revenue	1,107	730
Customer deposits	247	270
Other deferred sales revenue	117	141
	6,522	5,410
Less current portion	4,205	3,182
Long-term portion of deferred income	\$2,317	\$2,228

### 5 • Debt and Lease Obligations

During fiscal 2000, the Company obtained a renewable \$5,000,000 revolving credit agreement with a major bank with interest at the bank's base rate or LIBOR plus 225 basis points. Any borrowings outstanding under the line of credit are due on demand or according to a payment schedule established at the time funds are borrowed. The line of credit is unsecured. The agreement contains restrictive covenants limiting the establishment of new liens, and the purchase of margin stock. No amounts were outstanding under the line of credit as of June 30, 2001.

#### Subordinated Notes

On October 15, 1998, the Company issued eight-year, 9.75%, subordinated term notes ("Note Agreement") to three investors in the aggregate amount of \$3.7 million, secured by the assets of the Company. The notes become due in October 2006, and require quarterly interest payments. The Company is required to make mandatory quarterly principal payments of \$185,000, along with any unpaid interest, beginning on January 31, 2002. In addition, the Company issued warrants to purchase 550,000 shares of common stock to the note holders which have an exercise price of \$4.00 per share and are exercisable through October 2006. The relative fair value ascribed to the warrants of \$836,000 (measured as of the date of issuance) was estimated using a Black-Scholes model assuming a 4.5% risk-free rate of return, an eight-year life of the warrant, a 72% volatility factor for an eight-year period, and

## Notes to Consolidated Financial Statements

no dividend rate. The relative fair value of the warrants has been recorded as a component of Additional Paid-in Capital. The relative fair value of the debt was recorded as \$2,864,000. In addition to the 9.75% stated interest rate, interest expense of an additional \$836,000 will be accreted to debt using the interest method over the eight-year life of the debt to bring the value of that debt to its \$3.7 million face value. At June 30, 2001, 465,000 warrants were outstanding. The Note Agreement also contains clauses that prohibit the Company from redeeming the notes earlier than November 1, 2001, except in certain circumstances. The Company is also subject to an early redemption premium amounting to 10% if paid in the first year following November 1, 2001. This premium decreases by 2% per year for the next two years following November 1, 2001 and allows for the Company to redeem the notes without penalty after November 1, 2004. The agreement contains restrictive covenants establishing maximum leverage, certain minimum ratios, and minimum levels of net income. As of June 30, 2001, the Company is in violation of minimum profitability levels, for which a waiver has been received for the fourth quarter.

### Long-Term Debt

The Company's long-term debt consists of the following:

<small>(in thousands)</small>	<b>June 30 2001</b>	<b>July 1 2000</b>
Subordinated notes	\$3,123	\$3,025
Obligations under capital leases collateralized by the related equipment interest from 5.8% to 12.31% per annum; payments of principal and interest through March 2002	10	24
	3,133	3,049
Less current portion	318	15
Total long-term debt	<u>\$2,815</u>	<u>\$3,034</u>

As of June 30, 2001, the Company's scheduled maturities under debt obligations are as follows :

<b>Fiscal</b>	<small>(in thousands)</small>
2002	\$380
2003	740
2004	740
2005	740
2006	740
Thereafter	370
Total obligations	3,710
Less: future accretion	(577)
Long-term obligations	<u>\$3,133</u>

### Operating Lease Commitments

The Company leases several facilities and automobiles under noncancellable lease arrangements. The facility leases may be adjusted for increases in maintenance and insurance costs above specified levels. In addition, certain facility leases contain escalation provisions based on certain specified criteria, and one lease calls for the payment of additional rent based on a percentage of gross revenues above a base gross sales level for that particular location. These operating leases expire in various years through 2009. These leases may be renewed for periods ranging from one to five years.

## Notes to Consolidated Financial Statements

Future minimum lease payments under noncancellable operating leases with initial terms of one year or more consisted of the following at June 30, 2001:

	(in thousands)
2002	\$935
2003	675
2004	588
2005	555
2006	549
Thereafter	20
Total minimum lease payments	<u>\$3,322</u>

Total rent expense was approximately \$935,000; \$912,000; and \$769,000, for fiscal 2001, 2000, and 1999, respectively.

### 6 • Stockholders' Equity

#### Stock Plans

##### 1990 Candela Corporation Employee Stock Purchase Plan

The 1990 Employee Stock Purchase Plan (the "Purchase Plan") provides for the sale of up to 750,000 shares of common stock to eligible employees. The shares are issued at the lesser of 85% of the average market price on the first or last day of semiannual periods. Substantially, all full-time employees are eligible to participate in the Purchase Plan. At June 30, 2001, there were 453,619 shares available for grant.

The following is a summary of shares issued under the Purchase Plan:

	Shares	Range of Price per Share
1999	31,802	\$1.67 - \$3.33
2000	25,382	\$7.75 - \$8.33
2001	30,885	\$4.75

##### 1985, 1987, 1989, and 1998 Candela Corporation Stock Option Plans

The 1985, 1987, 1989, and 1998 Stock Option Plans (the "Stock Option Plans") provide for the granting of incentive stock options to employees for the purchase of common stock at an exercise price not less than the fair market value of the stock on the date of grant. The Stock Option Plans also provide for the granting of nonqualified stock options.

The Board of Directors has terminated the granting of options under the 1985 and 1987 Stock Option Plans. Options granted under the 1989 Stock Option Plan become exercisable ratably over two or four years from the date of the grant and expire ten years from the date of the grant. Options granted under the 1998 Stock Option Plan become exercisable on the date of the grant or in installments, as specified by a Committee established by the Board of Directors, and expire ten years from the date of the grant. The maximum number of shares for which options may be granted under the 1989 Stock Option Plan is 1,500,000 shares. The maximum number of shares for which options may be granted under the 1998 Stock Option Plan is 750,000 shares.

## Notes to Consolidated Financial Statements

### 1990 and 1993 Candela Corporation Non-Employee Director Stock Option Plans

The 1990 and 1993 Non-Employee Director Stock Option Plans (the "Non-Employee Director Plans," collectively with the Stock Option Plans, the "Plans") provide for the issuance of options for the purchase of up to 90,000 and 120,000 shares of common stock, respectively. Under the Non-Employee Director Plans, each director who is neither an employee nor an officer receives a one-time grant of an option to purchase 10,000 shares of common stock at an exercise price equal to the fair market value of the common stock on the date of the grant. Under the Non-Employee Director Plans, options become exercisable in equal amounts over a period of four and two years, respectively. Shares under the Non-Employee Director Plans expire four and ten years, respectively, after the date of the grant and are nontransferable.

The following is a summary of stock option activity under the Plans:

	Number of Shares	Option Price	Weighted Average Exercise Price per Share
Balance at June 27, 1998	1,186,890		\$2.4800
Granted	571,500	\$2.29 - \$5.63	\$3.6533
Exercised	(94,940)	\$1.33 - \$5.00	\$2.4352
Canceled	(189,843)	\$2.13 - \$5.17	\$2.7977
Balance at July 3, 1999	1,473,607		\$3.0470
Granted	172,500	\$8.33 - \$12.04	\$10.1875
Exercised	(635,294)	\$1.00 - \$5.63	\$3.3127
Canceled	(165,375)	\$2.1 - \$9.67	\$5.9191
Balance at July 1, 2000	845,438		\$5.0869
Granted	473,161	\$6.66 - \$9.25	\$7.9530
Exercised	(125,101)	\$2.13 - \$5.63	\$3.8752
Canceled	(78,099)	\$2.17 - \$12.04	\$7.1044
Balance at June 30, 2001	<u>1,115,399</u>		\$6.2190
Options available for grant at June 30, 2001	<u>558,689</u>		

The following table summarizes information about stock options under the Plans outstanding as of June 30, 2001:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$1.8333 - \$3.1667	236,190	4.61	\$2.5103	212,134	\$2.4928
\$3.8333 - \$5.0000	223,336	6.62	\$4.3842	163,336	\$4.2804
\$5.3333 - \$6.6560	104,062	8.76	\$6.1775	28,316	\$5.4706
\$6.8440 - \$6.8440	274,000	9.32	\$6.844	68,501	\$6.844
\$7.3750 - \$12.0420	<u>277,811</u>	8.85	\$10.2463	<u>109,562</u>	\$10.0856
\$1.8333 - \$12.0420	<u>1,115,399</u>	7.61	\$6.219	<u>581,849</u>	\$5.0815

## Notes to Consolidated Financial Statements

The Company applies Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations in accounting for its option plans. Accordingly, no compensation expense has been recognized for options granted to employees and directors of the Company. Had compensation expense for the Plans been determined based on the fair value at the grant date for awards under the Plans consistent with the methodology prescribed under SFAS No. 123, the Company's net income and net income per share would have been reduced by \$1.3 million or \$0.11 per share in 2001; \$579,000, or \$0.05 per share in 2000; and \$479,000 or \$0.08 per share in 1999. The weighted average fair value of the options granted under the Plans in 2001, 2000, and 1999, calculated using the Black-Scholes pricing model, was \$4.39, \$7.54, and \$2.16 per share, respectively. The weighted average fair value of shares issued under the Purchase Plan for 2001, 2000, and 1999 calculated using the Black-Scholes pricing model, were \$3.85, \$4.87, and \$0.92 per share. The following assumptions were used in the Black-Scholes pricing model for options granted in 2001, 2000, and 1999, respectively:

	2001	2000	1999
Risk-free interest rate	5.63%	6.61%	4.84%
Estimated volatility	82%	82%	77%
Expected life for stock options (yrs.)	3.55	4.06	3.80
Expected life for stock purchase plan (yrs.)	0.50	0.50	0.50
Expected dividends	none	none	none

### Candela Corporation Common Stock Warrants

In connection with a litigation settlement in January 1991, the Company authorized warrants to purchase 300,000 shares of common stock (450,000 shares post-split) in March 1992. The exercise price for the warrants is \$6.875 per share, which was not affected by the stock split. These warrants expired in November 2000.

### Reserved Shares

The Company has reserved 1,737,153 shares of common stock for issuance under its Purchase, Stock Option, Non-Employee Director Plans, and Warrants.

### Candela Corporation Stockholder Rights Plan

On September 4, 1992, the Company adopted a Stockholder Rights Plan under which it declared a dividend of one common stock purchase right (the Right) for each share of the Company's common stock outstanding on September 22, 1992. The Rights are not currently exercisable, but would become exercisable if certain triggering events occur, such as the initiation of certain tender offers for the Company's common stock. If such an event occurs, each Right would initially entitle shareholders to purchase one share of the Company's common stock at an exercise price of \$48 per share, subject to adjustment. In the event that the Rights are exercised after further triggering events, each Right would entitle holders to purchase, for the exercise price then in effect, shares of the Company's common stock (or other property, under certain circumstances) having a value of twice the exercise price.

Such Rights do not extend to any shareholders whose action triggered the Rights. The Company can in certain circumstances redeem the Rights at \$0.005 per Right. The Rights expire on September 22, 2002, unless redeemed earlier by the Company.

## Notes to Consolidated Financial Statements

### 7 • Income Taxes

The components of income before income taxes and the related provision for income taxes consists of the following periods:

(in thousands)	For the Years Ended		
	June 30 2001	July 1 2000	July 3 1999
Income (loss) before income taxes:			
Domestic	\$3,350	\$16,559	\$8,063
Foreign	610	1,645	1,793
	<u>\$3,960</u>	<u>\$18,204</u>	<u>\$9,856</u>
Provision for income taxes:			
Current provision:			
Federal	\$1,280	\$5,341	\$ 1,890
State	336	707	635
Foreign	501	1,136	940
Total current provision for income taxes	2,117	7,184	3,465
Deferred provision:			
Federal	(684)	(3,543)	(1,100)
Total provision for income taxes	<u>\$1,433</u>	<u>\$3,641</u>	<u>\$2,365</u>

The components of the Company's deferred tax assets consist of the following:

(in thousands)	June 30 2001	July 1 2000
Warranty reserve	\$2,336	\$2,237
Inventory valuation reserves	670	599
Restructuring reserve	669	412
Deferred revenue	470	344
State tax credit carryforwards	321	321
Bad debt reserve	319	391
Pre-opening expense	257	256
Other	285	83
Deferred tax assets	<u>\$5,327</u>	<u>\$4,643</u>

A reconciliation from the federal statutory tax rate to the effective tax rate is as follows:

	June 30 2001	July 1 2000	July 3 1999
Statutory rate	34%	35%	34%
State income taxes	4	4	4
Differences between foreign and U.S. tax rates	8	2	3
Utilization of research and experimentation credit	(4)	(4)	(11)
Benefit from foreign sales corporation	(4)	(1)	(1)
Utilization of deferred tax assets	-	(17)	(2)
Unbenefitted losses	-	-	(6)
Other	(2)	1	3
Effective tax rate	<u>36%</u>	<u>20%</u>	<u>24%</u>

## Notes to Consolidated Financial Statements

As of July 3, 1999, the Company had approximately \$3.1 million of valuation allowance relating to a deferred tax asset resulting principally from U.S. tax losses, research and development tax credits, and timing differences relating to U.S. assets and liabilities. Income tax expense for the year ended July 1, 2000 was reduced by approximately \$3.1 million through a reduction in the valuation allowance. As of June 30, 2001, the Company has no valuation allowance against the deferred tax asset. In accounting for the deferred tax asset, the Company had relied on historic data to determine the necessity of providing a valuation allowance for this asset. Under the requirements of SFAS No. 109, "Accounting for Income Taxes," Candela believed it more likely than not that the deferred tax asset would be fully utilized against future income taxes. At June 30, 2001, the Company had available research and development tax credits for state income tax purposes of approximately \$321,000, which will begin expiring in fiscal year 2006.

### 8 • Segment, Geographic, and Major Customer Information

The Company operates principally in two industry segments; the design, manufacture, sale, and service of medical devices and related equipment, and the performance of services in the skin care/health spa industry.

#### Geographic Data

Geographic information for fiscal 2001 and fiscal 2000 is as follows:

(in thousands)	2001	2000	1999
<b>Revenue:</b>			
United States	\$40,947	\$47,482	\$39,403
Intercompany	14,699	17,690	14,374
	55,646	65,172	53,777
Europe	7,961	8,010	6,059
Japan	15,864	19,898	13,126
	79,471	93,080	72,962
Elimination	(14,699)	(17,690)	(14,374)
Consolidated total	\$64,772	\$75,390	\$58,588
United States	\$1,550	\$16,034	\$9,381
Europe	(290)	(782)	404
Japan	982	1,709	1,411
Elimination	470	56	(960)
Consolidated total	\$2,712	\$17,017	\$10,236
<b>Geographic identification of long-lived assets:</b>			
United States	\$2,623	\$7,291	\$3,975
Europe	55	51	43
Japan	-	-	-
Consolidated total	\$2,678	\$7,342	\$4,018

## Notes to Consolidated Financial Statements

### Line of Business Data

(in thousands)	2001	2000	1999
<b>Revenue:</b>			
Product sales and service	\$60,873	\$71,660	\$55,509
Skin care/health spa services	3,899	3,730	3,079
Total Revenue	\$64,772	\$75,390	\$58,588
<b>Income from operations:</b>			
Product sales and service	\$5,350	\$17,647	\$11,321
Skin care/health spa services	(2,638)	(630)	(1,085)
Total income from operations	\$2,712	\$17,017	\$10,236
<b>Interest income (expense):</b>			
Product sales and service	\$1,246	\$1,194	\$(315)
Skin care/health spa services	2	(7)	(65)
Total interest income (expense)	\$1,248	\$1,187	\$(380)
<b>Depreciation and amortization:</b>			
Product sales and service	\$332	\$331	\$520
Skin care/health spa services	1,059	384	221
Total depreciation and amortization	\$1,391	\$715	\$741
<b>Capital expenditures:</b>			
Product sales and service	\$1,120	\$336	\$566
Skin care/health spa services	23	218	-
Total capital expenditures	\$1,143	\$554	\$566
<b>Total assets (net of intercompany accounts):</b>			
Product sales and service	\$72,718	\$71,151	\$34,250
Skin care/health spa services	1,300	2,013	2,201
Total assets	\$74,018	\$73,164	\$36,451

United States revenue includes export sales to unaffiliated companies located principally in Western Europe, the Middle East, and in the Asia-Pacific region, which approximated \$12,252,000; \$11,781,000; and \$11,218,000 for fiscal 2001, 2000, and 1999, respectively. One customer, a domestic distributor, accounted for 11% of net revenue and 12% of gross receivables as of June 30, 2001 in comparison to 13% of net revenue and 22.2% of gross receivables as of July 1, 2000.

### 9 • Employee Benefit Plans

The Company offers a savings plan which allows eligible U.S. employees to make tax-deferred contributions, a portion of which is matched by the Company. Company contributions vest ratably with three years of employment and amounted to \$173,000; \$168,000; and \$102,000, in fiscal 2001, 2000, and 1999, respectively.

## Notes to Consolidated Financial Statements

### 10 • Restructuring Costs and Other Charges

During the second quarter ended December 27, 1997, the Company recorded a restructuring charge against income in the amount of \$2,609,000. This charge represented the anticipated costs, less assumed future sublease payments, associated with closing the Scottsdale, Arizona, LaserSpa™, including costs of maintaining the facility, reserve for leasehold improvements and fixed assets (carrying value before reserve of \$1,123,000), and a reserve against loss upon liquidation of the equipment at the site. During the three months ended June 30, 2001, the Company recorded an additional restructuring charge of \$1,113,000 as no sublessee was located for the facility. The 2001 charge represents the estimated future lease and maintenance costs expected to be incurred through the end of the lease in 2006. Charges against the reserve for the years ended June 30, 2001 and July 1, 2000 total \$467,000 and \$476,000, respectively, leaving a reserve balance of \$1,689,000 at June 30, 2001. Candela continues to pursue a sublease of the Scottsdale facility.

During the quarter ended June 30, 2001, the Company determined that impairment indicators existed relating to its skin care/health spa services. In accordance with SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of," the Company evaluated the recoverability of its spa-related long-lived assets, principally leasehold improvements. The Company determined that the estimated future undiscounted cash flows were below the carrying value of the spa-related long-lived assets at June 30, 2001. Accordingly, the Company has charged off all remaining undepreciated long-lived spa-related assets of \$640,000. The estimated fair value was based on anticipated future cash flows discounted at a rate of 9.5%, which is commensurate with the risk involved.

	Scottsdale Payroll & Severance	Scottsdale Fixed Assets	Scottsdale Facility Costs	Scottsdale Total
<b>Balance at June 27, 1998</b>	\$285	\$984	\$726	\$1,995
Cash Charges	(75)	–	(214)	(289)
Non - Cash Charges	–	(187)	–	(187)
<b>Balance at June 27, 1999</b>	210	797	512	1,519
Cash Charges	(65)	–	(206)	(271)
Non - Cash Charges	–	(205)	–	(205)
<b>Balance at July 1, 2000</b>	145	592	306	1,043
Restructuring Reserve	113	447	553	1,113
Cash Charges	(80)	–	(189)	(269)
Non - Cash Charges	–	(198)	–	(198)
<b>Balance at June 30, 2001</b>	\$178	\$841	\$670	\$1,689

As of June 30, 2001, the payroll and severance costs will be paid through December 2003, and the facility lease expires in 2006.

## Notes to Consolidated Financial Statements

### 11 • Legal Proceedings

On August 11, 2000, the Company reported that it had reached a settlement of legal disputes with the Regents of the University of California (“Regents”) and New Star Technology Inc. (“New Star”) relating to the Dynamic Cooling Device (DCD) technology licensed by Candela from the Regents, and that the parties continued their negotiations of a definitive settlement agreement and amended and restated the license agreement. The terms of the settlement agreement call for an exclusivity fee in the amount of approximately \$1.7 million, which was prepaid in full, for the estimated life of the patent. This amount will be amortized over the estimated life of the patent of ten years, in addition to royalty payments made to the Regents for the exclusive rights to the DCD.

From time to time, we are a party to various legal proceedings incidental to our business. We believe that none of the presently pending legal proceedings will have a material adverse effect upon our financial position, results of operations, or liquidity.

### 12 • Quarterly Results of Operations (unaudited)

2000	Quarter			
	First	Second	Third	Fourth
Revenues	\$16,040	\$17,779	\$19,207	\$22,364
Gross profit	9,141	10,107	11,422	12,837
Net income	2,714	3,246	3,657	4,946
<b>Earning per common share</b>				
Basic earnings per share	\$0.26	\$0.30	\$0.33	\$0.44
Diluted earnings per share	\$0.23	\$0.27	\$0.30	\$0.40

2001	Quarter			
	First	Second	Third	Fourth
Revenues	\$13,111	\$14,689	\$18,796	\$18,177
Gross profit	6,624	7,762	9,432	9,658
Net income (loss)	169	848	1,554	(44)
<b>Earnings per common share</b>				
Basic earnings per share	\$0.02	\$0.08	\$0.14	\$0.00
Diluted earnings per share	\$0.01	\$0.07	\$0.14	\$0.00

During the quarter ended June 30, 2001, an additional restructuring charge of \$1.1 million was recorded resulting from the change in estimate of future sublease payments regarding the skin care center located in Scottsdale, Arizona. An impairment of assets charge of \$640,000 was recorded for the long-lived assets, principally, leasehold improvements, located at the skin care center located in Boston, Massachusetts.

## *Board of Directors*

**Kenneth D. Roberts**, Chairman, Independent Financial Consultant

**Gerard E. Puorro**, President and Chief Executive Officer

**Richard J. Cleveland, M.D.**, Professor of Surgery, Tufts University School of Medicine

**Nancy Nager**, Principal and CEO, Specialized Health Management, Inc.

**Douglas W. Scott**, Partner, Phildius, Kenyon and Scott, a HealthCare management and investment company

## *Corporate Officers*

**Gerard E. Puorro**, President and Chief Executive Officer

**F. Paul Broyer**, Senior Vice President, Finance and Administration and Chief Financial Officer

**William H. McGrail**, Vice President of Research and Development and Operations

**Dr. Kathleen McMillan**, Vice President of Research

**Robert J. Wilber**, Vice President of European Operations

**Toshio Mori**, President, Candela KK; Vice President, Candela Corporation

**Darrell W. Simino**, Treasurer and Corporate Controller

## *Stockholder Information*

### **Stock Listing**

Candela Corporation common stock is traded on the NASDAQ National Market System under the symbol CLZR. Common stock warrants: CLZRW.

### **Transfer Agent and Registrar**

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c/o EquiServe

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Boston, MA 02266-8040

To submit documents requesting a transfer, address change, or account consolidations, use the same address.

If you would like to contact the transfer agent by telephone, call 781-575-3120.

### **General Counsel**

Testa, Hurwitz & Thibault, LLP

Boston, Massachusetts

### **Independent Auditors**

Ernst & Young LLP

Boston, Massachusetts

### **Information Requests**

Stockholder inquiries about Candela Corporation may be addressed to:

Investor Relations

Candela Corporation

530 Boston Post Road

Wayland, MA 01778

508-358-7637 extension 488

A copy of Form 10-K, as filed with the Securities and Exchange Commission, may also be obtained from Investor Relations.



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