SURMODICS INC
Form 10-Q
May 10, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2016

or

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

For the transition period from ______________ to ______________

Commission File Number: 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

(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 x No o

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 x No o

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	o	Accelerated filer	x
Non-accelerated filer	o (Do not check if a smaller reporting company)	Smaller reporting company	o

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

The number of shares of the registrant's Common Stock, $.05 par value per share, outstanding as of April 29, 2016 was 13,014,939.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

SurModics, Inc. and Subsidiaries

Condensed Consolidated Balance Sheets

(in thousands, except share and per share data)	March 31, 2016 (Unaudited)	September 30, 2015
ASSETS		
Current Assets:		
Cash and cash equivalents	$38,989	$ 55,588
Restricted cash	822	—
Accounts receivable, net of allowance for doubtful accounts of $34 and $10 as of March 31, 2016 and September 30, 2015, respectively	6,932	7,478
Inventories	3,335	2,979
Deferred tax assets	—	546
Prepaids and other	1,643	1,198
Total Current Assets	51,721	67,789
Property and equipment, net	13,881	12,968
Deferred tax assets	5,190	6,704
Intangible assets, net	24,059	2,760
Goodwill	26,965	8,010
Other assets, net	669	479
Total Assets	$122,485	$ 98,710
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$2,085	$ 781
Accrued liabilities:		
Compensation	1,785	2,772
Due to customers	1,471	63
Accrued other	1,431	731
Business combination consideration payable	822	305
Contingent consideration	400	—
Deferred revenue	315	48
Total Current Liabilities	8,309	4,700
Contingent consideration	13,246	—
Deferred revenue, less current portion	199	217
Other long-term liabilities	1,900	1,920
Total Liabilities	23,654	6,837
Commitments and Contingencies (Note 16)		
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; 13,012,656 and 12,945,157 shares issued and outstanding, respectively	651	647
Additional paid-in capital	4,950	3,060
Accumulated other comprehensive income	1,731	5
Retained earnings	91,499	88,161
Total Stockholders' Equity	98,831	91,873
Total Liabilities and Stockholders' Equity	$122,485	$ 98,710

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

SurModics, Inc. and Subsidiaries

Condensed Consolidated Statements of Income

(In thousands, except per share data)	Three Months Ended March 31, 2016 (Unaudited)	2015	Six Months Ended March 31, 2016 (Unaudited)	2015
Revenue:				
Royalties and license fees	$6,697	$7,383	$14,651	$14,658
Product sales	8,173	5,651	15,354	11,498
Research, development and other	1,829	1,381	3,235	2,464
Total revenue	16,699	14,415	33,240	28,620
Operating costs and expenses:				
Product costs	2,926	1,955	5,292	3,857
Research and development	4,868	4,403	8,502	7,979
Selling, general and administrative	4,853	3,974	8,501	7,515
Acquisition transaction, integration and other costs	640	—	3,131	—
Acquisition related intangible asset amortization	780	151	1,134	303
Contingent consideration accretion expense	392	—	501	—
Total operating costs and expenses	14,459	10,483	27,061	19,654
Operating income	2,240	3,932	6,179	8,966
Other (loss) income:				
Investment income, net	16	56	17	113
Foreign exchange loss	(434)	—	(569)	—
Other income, net	361	543	361	536
Other (loss) income, net	(57)	599	(191)	649
Income before income taxes	2,183	4,531	5,988	9,615
Income tax provision	(1,358)	(1,480)	(2,650)	(2,950)
Net income	$825	$3,051	$3,338	$6,665
Basic net income per share	$0.06	$0.24	$0.26	$0.51
Diluted net income per share	$0.06	$0.23	$0.25	$0.50
Weighted average number of shares outstanding:				
Basic	12,969	12,944	12,956	13,092
Diluted	13,190	13,207	13,187	13,365

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

SurModics, Inc. and Subsidiaries

Condensed Consolidated Statements of Comprehensive Income

(In thousands)	Three Months Ended March 31, 2016 (Unaudited)	Three Months Ended March 31, 2015 (Unaudited)	Six Months Ended March 31, 2016 (Unaudited)	Six Months Ended March 31, 2015 (Unaudited)
Net income	$825	$3,051	$3,338	$6,665
Other comprehensive income (loss), net of tax:				
Unrealized holding losses on available-for-sale securities arising during the period	—	(70)	(2)	(1,156)
Reclassification adjustment for realized gains included in net income	—	(346)	—	(342)
Foreign currency translation adjustments	1,320	—	1,728	—
Other comprehensive income (loss)	1,320	(416)	1,726	(1,498)
Comprehensive income	$2,145	$2,635	$5,064	$5,167

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)	Six Months Ended March 31, 2016 (Unaudited)	2015
Operating Activities:		
Net income	$3,338	$6,665
Adjustments to reconcile net income to net cash provided by operating activities from continuing operations:		
Depreciation and amortization	2,297	1,389
Stock-based compensation	1,899	1,211
Contingent consideration accretion and unrealized foreign exchange loss	1,065	—
Deferred taxes	2,060	795
Gain on sales of available-for-sale securities and strategic investment	(361)	(515)
Excess tax benefit from stock-based compensation plans	(136)	(442)
Other	(18)	(40)
Change in operating assets and liabilities, net of acquisitions:		
Accounts receivable	874	(176)
Inventories	(97)	(378)
Prepaids and other	9	(245)
Accounts payable and accrued liabilities	439	(609)
Income taxes	(1,925)	(825)
Net cash provided by operating activities from continuing operations	9,444	6,830
Investing Activities:		
Purchases of property and equipment	(983)	(163)
Cash proceeds from sales of property and equipment	15	42
Payments for acquisitions, net of cash acquired	(25,149)	—
Purchases of available-for-sale securities	—	(3,385)
Sales and maturities of available-for-sale securities	—	3,176
Cash received from sale of strategic investment	361	—
Cash transferred to discontinued operations	—	(45)
Net cash used in investing activities from continuing operations	(25,756)	(375)
Financing Activities:		
Excess tax benefit from stock-based compensation plans	136	442
Issuance of common stock	225	348
Repurchase of common stock	—	(20,000)
Purchase of common stock to pay employee taxes	(366)	(741)
Payment of contingent consideration	(305)	—
Net cash used in financing activities from continuing operations	(310)	(19,951)
Net cash used in continuing operations	(16,622)	(13,496)
Discontinued Operations:		
Net cash used in operating activities	—	(45)

Net cash provided by financing activities	—	45
Net cash provided by discontinued operations	—	—
Effect of exchange rate changes on cash	23	—
Net change in cash and cash equivalents	(16,599)	(13,496)
Cash and Cash Equivalents:		
Beginning of period	55,588	43,511
End of period	$38,989	$30,015
Supplemental Information:		
Cash paid for income taxes	$2,486	$2,981
Noncash transactions from investing and financing activities:		
Acquisition of property and equipment on account	$99	$155
Contingent consideration and debt assumed in acquisitions	$13,374	$—
Issuance of performance shares, restricted and deferred stock units	$1,327	$2,250

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 March 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. The preparation of financial statements in conformity with US GAAP requires management to make estimates and assumptions that affect the reported amounts of the assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates. The results of operations for the three and six months ended March 31, 2016 are not necessarily indicative of the results that may be expected for the entire 2016 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, 2015, and footnotes thereto included in the Company’s Form 10-K as filed with the SEC on December 4, 2015, and as amended on May 10, 2016.

During the quarter ended March 31, 2016, the Company recorded an out-of-period adjustment of $1.1 million to correct a cumulative overstatement of royalty revenue, or which $1.0 million related to years prior to fiscal 2016. The overstatement was evaluated and concluded to not be material to fiscal 2016, the three and six months ended March 31, 2016, or any prior periods.

2. New Accounting Pronouncements

Accounting Standards to be Adopted

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 results of operations, cash flows and financial position.

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) 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 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 will be effective for the Company beginning in the first quarter of fiscal 2018 (October 1, 2017), and early adoption is permitted. We currently are evaluating the impact that the adoption of this standard will have on the Company's results of operations, cash flows and financial position.

Accounting Standards Adopted

In September 2015, the FASB issued ASU 2015-16, Business Combinations (ASC Topic 805): Simplifying the Accounting for Measurement-Period Adjustments. The update requires that an acquirer recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined, including the cumulative effect of the change in provisional amounts as if the accounting had been completed at the acquisition date. The adjustments related to previous reporting periods since the acquisition date must be disclosed by income statement line item either on the face of the income statement or in the notes. The accounting standard is effective for fiscal years beginning after December 15, 2015, including interim periods within those fiscal years, with early adoption permitted. The Company adopted this accounting standard in the first quarter of fiscal 2016 without any material impact on the Company's financial position or financial results.

In November 2015, the FASB issued ASU 2015-17, Balance Sheet Classification of Deferred Taxes, which eliminates the current requirement to present deferred tax liabilities and assets as current and noncurrent in a classified balance sheet. Instead, entities will be required to classify all deferred tax assets and liabilities as noncurrent. This accounting standard is effective for the Company beginning in its first quarter of fiscal year 2018 and early implementation is permitted using either the prospectively or retroactive adoption method. The Company prospectively adopted this accounting standard in the first quarter of fiscal 2016.

No other new accounting pronouncement issued or effective has had, or is expected to have, a material impact on the Company's 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, generally at their fair values starting in the period when the acquisition is completed. 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 results of Creagh Medical's operations have been included in the Company's condensed consolidated financial statements as of the Creagh Medical acquisition date. The acquisition was financed with cash on hand. 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 met will occur in the quarter ending December 31, 2018. As of March 31, 2016, the Company had paid $18.4 million in cash for this acquisition, in addition to $0.8 million to an escrow account to fund the repurchase of certain Creagh Medical debt classified securities during fiscal 2016. As these securities have not been legally defeased by the establishment of the escrow fund, the Company has recorded a corresponding restricted cash and business combination consideration payable. It is expected that these securities will be repaid in the third quarter of fiscal 2016. The Company also assumed $0.8 million of debt that was repaid in the second quarter of fiscal 2016. Total transaction, integration and other costs associated with the Creagh Medical acquisition aggregated $2.4

million and $2.6 million for the three and six months ended March 31, 2016, respectively. Creagh Medical is included in the Company's Medical Device reporting segment.

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, packaging and regulatory capabilities to approved products for exclusive distribution. The acquisition is a major step forward in the Company's strategy to transform its Medical Device segment from being a provider of coatings technologies to offering whole-product solutions to medical device customers in the large and growing global interventional vascular market.

The purchase price of Creagh Medical consisted of the following:

(Dollars in thousands)	
Cash paid	$18,417
Debt assumed	793
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 preliminary 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 (Dollars in thousands)	Estimated Useful Life (In years)
Current assets	$ 708	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	(923)	N/A
Deferred tax liabilities	(9)	N/A
Net assets acquired	14,414	
Goodwill	13,609	N/A
Total purchase price, net of cash acquired	$ 28,023	

The Creagh Medical goodwill is a result of acquiring and retaining the Creagh Medical existing workforce and expected synergies from integrating their business into SurModics. The goodwill will not be deductible for tax purposes. Purchase accounting is considered preliminary, subject to revision, mainly with respect to working capital, income taxes and goodwill, as final information was not available as of March 31, 2016.

As a result of the Creagh Medical acquisition, the Company has adopted a foreign currency translation policy. Assets and liabilities of non-U.S. dollar functional currency subsidiaries are translated into U.S. dollars at the period-end exchange rates, and revenues and expenses are translated at the average exchange rate for the period. The net effect of these translation adjustments in the condensed consolidated financial statements are recorded as a foreign currency translation adjustment, as a component of accumulated other comprehensive income. Foreign currency transaction gains and losses are included in other, income (loss) net in our Condensed Consolidated Statements of Income.

NorMedix, Inc.

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. The Company acquired NorMedix for $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 strengthens the Company's vascular device expertise and Research and Development ("R&D) capabilities. This acquisition positions the Company to make significant progress on its strategy to offer whole-product solutions to medical device customers, while continuing its commitment to consistently deliver innovation in coating technologies and in vitro diagnostics. Total transaction, integration and other costs associated with the NorMedix acquisition aggregated $0.3 million for both the three and six months ended March 31, 2016. NorMedix is included in the Company's Medical Device reporting segment.

The purchase price of NorMedix consisted of the following:

(Dollars in thousands)	
Cash paid	$7,000
Contingent consideration	3,740
Total purchase price	10,740
Less cash and cash equivalents acquired	(17)
Total purchase price, net of cash acquired	$10,723

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

	Fair Value (Dollars in thousands)	Estimated Useful Life (In years)
Net current assets	$ 98	N/A
Property and equipment	76	N/A
Developed technology	6,850	10.0-14.0
Customer relationships	900	4.0
Deferred tax asset	746	N/A
Other noncurrent asset	12	N/A
Deferred tax liabilities	(2,474)	N/A
Net assets acquired	6,208	
Goodwill	4,515	N/A
Total purchase price, net of cash acquired	$ 10,723	

The NorMedix goodwill is a result of acquiring and retaining the NorMedix existing workforce and expected synergies from integrating their business into SurModics. The goodwill will not be deductible for tax purposes. Purchase accounting is considered preliminary, subject to revision, mainly with respect to working capital, income taxes and goodwill, as final information was not available as of March 31, 2016.

These strategic acquisitions combine the best-in-class capabilities of NorMedix's catheter-based technologies, Creagh Medical's PTA balloon platform capabilities, and SurModics' innovative coating and drug delivery technologies to develop highly differentiated delivery and therapeutic intravascular solutions. The result is an organization with unique device design and development expertise, rich technology content, manufacturing capabilities, and a state-of-the-art facility equipped for medical device R&D and manufacturing.

Pro Forma Results

The following unaudited pro forma financial information presents the combined results of operation of the Company as if the acquisitions of Creagh Medical and NorMedix had occurred as of October 1, 2014. The Company has realized $1.6 million of revenue and a loss of $1.1 million from the Creagh Medical and NorMedix operations since their acquisitions.

The fiscal 2016 six month 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 $2.9 million, and tax effect impact of $0.3 million.

As NorMedix was acquired on January 8, 2016, substantially all of the activity of NorMedix and all activity of Creagh Medical is included in the quarter ended March 31, 2016 condensed consolidated financial statements, therefore, pro forma activity for the second quarter of fiscal 2016 has not been presented.

The fiscal 2015 three and six month pro forma financial information includes adjustments for additional amortization expense on identifiable intangible assets of $0.6 million and $1.3 million, contingent consideration accretion expense of $0.4 million and $0.8 million and tax effect impact of $0.2 million and $0.3 million, respectively.

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.

The unaudited pro forma financial information is not necessarily indicative of what the Company's consolidated results of operations actually would have been had the acquisition occurred at the beginning of each year. Additionally, the unaudited pro forma financial information does not attempt to project the future results of operations of the combined company.

	Three Months Ended March 31,	Six Months Ended March 31,	
	2015	2016	2015
(In thousands, except per share data)	(Unaudited)	(Unaudited)	
Revenue	$ 15,267	$	