

NUVASIVE INC
Form 10-Q
July 26, 2012
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2012

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 000-50744

NUVASIVE, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

33-0768598
(I.R.S. Employer
Identification No.)

7475 Lusk Boulevard

San Diego, CA 92121

(Address of principal executive offices, including zip code)

(858) 909-1800

(Registrant's telephone number, including area code)

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(Former name, former address and former fiscal year, if changed since last report)

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 website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

(Do not check if a 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

As of July 20, 2012, there were 43,470,330 shares of the registrant's common stock outstanding.

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NUVASIVE, INC.

QUARTERLY REPORT ON FORM 10-Q

June 30, 2012

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	June 30, 2012 (Unaudited)	December 31, 2011
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 121,156	\$ 163,492
Short-term marketable securities	120,656	146,228
Accounts receivable, net	85,749	87,736
Inventory	128,559	119,313
Deferred tax assets, current	54,550	54,550
Prepaid expenses and other current assets	8,130	20,518
Total current assets	518,800	591,837
Property and equipment, net	129,435	124,754
Long-term marketable securities	23,707	32,503
Intangible assets, net	105,128	108,140
Goodwill	160,745	159,349
Deferred tax assets	19,857	19,857
Restricted cash and investments	181,815	68,600
Other assets	27,756	18,522
Total assets	\$ 1,167,243	\$ 1,123,562
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 61,232	\$ 51,744
Accrued payroll and related expenses	20,746	22,215
Litigation liability		101,200
Acquisition-related liabilities	32,290	32,221
Senior Convertible Notes, current	74,311	
Total current liabilities	188,579	207,380
Senior Convertible Notes	325,941	394,019
Deferred tax liabilities	3,952	3,952
Litigation liability	101,200	
Other long-term liabilities	14,564	13,461
Commitments and contingencies		
Noncontrolling interests	10,248	10,705
Stockholders' equity:		
Preferred stock, \$0.001 par value; 5,000 shares authorized, none outstanding		
Common stock, \$0.001 par value; 120,000 shares authorized, 43,441 and 42,455 issued and outstanding at June 30, 2012 and December 31, 2011, respectively	43	42
Additional paid-in capital	700,409	674,790
Accumulated other comprehensive income	35	477

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Accumulated deficit	(177,728)	(181,264)
Total stockholders' equity	522,759	494,045
Total liabilities and stockholders' equity	\$ 1,167,243	\$ 1,123,562

See accompanying notes to unaudited condensed consolidated financial statements.

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NUVASIVE, INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Revenue	\$ 154,419	\$ 132,966	\$ 306,110	\$ 257,432
Cost of goods sold (excluding amortization of purchased technology)	36,534	25,508	73,467	49,034
Gross profit	117,885	107,458	232,643	208,398
Operating expenses:				
Sales, marketing and administrative	92,346	84,323	186,617	168,543
Research and development	9,604	10,258	19,999	21,027
Amortization of intangible assets	2,903	1,395	5,749	2,737
Total operating expenses	104,853	95,976	212,365	192,307
Interest and other expense, net:				
Interest income	204	151	412	334
Interest expense	(6,972)	(1,915)	(13,797)	(3,686)
Other (expense) income, net	(551)	80	(114)	577
Total interest and other expense, net	(7,319)	(1,684)	(13,499)	(2,775)
Income before income tax expense	5,713	9,798	6,779	13,316
Income tax expense	3,103	4,776	3,700	6,316
Consolidated net income	\$ 2,610	\$ 5,022	\$ 3,079	\$ 7,000
Net loss attributable to noncontrolling interests	\$ (253)	\$ (358)	\$ (457)	\$ (739)
Net income attributable to NuVasive, Inc.	\$ 2,863	\$ 5,380	\$ 3,536	\$ 7,739
Net income per share attributable to NuVasive, Inc.:				
Basic	\$ 0.07	\$ 0.14	\$ 0.08	\$ 0.19
Diluted	\$ 0.06	\$ 0.13	\$ 0.08	\$ 0.19
Weighted average shares outstanding:				
Basic	43,347	39,786	43,095	39,701
Diluted	44,318	40,868	43,857	40,691

See accompanying notes to unaudited condensed consolidated financial statements.

Table of Contents**NUVASIVE, INC.****UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME***(in thousands)*

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Consolidated net income	\$ 2,610	\$ 5,022	\$ 3,079	\$ 7,000
Other comprehensive income:				
Unrealized (loss) gain on investments	(87)	37	(145)	26
Translation adjustments	(978)	346	(297)	1,056
Total consolidated comprehensive income	1,545	5,405	2,637	8,082
Plus: Net loss attributable to noncontrolling interests	253	358	457	739
Comprehensive income attributable to NuVasive, Inc.	\$ 1,798	\$ 5,763	\$ 3,094	\$ 8,821

See accompanying notes to unaudited condensed consolidated financial statements.

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NUVASIVE, INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	Six Months Ended June 30,	
	2012	2011
Operating activities:		
Consolidated net income	\$ 3,079	\$ 7,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	25,313	15,888
Amortization of debt discount	6,233	99
Amortization of debt issuance costs	912	756
Stock-based compensation	14,966	15,671
Allowance for excess and obsolete inventory, net of write-offs	1,275	2,341
Allowance for doubtful accounts and sales return reserves	1,622	529
Accretion of contingent consideration	599	914
Other non-cash adjustments	2,942	2,038
Changes in operating assets and liabilities, net of effects from acquisitions:		
Accounts receivable	671	(5,351)
Inventory	(10,967)	(12,146)
Prepaid expenses and other current assets	12,185	(791)
Accounts payable and accrued liabilities	7,099	(2,300)
Accrued payroll and related expenses	(1,973)	(1,997)
Income taxes payable	1,803	5,043
Net cash provided by operating activities	65,759	27,694
Investing activities:		
Cash paid for business and asset acquisitions	(7,917)	
Purchases of property and equipment	(23,930)	(27,944)
Purchases of marketable securities	(110,915)	(54,317)
Sales of marketable securities	144,427	113,559
Purchases of restricted investments	(113,126)	(4,701)
Payment for specific rights in connection with supply agreement, net of refund received		(5,000)
Net cash (used in) provided by investing activities	(111,461)	21,597
Financing activities:		
Proceeds from the sale of warrants		47,898
Proceeds from the issuance of convertible debt, net of issuance costs		391,548
Purchase of convertible note hedges		(80,097)
Proceeds from the issuance of common stock	3,094	4,334
Other assets	242	(557)
Net cash provided by financing activities	3,336	363,126
Effect of exchange rate changes on cash	30	70
(Decrease) increase in cash and cash equivalents	(42,336)	412,487
Cash and cash equivalents at beginning of period	163,492	92,597
Cash and cash equivalents at end of period	\$ 121,156	\$ 505,084

Supplemental disclosure of non-cash transactions:

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Issuance of common stock in connection with asset acquisitions	\$	7,560	\$
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See accompanying notes to unaudited condensed consolidated financial statements.

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NuVasive, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements

1. Description of Business and Basis of Presentation

Description of Business

NuVasive, Inc. (the Company or NuVasive) was incorporated in Delaware on July 21, 1997, and began commercializing its products in 2001. The Company is focused on developing minimally disruptive surgical products and procedurally integrated solutions for the spine. NuVasive's principal product offering is based on its Maximum Access Surgery, or MAS[®] platform. The MAS platform combines several categories of solutions that collectively minimize soft tissue disruption during spine fusion surgery with maximum visualization and safe, easy reproducibility for the surgeon. The platform includes a proprietary software-driven nerve avoidance system and intra-operative monitoring (IOM) support; MaXcess[®], a unique split-blade retractor system; a wide variety of specialized implants; and several biologic fusion options. MAS significantly reduces surgery time and returns patients to activities of daily living much faster than conventional approaches. The Company continues to focus significant research and development efforts to expand its MAS product platform and advance the applications of its unique technology into procedurally integrated surgical solutions. The Company dedicates significant resources toward training spine surgeons on its unique technology and products.

The Company's primary business model is to loan its MAS systems to surgeons and hospitals who purchase disposables and implants for use in individual procedures. In addition, for larger customers, the Company's proprietary nerve monitoring systems, MaXces[®] and surgical instrument sets are placed with hospitals for an extended period at no up-front cost to them. The Company also offers a range of bone allograft in patented saline packaging, disposables and spine implants, which include its branded CoRoent[®] products and fixation devices such as rods, plates and screws. Implants and disposables are shipped from the Company's inventories. The Company sells an immaterial quantity of MAS instrument sets, MaXcess and nerve monitoring systems to hospitals.

On October 7, 2011, the Company completed the acquisition of Impulse Monitoring, Inc. (Impulse Monitoring), a company which provides IOM services of the nervous system during spine and other surgeries. The acquisition complements the Company's existing nerve monitoring systems, which are designed for discreet and directional nerve avoidance and detection, making lateral access to the spine during the eXtreme lateral interbody fusion (XLIF[®]) procedure safe and reproducible.

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Pursuant to these rules and regulations, the Company has condensed or omitted certain information and footnote disclosures it normally includes in its annual consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States (GAAP). In the opinion of management, the consolidated financial statements include all adjustments necessary, which are of a normal and recurring nature, for the fair presentation of the Company's financial position and of the results of operations and cash flows for the periods presented.

The accompanying unaudited condensed consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. Additionally, the unaudited condensed consolidated financial statements as of June 30, 2012 and December 31, 2011 and for three and six months ended June 30, 2012 and 2011 include the accounts of a variable interest entity, Progentix Orthobiology, B.V. (Progentix), which is consolidated pursuant to existing guidance issued by the Financial Accounting Standards Board (FASB). All significant intercompany balances and transactions have been eliminated in consolidation.

As a result of the October 2011 acquisition of Impulse Monitoring, the Company maintains a contractual relationship with several physician practices (PCs) whereby the PCs provide the physician oversight service associated with the IOM services. Pursuant to such contractual arrangements, the Company provides management services to the PCs. As of June 30, 2012 and December 31, 2011, the associated PCs are American Neuromonitoring Associates, P.C.; Pacific Neuromonitoring Associates, Inc.; Keystone Neuromonitoring Associates, P.C.; North Pacific Neuromonitoring Associates, P.C.; and Midwest Neuromonitoring Associates, Inc. Under the management services agreements, the Company provides all non-medical services to the PCs in return for a management fee that is settled on a monthly basis. The management services include management reporting, billing and collections of all charges for medical services provided and all administrative support to the PCs. Pursuant to existing guidance issued by the FASB, these represent variable interest entities for which the Company is the primary beneficiary, and the accompanying unaudited condensed consolidated financial statements include the accounts of the PCs from the date of acquisition.

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These financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto for the year ended December 31, 2011 included in NuVasive’s Annual Report on Form 10-K filed with the SEC. Operating results for the three and six months ended June 30, 2012 are not necessarily indicative of the results that may be expected for any other interim period or for the full year. The balance sheet at December 31, 2011 has been derived from the audited financial statements at that date, but does not include all of the information and footnotes required by GAAP for complete financial statements.

Reclassifications

Certain reclassifications have been made to the prior year condensed consolidated financial statements to conform to the current year presentation.

2. Recently Adopted Accounting Standards

Effective January 1, 2012, the Company adopted the FASB’s updated accounting guidance related to annual and interim goodwill impairment tests. The updated accounting guidance allows entities to first assess qualitative factors before performing a quantitative assessment of the fair value of a reporting unit. If it is determined on the basis of qualitative factors, that the fair value of the reporting unit is more-likely-than-not less than the carrying amount, the existing quantitative impairment test is required. Otherwise, no further impairment testing is required. The adoption of this accounting guidance did not have a material impact on the Company’s condensed consolidated financial statements.

Additionally, effective January 1, 2012, the Company adopted the FASB’s amended requirements for the presentation of comprehensive income. The amended guidance requires companies to disclose the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The updated guidance does not affect how earnings per share is calculated or presented. The adoption of this authoritative guidance did not have an impact on the Company’s financial position or results of operations.

3. Impulse Monitoring, Inc. Acquisition

On October 7, 2011 (the Closing Date), the Company completed the purchase of all of the outstanding shares of Impulse Monitoring pursuant to an Agreement and Plan of Merger dated September 28, 2011 for an initial payment of approximately \$79.7 million consisting of cash totaling approximately \$40.5 million and the issuance of 2,336,200 shares of NuVasive common stock to certain stockholders of Impulse Monitoring. During the three months ended March 31, 2012, the Company made an additional cash payment of approximately \$1.2 million related to a working capital adjustment, resulting in a total purchase price of approximately \$80.9 million and a corresponding adjustment to goodwill. Impulse Monitoring provides IOM services of the nervous system during spine and other surgeries. The acquisition complements the Company’s existing nerve monitoring systems, which are designed for discreet and directional nerve avoidance and detection, making lateral access to the spine during the XLIF procedure safe and reproducible.

Purchase Price

The acquisition of Impulse Monitoring has been recorded using the acquisition method of accounting in accordance with the authoritative guidance for business combinations.

The purchase price is as follows (*in thousands*):

Cash paid to sellers	\$ 41,700
Market value of NuVasive common stock issued on Closing Date	39,200
Total purchase price	\$ 80,900

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The preliminary allocation of the purchase price was based on management's preliminary valuation of the fair value of tangible and identifiable intangible assets acquired and liabilities assumed as of the Closing Date and such estimates are subject to revision. The provisional items pending finalization are the valuation of the acquired intangible assets, goodwill, and income tax related matters. Thus, the purchase price allocation recorded at June 30, 2012 is preliminary, and is subject to change. The following table summarizes the preliminary allocation of the purchase price (*in thousands*):

	Estimated Fair Value	Estimated Useful Life
Cash	\$ 5,100	
Total other current assets	7,300	
Property, plant and equipment	1,100	
Developed technology	700	4 years
Non-compete agreement	300	1 year
Trade name	500	3 years
Customer relationships	25,100	10 years
Goodwill	57,700	
Current liabilities	(8,900)	
Deferred income tax liabilities, net	(8,000)	
Total purchase price allocation	\$ 80,900	

Goodwill totaling \$57.7 million represents the excess of the purchase price over the fair value of tangible and identifiable intangible assets acquired and is due primarily to increased market penetration from customers and synergies expected from combining the assembled workforce with the Company's existing IOM workforce. This acquisition was nontaxable and, as a result, there is no tax basis in goodwill. Accordingly, none of the goodwill associated with the Impulse Monitoring acquisition is deductible for tax purposes.

As a result of the acquisition, the Company maintains a contractual relationship with several PCs whereby the PCs provide the physician oversight service associated with the IOM services. Pursuant to such contractual arrangements, the Company provides management services to the PCs in return for a management fee that is settled on a monthly basis. In accordance with authoritative guidance, the Company has determined that the PCs are variable interest entities. Additionally, pursuant to this guidance, the Company is considered the primary beneficiary of the PCs as the Company has both (1) the power to direct the economically significant activities of the PCs and (2) the obligation to absorb losses of, or the right to receive benefits from, the PCs. Accordingly, the financial position and results of operations of the PCs have been included in the Company's consolidated financial statements from the Impulse Closing Date. The liabilities recognized as a result of consolidating the PCs, which are not material, do not represent additional claims on the Company's general assets. The creditors of the PCs have claims only on the assets of the PCs, which are not material, and the assets of the PCs are not available to the Company.

Results of Operations

The accompanying condensed consolidated statement of operations for the three and six months ended June 30, 2012 reflect the operating results of Impulse Monitoring since the date of the acquisition. The Company has prepared the following unaudited pro forma financial statement information to compare results of the periods presented assuming the Impulse Monitoring acquisition had occurred as of January 1, 2010. These unaudited pro forma results have been prepared for comparative purposes only and do not purport to be an indicator of the results of operations that would have actually resulted had the acquisition occurred as of January 1, 2010, or of future results of operations. Assuming the Impulse Monitoring acquisition occurred as of January 1, 2010, the pro forma unaudited results of operations would have been as follows (*in thousands, except per share data*):

	Three Months Ended June 30, 2011	Six Months Ended June 30, 2011
Revenue	\$ 142,387	\$ 276,420
Net income attributable to NuVasive, Inc.	5,751	8,498
Net income per share - basic	0.14	0.20
Net income per share - diluted	0.13	0.20

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The above pro forma unaudited results of operations do not include pro forma adjustments relating to costs of integration or post-integration cost reductions that may be incurred or realized by the Company in excess of actual amounts incurred or realized through June 30, 2011.

4. Investment in Progentix Orthobiology, B.V.

In 2009, the Company completed the purchase of forty percent (40%) of the capital stock of Progentix, a company organized under the laws of the Netherlands, from existing shareholders (the Progentix Shareholders) pursuant to a Preferred Stock Purchase Agreement for \$10 million in cash (the Initial Investment). Concurrent with the Initial Investment, NuVasive and Progentix also entered into a Senior Secured Facility Agreement, whereby Progentix may borrow up to \$5.0 million from NuVasive to fund ongoing clinical and regulatory efforts (the Loan). At June 30, 2012, the Company had advanced Progentix the full \$5.0 million in accordance with the Loan Agreement. The Loan accrues interest at a rate of six percent (6%) per year. Other than its obligations under the Loan Agreement, NuVasive is not obligated to provide additional funding, nor has any additional funding been provided, to Progentix.

Also concurrent with the Preferred Stock Purchase Agreement, NuVasive, Progentix and the Progentix Shareholders entered into an Option Purchase Agreement, as amended (the Option Agreement), whereby NuVasive may be obligated (the Put Option), upon the achievement of an annual sales run rate on Progentix products in excess of a specified amount between June 14, 2011 and June 13, 2013 (the Option Period), to purchase the remaining sixty percent (60%) of capital stock of Progentix from its shareholders (the Remaining Shares) for an amount up to \$35.0 million, subject to certain reductions, payable in a combination of cash and NuVasive common stock, at NuVasive's sole discretion. In accordance with the Option Agreement, NuVasive has the right to purchase the Remaining Shares (the Call Option) during the Option Period for an amount up to \$35.0 million, subject to certain reductions, payable in a combination of cash and NuVasive common stock, at NuVasive's sole discretion. NuVasive and Progentix also entered into a Distribution Agreement, as amended, whereby Progentix appointed NuVasive as its exclusive distributor for certain Progentix products. The Distribution Agreement will be in effect for a term of ten years unless terminated earlier in accordance with its terms.

In accordance with authoritative guidance issued by the FASB, the Company has determined that Progentix is a variable interest entity as it does not have the ability to finance its activities without additional subordinated financial support and its equity investors will not absorb their proportionate share of expected losses and will be limited in the receipt of the potential residual returns of Progentix. Additionally, pursuant to this guidance, NuVasive is considered its primary beneficiary as NuVasive has both (1) the power to direct the economically significant activities of Progentix and (2) the obligation to absorb losses of, or the right to receive benefits from, Progentix. Accordingly, the financial position and results of operations of Progentix have been included in the consolidated financial statements from the date of the Initial Investment. The liabilities recognized as a result of consolidating Progentix do not represent additional claims on the Company's general assets. The creditors of Progentix have claims only on the assets of Progentix, which are not material, and the assets of Progentix are not available to NuVasive.

Pursuant to authoritative guidance, the equity interests in Progentix not owned by the Company, which includes shares of both common and preferred stock, are reported as noncontrolling interests on the consolidated balance sheet of the Company. The preferred stock represents 18% of the noncontrolling equity interests and provides for a cumulative 8% dividend, if and when declared by Progentix's Board of Directors. As the rights and conversion features of the preferred stock are substantially the same as those of the common stock, the preferred stock is classified as noncontrolling interest and shares in the allocation of the losses incurred by Progentix. Losses incurred by Progentix are charged to the Company and to the noncontrolling interest holders based on their ownership percentage. The Remaining Shares and the Option Agreement that was entered into between NuVasive, Progentix and the Progentix Shareholders are not considered to be freestanding financial instruments as defined by authoritative guidance. Therefore the Remaining Shares and the Option Agreement are accounted for as a combined unit on the consolidated financial statements as a redeemable noncontrolling interest that was initially recorded at fair value and classified as mezzanine equity.

Pursuant to authoritative guidance, when the embedded Put Option is exercisable and therefore the Remaining Shares considered currently redeemable (i.e., at the option of the holder), the instrument will be adjusted to its maximum redemption amount. If the embedded Put Option is considered not currently exercisable (e.g., because a contingency has not been met), and it is not probable that the embedded Put Option will become exercisable, an adjustment is not necessary until it is probable that the embedded Put Option will become exercisable. At June 30, 2012, the embedded Put Option was not deemed currently exercisable and therefore the Remaining Shares were not redeemable because the milestones referred to previously had not been met. Furthermore, at June 30, 2012, the Company concluded it is not probable that the milestones will be met, therefore the Remaining Shares are not expected to become redeemable. The probability of redemption is reevaluated at each reporting period.

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Total assets and liabilities of Progentix included in the accompanying condensed consolidated balance sheet are as follows (*in thousands*):

	June 30, 2012	December 31, 2011
Total current assets	\$ 562	\$ 640
Identifiable intangible assets, net	15,105	15,338
Goodwill	12,654	12,654
Other long-term assets	50	53
Accounts payable & accrued expenses	303	411
Other long-term liabilities	84	
Deferred tax liabilities, net	3,318	3,318
Noncontrolling interests	10,248	10,705

The following is a reconciliation of equity (net assets) attributable to the noncontrolling interests (*in thousands*):

	Six Months Ended June 30,	
	2012	2011
Noncontrolling interests at beginning of period	\$ 10,705	\$ 11,877
Net loss attributable to the noncontrolling interests	(457)	(739)
Noncontrolling interests at end of period	\$ 10,248	\$ 11,138

5. Balance Sheet Reserves

The balances of the reserves for accounts receivable and inventory are as follows (*in thousands*):

	June 30, 2012	December 31, 2011
Reserves for accounts receivable and sales returns	\$ 4,111	\$ 3,430
Reserves for excess and obsolete inventory	14,331	12,710

The Company's inventory consists primarily of purchased finished goods, which includes specialized implants and disposables, and is stated at the lower of cost or market determined by a weighted average cost method. The Company reviews the components of its inventory on a periodic basis for excess, obsolete or impaired inventory, and records a reserve for the identified items.

6. Marketable Securities and Fair Value Measurements

Marketable securities consist of certificates of deposit, corporate notes, commercial paper, U.S. government treasury securities and securities of government sponsored entities. The Company classifies all securities as available-for-sale, as the sale of such securities may be required prior to maturity to implement management strategies. These securities are carried at fair value, with the unrealized gains and losses reported as a component of other comprehensive income in stockholders' equity until realized. A decline in the market value of any marketable security below cost that is determined to be other-than-temporary will result in a revaluation of its carrying amount to fair value. The impairment is charged to earnings and a new cost basis for the security is established. No such impairment charges were recorded for any period presented.

Realized gains and losses from the sale of marketable securities, if any, are determined on a specific identification basis. Realized gains and losses and declines in value judged to be other-than-temporary, if any, on available-for-sale securities are included in other income or expense on the consolidated statements of operations. Realized gains and losses during the periods presented were immaterial. Premiums and discounts are amortized or accreted over the life of the related security as an adjustment to yield using the straight-line method and are included in interest income on the condensed consolidated statements of operations. Interest and dividends on securities classified as available-for-sale are included in interest income on the condensed consolidated statements operations.

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The composition of marketable securities is as follows (in thousands, except years):

	Contractual Maturity (in Years)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
June 30, 2012:					
Classified as current assets:					
Certificates of deposit	Less than 1	\$ 95	\$	\$	\$ 95
Corporate notes	Less than 1	18,281	2	(12)	18,271
Commercial paper	Less than 1	4,998			4,998
U.S. government treasury securities	Less than 1	5,015			5,015
Securities of government-sponsored entities	Less than 1	92,282	17	(22)	92,277
Short-term marketable securities		120,671	19	(34)	120,656
Classified as non-current assets:					
Securities of government-sponsored entities	1 to 2	23,719	2	(14)	23,707
Long-term marketable securities		23,719	2	(14)	23,707
Classified as restricted investments:					
U.S. government treasury securities	Less than 2	31,162	2	(7)	31,157
Securities of government-sponsored entities	Less than 2	79,101	13	(25)	79,089
Restricted investments		110,263	15	(32)	110,246
Total marketable securities at June 30, 2012		\$ 254,653	\$ 36	\$ (80)	\$ 254,609

	Contractual Maturity (in Years)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2011:					
Classified as current assets:					
Certificates of deposit	Less than 1	\$ 526	\$	\$	\$ 526
Corporate notes	Less than 1	21,153	16	(1)	21,168
Commercial paper	Less than 1	5,000			5,000
U.S. government treasury securities	Less than 1	32,131	11		32,142
Securities of government-sponsored entities	Less than 1	87,353	39		87,392
Short-term marketable securities		146,163	66	(1)	146,228
Classified as non-current assets:					
Securities of government-sponsored entities	1 to 2	32,502	5	(4)	32,503
Long-term marketable securities		32,502	5	(4)	32,503
Classified as restricted investments:					
U.S. government treasury securities	Less than 2	12,017	9		12,026
Securities of government-sponsored entities	Less than 2	50,880	27	(1)	50,906
Restricted investments		62,897	36	(1)	62,932
Total marketable securities at December 31, 2011		\$ 241,562	\$ 107	\$ (6)	\$ 241,663

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As of June 30, 2012, the Company had no significant investment positions that were in an unrealized loss position. The Company reviews its investments to identify and evaluate investments that have an indication of possible other-than-temporary impairment. Factors considered in determining whether a loss is other-than-temporary include the length of time and extent to which fair value has been less than the cost basis, the financial condition and near-term prospects of the investee, and the Company's intent and ability to hold the investment for a period of time sufficient to allow for any anticipated recovery in market value. The Company maintains an investment portfolio of various holdings, types and maturities. The Company does not hold derivative financial investments. The Company places its cash investments in instruments that meet high credit quality standards, as specified in its investment policy guidelines. These guidelines also limit the amount of credit exposure to any one issue, issuer or type of instrument.

The Company measures certain assets and liabilities in accordance with authoritative guidance which requires fair value measurements be classified and disclosed in one of the following three categories:

Level 1: Quoted prices (unadjusted) in active markets that are accessible at the measurement date for assets or liabilities.

Level 2: Observable prices that are based on inputs not quoted on active markets, but corroborated by market data.

Level 3: Unobservable inputs are used when little or no market data is available.

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Assets and liabilities are classified based on the lowest level of input that is significant to the fair value measurements. The Company reviews the fair value hierarchy classification on a quarterly basis. Changes in the ability to observe valuation inputs may result in a reclassification of levels for certain securities within the fair value hierarchy. The Company did not have any transfers of assets and liabilities between Level 1 and Level 2 and no transfers to or from Level 3 of the fair value measurement hierarchy during the three and six months ended June 30, 2012 and 2011, respectively.

The fair values of the Company's assets and liabilities, which are measured at fair value on a recurring basis, were determined using the following inputs (*in thousands*):

	Total	Quoted Price in Active Market (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
June 30, 2012:				
Cash Equivalents, Marketable Securities and Restricted Investments:				
Money market funds	\$ 140,706	\$ 140,706	\$	\$
Certificates of deposit	95	95		
Corporate notes	18,271		18,271	
Commercial paper	4,998		4,998	
U.S government treasury securities	36,172	36,172		
Securities of government-sponsored entities	195,073		195,073	
Total cash equivalents, marketable securities and restricted investments	\$ 395,315	\$ 176,973	\$ 218,342	\$
Contingent Consideration:				
Acquisition-related liabilities	\$ (32,290)	\$	\$	\$ (32,290)
December 31, 2011:				
Cash Equivalents, Marketable Securities and Restricted Investments:				
Money market funds	\$ 121,666	\$ 121,666	\$	\$
Certificates of deposit	526	526		
Corporate notes	21,168		21,168	
Commercial paper	5,000		5,000	
U.S government treasury securities	44,168	44,168		
Securities of government-sponsored entities	170,801		170,801	
Total cash equivalents, marketable securities and restricted investments	\$ 363,329	\$ 166,360	\$ 196,969	\$
Contingent Consideration:				
Acquisition-related liabilities	\$ (32,221)	\$	\$	\$ (32,221)

The carrying amounts of financial instruments such as cash equivalents, accounts receivable, prepaid expenses, other current assets, accounts payable, accrued expenses, and other current liabilities approximate the related fair values due to the short-term maturities of these instruments. The estimated fair value of the Company's capital lease obligations approximated their carrying values as of June 30, 2012. The fair and carrying value of the Company's Senior Convertible Notes is discussed in Note 8.

Contingent Consideration Liability

In connection with the acquisition of Cervitech[®], Inc. (Cervitech) in May 2009, the Company is required to pay an additional amount not to exceed \$33.0 million in the event that the PCM[®] cervical total disc replacement device receives U.S. Food and Drug Administration approval. The fair value of the contingent consideration is determined using a probability-weighted discounted cash flow model, the significant inputs of

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which are not observable in the market. The key assumptions in applying this approach are the interest rate, the timing of expected approval and the probability assigned to the milestone being achieved. Based on the expected timing of the milestone being achieved, the estimated fair value of the contingent consideration was \$32.3 million and \$31.7 million at June 30, 2012 and December 31, 2011, respectively. Changes in fair value are recorded in the condensed consolidated statements of operations as sales, marketing and administrative expenses.

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In connection with an immaterial acquisition in 2010, the Company was required to pay an additional amount not to exceed \$3.0 million in the event three specified milestones are met. The fair value of the contingent consideration was determined using a probability-weighted discounted cash flow model, the significant inputs of which are not observable in the market. The key assumptions in applying this approach were the interest rate and the probabilities assigned to the milestones being achieved. During the year ended December 31, 2011, approximately \$1.8 million related to two of the specified milestones was paid. During the six months ended June 30, 2012, approximately \$0.5 million related to the remaining milestone payment was settled and paid.

Derivative Financial Instruments

In June 2011, the Company issued \$402.5 million principal amount of 2.75% Senior Convertible Notes due 2017 (the 2017 Notes). Prior to September 28, 2011, the 2017 Notes could only be settled in cash. On September 28, 2011, stockholder approval was obtained to increase the number of the Company's authorized shares of common stock from 70 million to 120 million. Prior to obtaining stockholder approval, in accordance with authoritative guidance, the cash conversion feature of the 2017 Notes (the 2017 Notes Embedded Conversion Derivative) required bifurcation from the 2017 Notes and was accounted for as a derivative liability.

In connection with the issuance of the 2017 Notes, the Company entered into convertible note hedge transactions (the 2017 Hedge) entitling the Company to purchase up to 9,553,096 shares of the Company's common stock at an initial stock price of \$42.13 per share, each of which is subject to adjustment. Prior to obtaining the stockholder approval to increase the number of the Company's authorized shares of common stock discussed above, the 2017 Hedge could only be settled in cash. In accordance with authoritative guidance, the 2017 Hedge was accounted for as a derivative asset.

Prior to their reclassification to stockholders' equity on September 28, 2011, the 2017 Hedge and the 2017 Notes Embedded Conversion Derivative were classified as Level 3 because these assets and liabilities were not actively traded and were valued using significant unobservable inputs. Significant inputs to these models were the Company's stock price, risk free interest rate, credit rating, bond yield, and expected volatility of the Company's stock price. Changes to fair value were recorded in the statement of operations as other income (expense).

The following table sets forth the changes in the estimated fair value for the Company's assets and liabilities measured on a recurring basis using significant unobservable inputs (Level 3) (*in thousands*):

	Three Months Ended		Six Months Ended	
	June 30, 2012	June 30, 2011	June 30, 2012	June 30, 2011
Assets:				
Fair value measurement at beginning of period	\$	\$	\$	\$
Derivative asset purchased		80,098		80,098
Fair value measurement at end of period	\$	\$ 80,098	\$	\$ 80,098
Liabilities:				
Fair value measurement at beginning of period	\$ 32,089	\$ 33,494	\$ 32,221	\$ 33,041
Derivative liability recorded in connection with 2017 Notes		88,900		88,900
Change in fair value measurement included in operating expenses	201	461	599	914
Contingent consideration settled			(530)	
Fair value measurement at end of period	\$ 32,290	\$ 122,855	\$ 32,290	\$ 122,855

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Goodwill and intangible assets as of June 30, 2012 consisted of the following (*in thousands, except years*):

	Weighted- Average Amortization Period (in years)	Gross Amount	Accumulated Amortization	Intangible Assets, net
Intangible Assets Subject to Amortization:				
Purchased technology:				
Developed technology	11	\$ 37,535	\$ (12,577)	\$ 24,958
Manufacturing know-how and trade secrets	12	21,370	(7,005)	14,365
Trade name and trademarks	11	9,450	(1,845)	7,605
Customer relationships	9	37,234	(6,874)	30,360
	11	\$ 105,589	\$ (28,301)	\$ 77,288
Intangible Assets Not Subject to Amortization:				
In-process research and development				27,840
Goodwill				160,745
Total intangible assets, net				\$ 265,873

Goodwill and intangible assets as of December 31, 2011 consisted of the following (*in thousands, except years*):

	Weighted- Average Amortization Period (in years)	Gross Amount	Accumulated Amortization	Intangible Assets, net
Intangible Assets Subject to Amortization:				
Purchased technology:				
Developed technology	11	\$ 37,535	\$ (10,589)	\$ 26,946
Manufacturing know-how and trade secrets	12	21,389	(6,007)	15,382
Trade name and trademarks	12	6,700	(1,449)	5,251
Customer relationships	9	37,234	(4,513)	32,721
	11			