

SURMODICS INC
Form 10-Q
February 03, 2017

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 December 31, 2016

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: 0-23837

Surmodics, Inc.

(Exact name of registrant as specified in its charter)

MINNESOTA 41-1356149
(State of incorporation) (I.R.S. Employer
Identification No.)

9924 West 74th Street

Eden Prairie, Minnesota 55344

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(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (952) 500-7000

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.

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

The number of shares of the registrant's Common Stock, \$.05 par value per share, outstanding as of January 31, 2017 was 13,266,526.

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PART I. FINANCIAL INFORMATION

Item 1. Unaudited Condensed Financial Statements

Surmodics, Inc. and Subsidiaries

Condensed Consolidated Balance Sheets

	December 31, 2016	September 30, 2016
(in thousands, except share and per share data)		
(Unaudited)		
ASSETS		
Current Assets:		
Cash and cash equivalents	\$ 17,653	\$ 24,987
Available-for-sale securities	27,474	21,954
Accounts receivable, net of allowance for doubtful accounts of \$10 and \$19 as of December 31, 2016 and September 30, 2016, respectively	6,504	6,869
Inventories	3,472	3,579
Income tax receivable	358	697
Prepays and other	1,183	472
Total Current Assets	56,644	58,558
Property and equipment, net	20,186	19,601
Deferred tax assets	4,286	5,027
Intangible assets, net	21,094	22,525
Goodwill	25,694	26,555
Other assets	721	628
Total Assets	\$ 128,625	\$ 132,894
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	\$ 1,611	\$ 1,622
Accrued liabilities:		
Compensation	1,364	5,418
Due to customers	340	881
Accrued other	1,563	1,109
Contingent consideration	925	925
Deferred revenue	131	180
Total Current Liabilities	5,934	10,135
Contingent consideration, less current portion	13,366	13,592
Deferred revenue, less current portion	258	188
Other long-term liabilities	1,884	2,146
Total Liabilities	21,442	26,061
Commitments and Contingencies (Note 15)		
Stockholders' Equity:		
Series A Preferred stock- \$.05 par value, 450,000 shares authorized; no shares issued and outstanding	—	—
Common stock- \$.05 par value, 45,000,000 shares authorized; 13,268,530 and	663	660

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13,208,443 shares issued and outstanding, respectively

Additional paid-in capital	7,009	6,754
Accumulated other comprehensive (loss) income	(935)	1,273
Retained earnings	100,446	98,146
Total Stockholders' Equity	107,183	106,833
Total Liabilities and Stockholders' Equity	\$128,625	\$132,894

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

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Surmodics, Inc. and Subsidiaries

Condensed Consolidated Statements of Income

(In thousands, except per share data)	Three Months Ended December 31,	
	2016	2015
	(Unaudited)	
Revenue:		
Product sales	\$7,701	\$7,181
Royalties and license fees	8,001	7,954
Research, development and other	2,059	1,406
Total revenue	17,761	16,541
Operating costs and expenses:		
Product costs	2,628	2,366
Research and development	5,970	3,634
Selling, general and administrative	4,862	3,648
Acquisition transaction, integration and other costs	—	2,491
Acquired intangible asset amortization	596	354
Contingent consideration accretion expense	437	109
Total operating costs and expenses	14,493	12,602
Operating income	3,268	3,939
Other income (loss):		
Investment income, net	85	1
Foreign exchange gain (loss)	674	(135)
Other income (loss), net	759	(134)
Income before income taxes	4,027	3,805
Income tax provision	(1,727)	(1,152)
Net income	\$2,300	\$2,653
Basic net income per share	\$0.17	\$0.20
Diluted net income per share	\$0.17	\$0.20
Weighted average number of shares outstanding:		
Basic	13,200	12,966
Diluted	13,446	13,186

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

Surmodics, Inc. and Subsidiaries

Condensed Consolidated Statements of Comprehensive Income

	Three Months Ended December 31, 2016 2015 (Unaudited)	
(In thousands)		
Net income	\$2,300	\$2,653
Other comprehensive (loss) income:		
Unrealized holding gains (losses) on available-for-sale securities, net of tax	46	(2)
Foreign currency translation adjustments	(2,254)	408
Other comprehensive (loss) income	(2,208)	406
Comprehensive income	\$92	\$3,059

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

Surmodics, Inc. and Subsidiaries

Condensed Consolidated Statements of Cash Flows

(in thousands)	Three Months Ended December 31, 2016 2015 (Unaudited)	
Operating Activities:		
Net income	\$2,300	\$2,653
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,282	909
Stock-based compensation	789	684
Contingent consideration accretion	437	109
Unrealized foreign exchange (income) loss	(663)	135
Deferred taxes	742	753
Other	(5)	(3)
Change in operating assets and liabilities, net of acquisitions:		
Accounts receivable	345	2,194
Inventories	73	(83)
Prepays and other	(746)	(75)
Accounts payable and accrued liabilities	(2,713)	(1,354)
Income taxes	82	356
Deferred revenue	28	—
Net cash provided by operating activities	1,951	6,278
Investing Activities:		
Purchases of property and equipment	(1,545)	(384)
Purchases of available-for-sale securities	(12,541)	—
Maturities of available-for-sale securities	7,071	—
Payments for acquisition, net of cash acquired	—	(18,166)
Net cash used in investing activities	(7,015)	(18,550)
Financing Activities:		
Issuance of common stock	13	10
Payments for taxes related to net share settlement of equity awards	(2,129)	(353)
Payment of deferred financing costs	(38)	—
Payment of contingent consideration	—	(305)
Net cash used in financing activities	(2,154)	(648)
Effect of exchange rate changes on cash	(116)	—
Net change in cash and cash equivalents	(7,334)	(12,920)
Cash and Cash Equivalents:		
Beginning of period	24,987	55,588
End of period	\$17,653	\$42,668
Supplemental Information:		
Cash paid for income taxes	\$897	\$42
Noncash transactions from investing and financing activities:		
Acquisition of property and equipment on account	\$227	\$54
Deferred financing costs in accounts payable	45	—
Contingent consideration and debt assumed in Creagh Medical transaction	—	9,857

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Issuance of performance shares, restricted and deferred stock units 2,414 1,073

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

Surmodics, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

Period Ended December 31, 2016

(Unaudited)

1. Basis of Presentation

The accompanying unaudited interim condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“U.S.”) (“GAAP”) and, in the opinion of management, reflect all adjustments, consisting of normal recurring adjustments, needed to fairly present the financial results of Surmodics, Inc. and subsidiaries (“Surmodics” or the “Company”) for the periods presented. These financial statements include some amounts that are based on management’s best estimates and judgments. These estimates may be adjusted as more information becomes available, and any adjustment could be significant. The impact of any change in estimates is included in the determination of net income in the period in which the change in estimate is identified. The results of operations for the three months ended December 31, 2016 are not necessarily indicative of the results that may be expected for the entire 2017 fiscal year.

In accordance with the rules and regulations of the U.S. Securities and Exchange Commission (“SEC”), the Company has omitted footnote disclosures that would substantially duplicate the disclosures contained in the audited consolidated financial statements of the Company. These unaudited condensed consolidated financial statements should be read together with the audited consolidated financial statements for the fiscal year ended September 30, 2016, and footnotes thereto included in the Company’s Form 10-K as filed with the SEC on December 2, 2016.

2. New Accounting Pronouncements

Accounting Standards to be Implemented

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Codification (“ASC”) Update No. 2014-09, Revenue from Contracts with Customers (ASC Topic 606). Principles of this guidance require entities to recognize revenue in a manner that depicts the transfer of goods or services to customers in amounts that reflect the consideration an entity expects to be entitled to in exchange for those goods or services. The guidance also requires expanded disclosures relating to the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. Additionally, qualitative and quantitative disclosures are required about customer contracts, significant judgments and changes in judgments, and assets recognized from the costs to obtain or fulfill a contract. This accounting standard will be effective for the Company beginning in the first quarter of fiscal year 2019 (October 1, 2018) using one of two prescribed retrospective methods. The Company is currently evaluating the impact that the adoption of this standard will have on the Company’s business model and consolidated results of operations, cash flows and financial position. The Company expects to complete its evaluation during fiscal 2017. Based on a preliminary assessment, the Company currently estimates the impact may be material due to the potential acceleration of minimum license fees and a one quarter acceleration of royalty revenue pursuant to our hydrophilic license agreements.

In February 2016, the FASB issued Accounting Standards Update ASU 2016-02, Leases (ASC Topic 842). The new guidance primarily affects lessee accounting, while accounting by lessors will not be significantly impacted by the update. The update maintains two classifications of leases: finance leases, which replace capital leases, and operating leases. Lessees will need to recognize a right-of-use asset and a lease liability on the statement of financial position for those leases previously classified as operating leases under the old guidance. The liability will be equal to the present value of lease payments. The asset will be based on the liability, subject to adjustment, such as for direct costs. The accounting standard will be effective for the Company beginning the first quarter of fiscal year 2020 (October 1, 2019) and will be applied using a modified retrospective approach. The Company is currently evaluating the impact that the adoption of this standard will have on the Company's results of operations, cash flows and financial position.

In June 2016, the FASB issued ASU No 2016-13, Financial Instruments – Credit Losses (ASC Topic 326), Measurement of Credit Losses on Financial Statements. This ASU requires a financial asset (or a group of financial assets) measured at an amortized cost basis to be presented at the net amount expected to be collected. The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial asset(s) to present the net carrying value at the amount expected to be collected on the financial asset. The accounting standard will be effective for the Company beginning in the first quarter of fiscal 2020 (October 1, 2019). Early adoption is permitted and the guidance will be applied using a modified retrospective approach. The Company is currently evaluating the impact that the adoption of this standard will have on the Company's results of operations, cash flows and financial position.

In August 2016, the FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments. The new guidance clarifies requirements for presentation and classification of the following items within the statement of cash flows: debt prepayments, settlement of zero coupon debt instruments, contingent consideration payments, insurance proceeds, securitization transactions and distributions from equity method investees. The update also addresses classification of transactions that have characteristics of more than one class of cash flows. The accounting standard will be effective for the Company beginning in the first quarter of fiscal 2018. Early adoption is permitted, including adoption in an interim period, and the guidance will be applied retrospectively. The Company is currently evaluating the impact that the adoption of this standard will have on the Company's condensed consolidated statements of cash flows.

In January 2017, the FASB issued ASU No. 2017-04, Intangibles—Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment. The new guidance removes Step 2 of the goodwill impairment test, which requires a hypothetical purchase price allocation. A goodwill impairment will now be the amount by which a reporting unit's carrying value exceeds its fair value, not to exceed the carrying amount of goodwill. The accounting standard will be effective for the Company beginning in its fiscal 2020. Early adoption is permitted, and the guidance will be applied prospectively. The Company is currently evaluating the impact that the adoption of this standard will have on the Company's condensed consolidated financial statements.

Accounting Standards Implemented

In March 2016, the FASB issued ASU No. 2016-09, Compensation – Stock Compensation (ASC Topic 718): Improvements to Employee Share-Based Payment Accounting. The accounting standard intends to simplify several areas of accounting for share-based compensation arrangements, including the income tax impact, classification of awards as either equity or liabilities, and classification on the statement of cash flows. The accounting standard is effective for the Company beginning in the first quarter of fiscal 2018 (October 1, 2017), and early adoption is permitted. The Company elected to early-adopt this accounting standard in the fourth quarter of fiscal 2016, for the fiscal year ended September 30, 2016. As a result of the adoption, the Company records excess tax benefits and certain tax deficiencies as income tax expense or benefit in the condensed consolidated statements of income, whereas such excess tax benefits or tax deficiencies were previously recorded in additional paid-in capital. As this guidance was applied retroactively to the beginning of the fiscal year ended September 30, 2016, previously reported quarterly income tax and net income for interim periods therein were adjusted for the effects of the adoption. This resulted in an adjustment to reduce the income tax provision and increase net income by \$0.1 million in the three months ended December 31, 2015, with a corresponding increase in net income per basic and diluted share of \$0.01 per share.

The guidance also requires presentation of excess tax benefits as an operating activity on the statement of cash flows rather than as a financing activity. Prior to the adoption of ASU No. 2016-09, cash flows resulting from the tax benefits generated by tax deductions in excess of the compensation cost recognized for those options (excess tax benefits) are classified as financing cash flows. During the three months ended December 31, 2015, the Company realized tax benefits from stock options resulting in approximately \$0.1 million of gross excess tax benefits, which are included as a component of cash flows from operating activities for the three months ended December 31, 2015 in the accompanying condensed consolidated statements of cash flows. This amount was previously reported as a component of cash flows from financing activities, but has been reclassified to conform to current accounting guidance.

No other new accounting pronouncement issued or effective has had, or is expected to have, a material impact on the Company's condensed consolidated financial statements.

3. Business Combinations

For all business combinations, the Company records all assets and liabilities of the acquired business, including goodwill and other identified intangible assets, at their respective fair values as of the acquisition date. Contingent consideration, if any, is recognized at its fair value on the acquisition date and changes in fair value are recognized in earnings until settlement. Acquisition-related transaction costs are expensed as incurred.

Creagh Medical Ltd.

On November 20, 2015, the Company acquired 100% of the outstanding common shares and voting shares of Creagh Medical Ltd. ("Creagh Medical") located in Ballinasloe, Ireland. The acquisition was financed with cash on hand and contingent seller financing. The Company acquired Creagh Medical for up to €30 million (approximately \$32 million as of the acquisition date), including an upfront payment of €18 million (approximately \$19.3 million as of the acquisition date), and up to €12 million (approximately \$12.8 million as of the acquisition date) based on achievement of revenue and value-creating operational milestones

through September 30, 2018. The payment of the milestones, if any, will occur in the quarter ending December 31, 2018. Total transaction, integration and other costs associated with the Creagh Medical acquisition aggregated \$2.4 million for the quarter ended December 31, 2015. The operating results of Creagh Medical have been included in the Company's Medical Device segment since the acquisition date. The Company realized \$0.5 million of revenue and a loss of \$0.3 million from the Creagh Medical operations for the three months ended December 31, 2015.

Creagh Medical designs and manufactures high-quality percutaneous transluminal angioplasty ("PTA") balloon catheters. Since 2006, Creagh Medical has grown its technical and product capability with PTA products approved throughout the world, including Europe, the United States, and Japan. With these resources, the Company is uniquely positioned to offer a total solutions approach from product design and development through in-house extrusion, balloon forming, top-assembly and packaging and regulatory capabilities to approved products for exclusive distribution.

The purchase price of Creagh Medical consisted of the following:

(Dollars in thousands)	
Cash paid	\$ 18,449
Debt assumed	761
Contingent consideration	9,064
Total purchase price	28,274
Less cash and cash equivalents acquired	(251)
Total purchase price, net of cash acquired	\$ 28,023

The following table summarizes the final allocation of the purchase price to the fair values assigned to the assets acquired and the liabilities assumed at the date of the Creagh Medical acquisition:

	Fair Value	Estimated Useful Life
	(Dollars in thousands)	(In years)
Current assets	\$ 896	N/A
Property and equipment	634	1.0-10.0
Trade name	75	N/A
Developed technology	1,787	7.0
In-process research and development	942	N/A
Customer relationships	11,119	7.0-10.0
Other noncurrent assets	81	N/A
Current liabilities	(942)N/A
Deferred tax liabilities	(9)N/A
Net assets acquired	14,583	
Goodwill	13,440	N/A
Total purchase price, net of cash acquired	\$ 28,023	

The Creagh Medical goodwill, which is a result of acquiring and retaining the Creagh Medical existing workforce and expected synergies from integrating their business into the Company's Medical Device segment, is not deductible for tax purposes.

On January 8, 2016, the Company acquired 100% of the shares of NorMedix, Inc. (“NorMedix”), a privately owned design and development company focused on ultra thin-walled, minimally invasive catheter technologies based in Plymouth, Minnesota. The acquisition was financed with cash on hand and contingent seller financing. The Company acquired NorMedix for up to \$14.0 million, including an upfront payment of \$7.0 million, and up to \$7.0 million based on achievement of revenue and value-creating operational milestones through September 30, 2019. Contingent consideration associated with the NorMedix transaction is payable as earned. This acquisition strengthened the Company’s vascular device expertise and Research and Development (“R&D”) capabilities and was a significant component of the Company’s strategy to offer whole-product solutions to medical device customers, while continuing its commitment to consistently deliver innovation in coating technologies. Total transaction, integration and other costs associated with the NorMedix acquisition aggregated \$0.1 million for the three months ended December 31, 2015. The operating results for NorMedix have been included in the Medical Device segment since the acquisition date.

The purchase price of NorMedix consisted of the following:

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(Dollars in thousands)	
Cash paid	\$6,905
Contingent consideration	3,520
Total purchase price	10,425
Less cash and cash equivalents acquired	(17)
Total purchase price, net of cash acquired	\$10,408

The following table summarizes the final allocation of the purchase price to the fair values assigned to the assets acquired and the liabilities assumed at the date of the NorMedix acquisition:

	Fair Value	Estimated Useful Life
	(Dollars in thousands)	(In years)
Net current assets	\$ 113	N/A
Property and equipment	60	N/A
Developed technology	6,850	10.0-14.0
Customer relationships	900	4.0
Deferred tax asset	690	N/A
Other noncurrent asset	13	N/A
Accounts payable	(187)	N/A
Deferred tax liabilities	(2,483)	N/A
Net assets acquired	5,956	
Goodwill	4,452	N/A
Total purchase price, net of cash acquired	\$ 10,408	

The NorMedix goodwill is a result of acquiring and retaining the NorMedix existing workforce and expected synergies from integrating their business into the Medical Device segment. The goodwill is not deductible for tax purposes.

On a pro forma basis, as if the Creagh medical and NorMedix acquisitions had occurred as of the beginning of fiscal 2016, the Company's consolidated revenues and net income would have been \$17.6 million and \$4.2 million for the three months ended December 31, 2015, with basic and diluted earnings per share of \$0.32. This unaudited pro forma financial information includes adjustments for additional amortization expense on identifiable intangible assets of \$0.4 million and contingent consideration accretion expense of \$0.3 million, eliminating non-recurring transactional professional fees of \$2.5 million, and tax effect impact of \$0.3 million. The tax impact of the adjustments in all periods reflects no tax benefit from contingent consideration accretion as well as a significant portion of our transaction related costs in fiscal 2016 as they are not deductible for tax purposes. Further, Creagh Medical amortization expense does not reflect an Irish tax benefit as we acquired a net operating loss carryforward as of the acquisition date that was offset in the aggregate by deferred tax liabilities and valuation allowance. Therefore, the amortization of Creagh Medical intangible assets results in a decrease in deferred tax liabilities with a corresponding increase to a deferred tax valuation allowance. NorMedix amortization expense reflects a tax benefit based on our incremental U.S. tax rate.

4. Fair Value Measurements

The accounting guidance on fair value measurements defines fair value, establishes a framework for measuring fair value under GAAP, and expands disclosures about fair value measurements. The guidance is applicable for all

financial assets and financial liabilities and for all nonfinancial assets and nonfinancial liabilities recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). Fair value is defined as the exchange price that would be received from selling an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants at the measurement date. When determining the fair value measurements for assets and liabilities required or permitted to be recorded at fair value, the Company considers the principal or most advantageous market in which it would transact and also considers assumptions that market participants would use when pricing the asset or liability, such as inherent risk, transfer restrictions and risk of nonperformance.

Fair Value Hierarchy

Accounting guidance on fair value measurements requires that assets and liabilities carried at fair value be classified and disclosed in one of the following three categories:

Level 1 — Quoted (unadjusted) prices in active markets for identical assets or liabilities.

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The Company did not have any Level 1 assets as of December 31, 2016 and September 30, 2016.

Level 2 — Observable inputs other than quoted prices included in Level 1, such as quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the asset or liability.

The Company's Level 2 assets as of December 31, 2016 and September 30, 2016 consisted of money market funds, commercial paper instruments and corporate bonds.

Level 3 — Unobservable inputs to the valuation methodology that are supported by little or no market activity and that are significant to the measurement of the fair value of the assets or liabilities. Level 3 assets and liabilities include those whose fair value measurements are determined using pricing models, discounted cash flow methodologies or similar valuation techniques, as well as significant management judgment or estimation.

Level 3 liabilities at December 31, 2016 and September 30, 2016 consist of contingent consideration obligations for the achievement of revenue and value-creating milestones related to the acquisitions of Creagh Medical and NorMedix discussed in Note 3.

In valuing assets and liabilities, the Company is required to maximize the use of quoted market prices and minimize the use of unobservable inputs.

Assets and Liabilities Measured at Fair Value on a Recurring Basis

In instances where the inputs used to measure fair value fall into different levels of the fair value hierarchy, the fair value measurement has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Company's assessment of the significance of a particular item to the fair value measurement in its entirety requires judgment, including the consideration of inputs specific to the asset or liability.

The following table presents information about the Company's assets and liabilities measured at fair value on a recurring basis as of December 31, 2016:

	Quoted Prices in			Total Fair Value as of December 31, 2016
	Active Markets for Identical Instruments (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
(Dollars in thousands)	(Level 1)	(Level 2)	(Level 3)	2016
Assets				
Cash equivalents	\$ —	\$ 13,775	\$ —	\$ 13,775
Available-for-sale securities	—	27,474	—	27,474
Total assets	\$ —	\$ 41,249	\$ —	\$ 41,249
Liabilities				
Contingent consideration	\$ —	\$ —	\$ (14,291)	\$ (14,291)
Total liabilities	\$ —	\$ —	\$ (14,291)	\$ (14,291)

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The following table presents information about the Company's assets and liabilities measured at fair value on a recurring basis as of September 30, 2016:

	Quoted Prices in			Total Fair Value as of September 30, 2016
	Active Markets for Identical Instruments (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
(Dollars in thousands)	(Level 1)	(Level 2)	(Level 3)	2016
Assets				
Cash equivalents	\$ —	\$ 22,160	\$ —	\$ 22,160
Available-for-sale securities	—	21,954	—	\$ 21,954
Total assets	\$ —	\$ 44,114	\$ —	\$ 44,114
Liabilities				
Contingent consideration	\$ —	\$ —	\$ (14,517)	\$ (14,517)
Total liabilities	\$ —	\$ —	\$ (14,517)	\$ (14,517)

The following table summarizes the changes in the contingent consideration liabilities measured at fair value using Level 3 inputs for the three months ended December 31, 2016 and 2015:

(Dollars in thousands)	Three Months Ended December 31,	
	2016	2015
Beginning balance	\$ 14,517	\$ —
Additions	—	9,064
Fair value adjustments	—	—
Settlements	—	—
Interest accretion	437	109
Foreign currency translation (gain) loss	(663)	135
Ending balance	\$ 14,291	\$ 9,308

There were no transfers of assets or liabilities to or from amounts measured using Level 3 fair value measurements during fiscal 2017 or 2016.

Valuation Techniques

The valuation techniques used to measure the fair value of assets are as follows:

Cash equivalents — These assets are classified as Level 2 and are carried at historical cost which is a reasonable estimate of fair value because of the relatively short time between origination of the instrument and its expected realization.

Available-for-sale securities — Fair market values for these assets are based on quoted vendor prices and broker pricing in active markets underlying the securities where all significant inputs are observable. To ensure the accuracy of quoted vendor prices and broker pricing, the Company performs regular reviews of investment returns to industry

benchmarks and sample tests of individual securities to validate quoted vendor prices with other available market data.

Contingent consideration — The contingent consideration liabilities were determined based on discounted cash flow analyses that included revenue estimates, probability of strategic milestone achievement and a discount rate, which are considered significant unobservable inputs. For the revenue-based milestones, the Company discounted forecasted revenue by 14.1% to 22.8%, which represents the Company's weighted average cost of capital for each transaction, adjusted for the short-term nature of the cash flows. The resulting present value of revenue was used as an input into an option pricing approach, which also considered the Company's risk of non-payment of the revenue-based milestones. Non-revenue milestones were projected to have a 65-95% probability of achievement and related payments were discounted using the Company's estimated cost of debt, or 5.6% to 6.7%. To the extent that actual results differ from these estimates, the fair value of the contingent consideration liabilities could change significantly. The contingent consideration liability related to the Creagh Medical acquisition is denominated in Euros and is not hedged. The Company recorded a foreign currency gain of \$0.7 million and a loss of \$0.1 million for the three months ended

December 31, 2016 and 2015, respectively, related to this contingent consideration as this obligation was marked to period-end exchange rates.

5. Investments

Investments consisted principally of commercial paper securities and are classified as available-for-sale as of December 31, 2016 and September 30, 2016. Available-for-sale securities are reported at fair value with unrealized gains and losses, net of tax, excluded from the condensed consolidated statements of income and reported in the condensed consolidated statements of comprehensive income as well as a separate component of stockholders' equity in the condensed consolidated balance sheets, except for other-than-temporary impairments, which are reported as a charge to current earnings. A loss would be recognized when there is an other-than-temporary impairment in the fair value of any individual security classified as available-for-sale, with the associated net unrealized loss reclassified out of accumulated other comprehensive income with a corresponding adjustment to other income (loss). This adjustment results in a new cost basis for the investment. Interest earned on debt securities, including amortization of premiums and accretion of discounts, is included in other income. Realized gains and losses from the sales of debt securities, which are included in other income, are determined using the specific identification method.

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The amortized cost, unrealized holding gains and losses, and fair value of available-for-sale securities were as follows:

	December 31, 2016			
(Dollars in thousands)	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Commercial paper and corporate bonds	\$27,487	\$ —	\$ (13)	\$ 27,474
Total	\$27,487	\$ —	\$ (13)	\$ 27,474

	September 30, 2016			
(Dollars in thousands)	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Commercial paper and corporate bonds	\$22,019	\$ —	\$ (65)	\$ 21,954
Total	\$22,019	\$ —	\$ (65)	\$ 21,954

The following table summarizes sales of available-for-sale debt securities:

	Three Months Ended December 31,	
(Dollars in thousands)	2016	2015
Proceeds from maturities	\$ 7,071	\$ —
Gross realized gains	\$ —	\$ —
Gross realized losses	\$ —	\$ —

6. Inventories

Inventories are principally stated at the lower of cost or market using the specific identification method and include direct labor, materials and overhead, with cost of product sales determined on a first-in, first-out basis. Inventories consisted of the following components:

	December 31,	September 30,
(Dollars in thousands)	2016	2016
Raw materials	\$ 1,724	\$ 1,766
Work-in process	449	492
Finished products	1,299	1,321
Total	\$ 3,472	\$ 3,579

7. Other Assets

Other assets consist of the following:

	December 31,	September
(Dollars in thousands)	2016	30, 2016
ViaCyte, Inc.	\$ 479	\$ 479
Other noncurrent assets	242	149
Other assets, net	\$ 721	\$ 628

The Company has invested a total of \$5.3 million in ViaCyte, Inc. (“ViaCyte”), a privately-held California-based biotechnology firm that is developing a unique treatment for diabetes using coated islet cells, the cells that produce insulin in the human body. The balance of the investment of \$0.5 million, which is net of previously recorded other-than-temporary impairments of \$4.8 million is accounted for under the cost method and represents less than a 1% ownership interest. The Company does not exert significant influence over ViaCyte’s operating or financial activities.

The carrying value of each cost method investment is reviewed quarterly for changes in circumstances or the occurrence of events that suggest the Company’s investment may not be recoverable. The fair value of cost method investments is not adjusted if there are no identified events or changes in circumstances that may have a material adverse effect on the fair value of the investment.

8. Intangible Assets

Intangible assets consist principally of acquired patents and technology, customer lists and relationships, licenses and trademarks. The Company recorded amortization expense of \$0.6 million and \$0.4 million for the three months ended December 31, 2016 and 2015, respectively.

Intangible assets consisted of the following:

(Dollars in thousands)	December 31, 2016			
	Weighted Average Original Life (Years)	Gross Carrying Amount	Accumulated Amortization	Net
Definite-lived intangible assets:				
Customer lists and relationships	8.9	\$ 16,979	\$ (6,434)	\$ 10,545
Core technology	8.0	530	(530)	—
Developed technology	11.8	8,610	(800)	7,810
Non-compete	5.0	230	(69)	161
Patents and other	16.5	2,322	(1,312)	1,010
Subtotal		28,671	(9,145)	19,526
Unamortized intangible assets:				
In-process research and development		927	—	927
Trademarks and trade names		641	—	641
Total		\$ 30,239	\$ (9,145)	\$ 21,094

(Dollars in thousands)	September 30, 2016			
	Weighted Average Original Life (Years)	Gross Carrying Amount	Accumulated Amortization	Net