THERMAGE INC
Form 10-Q
November 10, 2008
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended September 30, 2008

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from __________ to __________

Commission File Number: 001-33123

THERMAGE, INC.

(Exact name of registrant as specified in its charter)

Delaware	**68-0373593**
(State or other jurisdiction of	**(I.R.S. Employer**
incorporation or organization)	**Identification No.)**

25881 Industrial Boulevard, Hayward, California 94545

(Address of principal executive offices) (Zip Code)

(510) 782-2286

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant is a Large accelerated filer, an accelerated filer, a non-accelerated filer or a small reporting company. See definition of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated Filer ¨	Accelerated filer x	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 x

As of October 31, 2008, 24,084,672 shares of the registrant s common stock were outstanding.

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THERMAGE, INC.

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Thermage, ThermaCool, ThermaCool TC, NXT and ThermaCool NXT are registered trademarks in the United States and several other countries. ThermaTip, Body by Thermage, Face by Thermage, Eyes by Thermage, Tummy by Thermage, Hands by Thermage and Cellulite Procedures by Thermage are unregistered trademarks. All other trademarks, trade names and service marks appearing in this document are the property of their respective owners.

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PART 1. FINANCIAL INFORMATION

Item 1. Financial Statements

Thermage, Inc.

CONDENSED BALANCE SHEETS

(in thousands of dollars, except share and per share data)

(Unaudited)

	September 30, 2008	December 31, 2007 (1)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 21,236	$ 13,650
Marketable investments	24,684	38,707
Accounts receivable, net	5,928	4,809
Inventories, net	6,823	6,639
Prepaid expenses and other current assets	1,401	1,782
Total current assets	60,072	65,587
Property and equipment, net	3,132	3,000
Note and interest receivable	5,164	
Other assets	1,784	140
Total assets	$ 70,152	$ 68,727
LIABILITIES AND STOCKHOLDERS EQUITY		
Liabilities:		
Accounts payable	$ 2,517	$ 1,341
Accrued liabilities	6,359	6,850
Current portion of deferred revenue	1,472	1,544
Customer deposits	57	18
Total current liabilities	10,405	9,753
Deferred rent, net of current portion	106	47
Deferred revenue, net of current portion	529	601
Other liabilities	216	208
Total liabilities	11,256	10,609
Contingencies (Note 6)		
Stockholders equity:		
Preferred stock, $0.001 par value: 10,000,000 shares authorized, none issued and outstanding		
Common stock, $0.001 par value: 100,000,000 shares authorized, 24,082,735 and 23,605,415 shares issued and outstanding at September 30, 2008 and December 31, 2007, respectively	24	24
Additional paid-in capital	103,127	99,588
Deferred stock-based compensation	(2)	(4)

Accumulated other comprehensive income (loss)		(1,400)		19
Accumulated deficit		(42,853)		(41,509)
Total stockholders equity		58,896		58,118
Total liabilities and stockholders equity	$	70,152	$	68,727

(1) December 31, 2007 condensed balance sheet data was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America.

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

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Thermage, Inc.

CONDENSED STATEMENTS OF OPERATIONS

(in thousands of dollars, except share and per share data)

(Unaudited)

	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Net revenue	$ 13,020	$ 13,865	$ 47,132	$ 46,519
Cost of revenue	3,209	3,111	11,662	12,081
Gross margin	9,811	10,754	35,470	34,438
Operating expenses:				
Sales and marketing	5,915	6,016	20,330	19,205
Research and development	2,150	2,282	7,054	6,980
General and administrative	2,575	2,695	10,173	8,162
Total operating expenses	10,640	10,993	37,557	34,347
Income (loss) from operations	(829)	(239)	(2,087)	91
Interest and other income	635	662	1,781	1,846
Loss on investments	(863)		(863)	
Income (loss) before income taxes	(1,057)	423	(1,169)	1,937
Provision for income taxes	(89)		(175)	(147)
Net income (loss)	$ (1,146)	$ 423	$ (1,344)	$ 1,790
Net income (loss) per share:				
Basic	$ (0.05)	$ 0.02	$ (0.06)	$ 0.08
Diluted	$ (0.05)	$ 0.02	$ (0.06)	$ 0.07
Weighted average shares outstanding used in calculating net income (loss) per share:				
Basic	24,067,548	23,364,409	23,861,079	23,151,949
Diluted	24,067,548	24,882,614	23,861,079	24,825,621

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

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Thermage, Inc.

CONDENSED STATEMENTS OF CASH FLOWS

(in thousands of dollars)

(Unaudited)

	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Cash flows provided by operating activities		
Net income (loss)	$ (1,344)	$ 1,790
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	1,002	1,068
Interest receivable on stockholder notes		13
Amortization of premium/discount on marketable investments	201	(51)
Other than temporary loss on investments	863	
Loss on disposal on property and equipment	8	11
Stock-based compensation	2,789	3,705
Tax expense from stock option exercises	32	
Allowance for doubtful accounts	2	(7)
Reserve for excess and obsolete inventory	(121)	(61)
Change in assets and liabilities		
Accounts receivable	(1,121)	(1,268)
Inventories	(132)	(2,047)
Prepaid expenses and other current assets	381	662
Other assets	(165)	(131)
Accounts payable	341	(79)
Accrued and other liabilities	(1,320)	(17)
Deferred revenue	(144)	428
Customer deposits	39	(45)
Deferred rent	59	(55)
Net cash provided by operating activities	1,370	3,916
Cash flows provided by (used in) investing activities		
Acquisition of property and equipment	(737)	(754)
Notes receivable	(5,000)	
Payment for merger & acquisition costs	(315)	
Purchase of marketable investments	(8,581)	(40,149)
Proceeds from sale of marketable investments	20,121	7,300
Net cash provided by (used in) investing activities	5,488	(33,603)
Cash flows provided by financing activities		
Collection of notes receivable from stockholders		112
Proceeds from exercise of stock options	532	550
Proceeds from employee stock purchase plan	196	514
Payments of capitalized IPO related costs		(409)
Net cash provided by financing activities	728	767
Net increase (decrease) in cash and cash equivalents	7,586	(28,920)

Cash and cash equivalents at beginning of period	13,650	45,915
Cash and cash equivalents at end of period	$ 21,236	$ 16,995
Supplemental disclosure of non-cash investing activities		
Merger & acquisition costs	$ 1,328	

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

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Thermage, Inc.

NOTES TO CONDENSED FINANCIAL STATEMENTS

(in thousands of dollars, except share and per share amounts)

(Unaudited)

NOTE 1 THE COMPANY AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Thermage, Inc. (the Company) develops, manufactures, and markets radiofrequency-based equipment and disposable products for non-invasive procedures designed to tighten and contour skin. The Company was incorporated in California on January 11, 1996 and reincorporated in Delaware on September 10, 2001. The Company commercially launched its first products in October 2002.

On July 7, 2008, the Company and Reliant Technologies, Inc. (Reliant) announced that they had entered into a definitive merger agreement under which the Company will acquire Reliant for approximately $25 million in cash and 23.6 million shares of the Company s common stock, subject to post closing adjustments. In addition, the Company has agreed to provide bridge financing to Reliant in the amount of $5 million. The bridge loan bears interest rate at 15% per annum and is due and payable on the earliest of (i) one year after the close of the merger, (ii) 10 days after the effectiveness of a change in control of Reliant, or (iii) upon occurrence of an event of default, as defined in the loan documentation. The proposed transaction will require stockholder approval. If the proposed transaction were not approved by stockholders, the Company would be required to pay up to $1.3 million of Reliant s transaction expenses. If the merger agreement is terminated under certain circumstances, the Company would be required to pay Reliant a termination fee of $3.5 million. The proposed transaction is expected to close during the fourth quarter of 2008.

Basis of Presentation

The unaudited interim condensed financial statements have been prepared on the same basis as the annual financial statements and, in the opinion of management, reflect all adjustments, which include only normal recurring adjustments, necessary to state fairly the Company s financial position as of the date of the interim balance sheet and results of operations and cash flows for the interim periods. The condensed balance sheet at December 31, 2007 was derived from audited financial statements, but does not include all disclosures required by generally accepted accounting principles. The results for the three and nine months ended September 30, 2008 are not necessarily indicative of the results to be expected for the year ending December 31, 2008 or for any other interim period or for any future year.

These unaudited interim condensed financial statements should be read in conjunction with the financial statements and notes for the year ended December 31, 2007 included in the Company s Annual Report on Form10-K.

Liquidity

The Company s future liquidity requirements may increase beyond currently expected levels if it fails to achieve sustained profitability or if unanticipated expenses or other uses of its cash arise. For example, in connection with the planned acquisition of Reliant, the Company may become required to repay, or may choose to repay, outstanding obligations of Reliant under a credit facility between Reliant and Pinnacle Ventures. As of June 30, 2008, Reliant had approximately $5.8 million of secured indebtedness under a loan agreement with Pinnacle Ventures. In order to meet its liquidity needs, the Company may be required to seek additional equity and/or debt financing. Additional financing may not be available on a timely basis on terms acceptable to the Company, particularly in the short-term due to the current credit and equity market funding environments. If adequate funds are not available, the Company may have to delay development of new products or reduce marketing, customer support or other resources devoted to its products. Any of these factors could harm the Company s business and financial condition.

Adoption of SFAS No. 157 and SFAS No. 159

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurement* (SFAS No. 157). This statement clarifies the definition of fair value, establishes a framework for measuring fair value and expands the disclosure on fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007. In February 2008, the FASB issued FASB Staff Position FAS 157-2, *Effective Date of FASB Statement No. 157*, which deferred the effective date of SFAS No. 157 for one year, as it relates to non-financial assets and liabilities. The partial adoption of SFAS No. 157 for financial assets and liabilities did not have a material impact to the Company s financial position, results of operations or cash flow. See Note 4 under the caption of cash, cash equivalents and marketable investments for further discussion and disclosure.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities including an amendment of FAS115* (SFAS No. 159). SFAS No. 159 allows companies to choose, at specified election dates, to measure eligible financial assets and liabilities at fair value that are not otherwise required to be measured at fair value. Unrealized gains and losses shall be reported on items for which the fair value option has been elected in earnings at each subsequent reporting date. SFAS No. 159 also establishes presentation and disclosure requirements. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007 and is applied prospectively. The Company has not expanded its eligible items subject to the fair value option under SFAS No. 159.

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Significant Accounting Policies

The Company s significant accounting policies are disclosed in the Company s Annual Report on Form 10-K filed on March 14, 2008, and have not changed since December 31, 2007, with the exception of adoption of SFAS No. 157 and SFAS No. 159.

Segment Information

The Company operates in one business segment, which encompasses the developing, manufacturing and marketing of radiofrequency based equipment for the aesthetics market. Management uses one measurement of profitability and does not segregate its business for internal reporting. All long-lived assets are maintained in the United States.

The following table summarizes net revenue by product:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	**2007**	**2008**	**2007**
ThermaCool Systems	$ 2,854	$ 3,267	$ 11,546	$ 12,673
ThermaTips and other consumables	9,801	10,199	34,391	32,557
Net revenue from products	12,655	13,466	45,937	45,230
Services and other	365	399	1,195	1,289
Total net revenue	$ 13,020	$ 13,865	$ 47,132	$ 46,519

The following table summarizes net revenue by geographic region:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	**2007**	**2008**	**2007**
United States	$ 6,645	$ 7,409	$ 23,834	$ 24,389
Asia Pacific	3,557	2,987	11,671	9,855
Europe/Middle East	1,661	2,095	6,933	7,684
Rest of the world	1,157	1,374	4,694	4,591
Total net revenue	$ 13,020	$ 13,865	$ 47,132	$ 46,519

NOTE 2 NET INCOME (LOSS) PER SHARE

Basic net income (loss) per share is computed by dividing the net income (loss) for the period by the weighted average number of common shares outstanding during the period as reduced by the weighted average unvested common shares subject to repurchase by the Company.

Diluted net income (loss) per share is computed by dividing the net income (loss) for the period by the weighted average number of common and potential common shares outstanding during the period, if the effect of each class of potential common shares is dilutive. Potential common shares include common stock subject to repurchase rights, incremental shares of common stock issuable upon the exercise of stock options and warrants, incremental shares of common stock issuable under employee stock purchase plans and restricted stock units. The dilutive effect of potential common shares is reflected in diluted net income (loss) per share by application of the treasury stock method, which includes consideration of stock-based compensation required by Statement of Financial Accounting Standards No. 123R, *Share-Based Payment (revised 2004)*, or (SFAS 123R), and SFAS No. 128, *Earnings Per Share.*

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	Three Months Ended September 30, 2008	2007	Nine Months Ended September 30, 2008	2007
Historical net income (loss) per share:				
Numerator				
Net income (loss)	$ (1,146)	$ 423	$ (1,344)	$ 1,790
Denominator				
Weighted-average shares outstanding	24,067,548	23,366,284	23,861,079	23,155,699
Less: weighted-average unvested common shares subject to repurchase		(1,875)		(3,750)
Denominator for basic net income (loss) per share	24,067,548	23,364,409	23,861,079	23,151,949
Dilutive potential common shares used in computing diluted net income per share		1,518,205		1,673,672
Denominator for diluted net income (loss) per share	24,067,548	24,882,614	23,861,079	24,825,621
Basic net income (loss) per share	$ (0.05)	$ 0.02	$ (0.06)	$ 0.08
Diluted net income (loss) per share	$ (0.05)	$ 0.02	$ (0.06)	$ 0.07

The following outstanding options, warrants, common stock issuable under the Employee Stock Purchase Plan and restricted stock units were excluded from the computation of diluted net income (loss) per common share for the periods presented because including them would have had an antidilutive effect:

	Three Months Ended September 30, 2008	2007	Nine Months Ended September 30, 2008	2007
Options to purchase common stock	4,429,424	1,329,024	4,429,424	1,378,451
Warrants to purchase common stock	27,778		27,778	
Common stock issuable under Employee Stock Purchase Plan	75,646		75,646	
Restricted stock units				20,561

NOTE 3 RECENT ACCOUNTING PRONOUNCEMENTS

In December 2007, the FASB issued Statement No. 141 (revised), *Business Combinations* (SFAS No. 141(R)). The statement changes the accounting for business combinations including the measurement of acquirer shares issued in consideration for a business combination, the recognition of contingent consideration, the accounting for preacquisition gain and loss contingencies, the recognition of capitalized in-process research and development, the accounting for acquisition-related restructuring cost accruals, the treatment of acquisition related transaction costs and the recognition of changes in the acquirer s income tax valuation allowance. SFAS 141(R) is effective for fiscal years beginning after December 15, 2008, with early adoption prohibited. The Company is evaluating the impact that the statement will have, if any, on its financial statements.

In December 2007, the FASB issued Statement No. 160, *Non-controlling Interests in Consolidated Financial Statements, an amendment of ARB No. 51* (SFAS 160). The standard changes the accounting for non-controlling (minority) interests in consolidated financial statements including the requirements to classify non-controlling interests as a component of consolidated stockholders equity, and the elimination of minority interest accounting in results of operations with earnings attributable to non-controlling interests reported as part of consolidated earnings. Additionally, SFAS 160 revises the accounting for both increases and decreases in a parent s controlling ownership interest. SFAS 160 is effective for fiscal years beginning after December 15, 2008, with early adoption prohibited. The Company is evaluating the impact that the statement will have, if any, on its financial statements.

In February 2008, the FASB issued FASB Staff Position FAS 157-2, which deferred the effective date of SFAS No. 157 for one year, effective for fiscal years beginning after November 15, 2008, as it relates to non-financial assets and liabilities. The Company has not determined the effect, if any, the adoption of this statement will have on its results of operations or financial position.

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In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133* (SFAS No. 161). SFAS No. 161 establishes, among other things, the disclosure requirements for derivative instruments and for hedging activities. This statement amends and expands the disclosure requirements of SFAS No. 133 with the intent to provide users of financial statements with an enhanced understanding of: a. How and why an entity uses derivative instruments, b. How derivative instruments and related hedged items are accounted for under SFAS No. 133 and its related interpretations, and c. How derivative instruments and related hedged items affect an entity s financial position, financial performance and cash flows. SFAS No. 161 is effective for fiscal years beginning after November 15, 2008, with early adoption encouraged. The Company has not determined, the effect, if any, the adoption of this statement will have on its results of operations or financial position.

NOTE 4 BALANCE SHEET DETAIL

Cash, Cash Equivalents and Marketable Investments

The Company considers all highly liquid investments, with an original maturity of three months or less at the time of purchase to be cash equivalents. Investments in debt securities are accounted for as available-for-sale securities held for use in current operations and are classified in current assets as Marketable Investments . Cash, cash equivalents and marketable investments consist of the following:

September 30, 2008	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Recognized Losses**	**Fair Market Value**
Checking and money market accounts	$ 21,236	$	$	$	$ 21,236
Corporate and Euro dollar bonds	10,545	5	(152)		10,398
Medium and short term notes	16,402		(1,253)	(863)	14,286
	$ 48,183	$ 5	($1,405)	($863)	$ 45,920
Reported as:					
Cash and cash equivalents	$ 21,236	$	$	$	$ 21,236
Marketable investments	26,947	5	(1,405)	(863)	24,684
	$ 48,183	$ 5	($1,405)	($863)	$ 45,920

December 31, 2007	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Recognized Losses**	**Fair Market Value**
Checking and money market accounts	$ 13,650	$	$	$	$ 13,650
Corporate and Euro dollar bonds	15,517	9			15,526
Medium and short term notes	15,719	10			15,729
Certificates of deposit	2,502				2,502
Auction rate securities	4,950				4,950
	$ 52,338	$ 19	$	$	$ 52,357
Reported as:					
Cash and cash equivalents	$ 13,650	$	$	$	$ 13,650
Marketable investments	38,688	19			38,707
	$ 52,338	$ 19	$	$	$ 52,357

During the quarter ended September 30, 2008, a security in the Company s investment portfolio suffered a substantial loss in fair market value. It was determined that such loss in fair market value was other than temporary , and as a result, the Company recorded approximately $0.9 million other than temporary impairment loss on investments in the quarter ended September 30, 2008. The Company will continue to monitor the value of its investments each reporting period for possible impairments if declines in fair value continues.

On January 1, 2008, the Company adopted the provisions of SFAS No. 157, *Fair Value Measurements*. SFAS No. 157 clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based

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on assumptions that market participants would use in pricing an asset or liability. As a basis for considering such assumptions, SFAS No. 157 establishes a three-tier value hierarchy, which prioritizes the inputs used in measuring fair value as follows: (Level 1) observable inputs such as quoted prices in active markets; (Level 2) inputs other than the quoted prices in active markets that are observable either directly or indirectly; and (Level 3) unobservable inputs in which there is little or no market data, which require the Company to develop its own assumptions. This hierarchy requires the Company to use observable market data, when available, and to minimize the use of unobservable inputs when determining fair value. On a recurring basis, the Company measures its cash equivalents and marketable investments at fair value.

The Company s cash equivalents and marketable investments are classified within Level 1 or Level 2 of the fair value hierarchy because they are valued using quoted market prices, broker or dealer quotations, or alternative pricing sources with reasonable levels of price transparency.

Fair value hierarchy of the Company s cash equivalents and marketable investments in connection with our adoption of SFAS No. 157 is as follows:

		Fair Value Measurements at Reporting Date using	
	Fair Market Value	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant other Observable Inputs (Level 2)**
Money market funds	$ 20,166	$ 20,166	$
Corporate and Euro dollar bonds	10,398		10,398
Medium and short term notes	14,286		14,286

Inventories, Net

Inventories, net consist of the following:

	September 30, 2008	**December 31, 2007**
Raw materials	$ 2,409	$ 2,382
Work-in-process	398	931
Finished goods	4,016	3,326
	$ 6,823	$ 6,639

Other Assets

Other assets consist of the following:

	September 30, 2008	**December 31, 2007**
Merger and acquisition costs	$ 1,643	
Other assets	141	140
	$ 1,784	$ 140

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Accrued Liabilities

Accrued liabilities consist of the following:

	September 30, 2008	December 31, 2007
Marketing expenses	$ 171	$ 282
Travel and entertainment	261	276
Warranty	547	577
Sales and use tax	156	162
Payroll and related expenses	2,799	4,181
Professional fees	932	447
Fixed assets	227	30
Accrued claims	312	331
Accrued inventory purchases	367	48
Other	587	516
	$ 6,359	$ 6,850

NOTE 5 WARRANTY AND SERVICE CONTRACTS

Standard Warranty

The Company currently accrues for the estimated cost to repair or replace products under warranty at the time of sale. A summary of standard warranty accrual activity is shown below:

	Nine Months Ended September 30, 2008	2007
Balance at beginning of period	$ 577	$ 329
Accruals for warranties issued during the period	357	483
Accruals related to pre-existing warranties (including changes in estimates)		17
Settlements made during the period	(387)	(312)
Balance at end of period	$ 547	$ 517

Extended Warranty Contracts

The Company sells extended warranty contracts to its customers. At the time of sale, the Company defers the amounts billed for such service contracts. Deferred service contract revenue is recognized on a straight-line basis over the period of the applicable extended warranty contract. A summary of extended warranty contract activity is shown below:

	Nine Months Ended September 30, 2008	2007
Balance at beginning of period	$ 1,471	$ 1,646
Payments received	596	834
Revenue recognized	(727)	(811)

Balance at end of period	$ 1,340	$ 1,669

Under extended warranty contracts, the Company incurred costs of $55 and $242 during the three and nine months ended September 30, 2008, respectively, and costs of $107 and $349 during the three and nine months ended September 30, 2007, respectively.

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NOTE 6 CONTINGENCIES

Contingencies

From time to time, the Company is involved in litigation relating to claims arising from the ordinary course of business. Management does not believe the final disposition of these matters will have a material adverse effect on the financial statements and future cash flows of the Company.

The Company advised Alma Lasers, Ltd. and Alma Lasers, Inc. (together Alma) in February 2006 that Alma s Accent product infringed numerous Thermage patents. On April 26, 2007, Alma filed a lawsuit against the Company in the United States District Court for the District of Delaware requesting declaratory judgment that Alma s Accent product does not infringe Thermage s patents and that Thermage s patents are invalid. Management believes that the Company has meritorious defenses in this action and intends to defend the action vigorously. On June 20, 2007, the Company filed counterclaims in the United States District Court for the District of Delaware asserting that Alma s Accent^{XL} and Harmony devices infringe 10 Thermage U.S. patents. The counterclaims were amended on December 10, 2007 to include a claim of infringement of an eleventh Thermage patent. In addition to damages and attorney fees, the Company is asking the Court to enjoin Alma from further infringement. The case is active and discovery is ongoing. During May, June and July 2008, Alma filed with the United States Patent and Trademark Office requests that all of the 11 patents asserted by Thermage be reexamined. The United States Patent and Trademark Office has granted these reexamination requests. Management believes the U.S. Patent Office will reaffirm the validity of the Company s patents. Management does not believe the final disposition of these matters will have a material adverse effect on the financial statements and future cash flows of the Company.

Commitments

Upon the completion of the merger with Reliant Technologies, Inc., the Company is obligated to make a payment in the amount of $1.7 million to an investment banker.

Indemnifications

In the normal course of business, the Company enters into contracts and agreements that contain a variety of representation and warranties and provide for general indemnifications. The Company s exposure under these agreements is unknown because it involves future claims that may be made against the Company in the future, but have not yet been made. To date, the Company has not paid any claims or been required to defend any action related to its indemnification obligations. However, the Company may record charges in the future as a result of these indemnification obligations.

In accordance with its certificate of incorporation, bylaws and individual indemnification agreements, the Company has indemnification obligations to its officers and directors and certain key employees for certain events or occurrences, subject to certain limits, while they are serving at the Company s request in such a capacity. There have been no claims to date and the Company has a director and officer insurance policy that enables it to recover a portion of any amount paid for future claims.

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NOTE 7 COMPREHENSIVE INCOME (LOSS)

Comprehensive income (loss) generally represents all changes in stockholders equity except those resulting from investments or contributions by stockholders. The Company s unrealized gain on marketable investments represents the only component of other comprehensive income (loss) that is excluded from net income (loss). The changes in components of comprehensive income (loss) for the periods presented are as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Net income (loss)	($1,146)	$ 423	($1,344)	$ 1,790
Unrealized gain (loss) on marketable investments	(1,291)	15	(1,419)	15
Comprehensive income (loss)	($2,437)	$ 438	($2,763)	$ 1,805

NOTE 8 STOCK-BASED COMPENSATION

Stock-based compensation expense recorded under SFAS No. 123R and EITF No. 96-18 related to options granted to employees and non-employees, Employee Stock Purchase Plan and restricted stock unit awards was allocated to cost of revenue, sales and marketing, research and development and general and administrative expense as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Cost of revenue	$ 47	$ 78	$ 143	$ 217
Sales and marketing	352	441	1,124	1,357
Research and development	80	226	296	780
General and administrative	408	477	1,226	1,351
Total stock-based compensation expense	$ 887	$ 1,222	$ 2,789	$ 3,705

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of the federal securities laws. These statements include, but are not limited to, those concerning our expectations that ThermaTip sales will continue to increase as a percentage of revenue versus generator sales; increase in ThermaTip revenue as a result of greater demand; introduction of new treatment procedures and associated treatment tips in the future; increase in average selling price; sales organization growth; growth in international sales and expansion into new international markets; increase operating expenses for research and development; increase general and administrative expenses to support overall business and for regulatory compliance requirements; proportionately larger increase in sales and marketing expenses; and our belief that our cash, cash equivalents and marketable investments will be sufficient to satisfy our anticipated cash requirements. These statements are subject to risks and uncertainties that could cause actual results and events to differ materially from those expressed or implied by such forward-looking statements. For a detailed discussion of these risks and uncertainties, see Risk Factors section in Item 1A of this Quarterly Report on Form 10-Q. We caution the reader not to place undue reliance on these forward-looking statements, which reflect management s analysis only as of the date of this Quarterly Report on Form 10-Q. We undertake no obligation to update forward-looking statements, which reflect events or circumstances occurring after the date of this Form 10-Q.

Overview

We design, develop, manufacture and market medical devices for the non-invasive treatment of wrinkles. We were incorporated in 1996 and received FDA clearance for treatment of periorbital wrinkles and commercially launched our ThermaCool system in 2002. In June 2004, we received FDA clearance for the treatment of facial wrinkles and rhytids. In December 2005, we received FDA clearance to market our ThermaCool system for the treatment of wrinkles and rhytids, without limitation to particular areas of the body. In October 2006, we received FDA clearance for the temporary improvement in the appearance of cellulite. In June 2007, we received FDA clearance for treatment of wrinkles and rhytids for the upper and lower eyelids. In January 2008, we received FDA clearance to market a multiplex treatment tip and associated handpiece. Our patented and FDA-cleared ThermaCool system uses radiofrequency, or RF, energy to heat and shrink collagen and tighten tissue while simultaneously cooling and protecting the surface of the skin. The ThermaCool system consists primarily of an RF generator with cooling capability and a reusable handpiece, a variety of consumable, single-use ThermaTips that attach to the handpiece, and several other consumable accessories. We offer a variety of ThermaTips that a physician can select based on the area of the body being treated. We currently offer four ThermaTip sizes in several configurations of pulse counts, pulse durations and heating profiles for efficient implementation of treatment guidelines. As of September 30, 2008, we had an installed base of approximately 2,617 ThermaCool systems and had sold approximately 580,000 ThermaTips.

During the quarter ended September 30, 2008, our business was impacted by the weakening of global economic conditions and tightening of credit markets which resulted in a slowdown in customer purchase decisions. As a result, net revenue for the three months ended September 30, 2008 decreased 6% from the quarter ended September 30, 2007. We also saw a slowing rate of growth in net revenue for the nine months ended September 30, 2008, which grew 1% from the nine months ended September 30, 2007.

On July 7, 2008, we entered into an agreement and plan of merger and reorganization with Reliant Technologies, Inc. (Reliant) pursuant to which we intend to acquire Reliant for approximately $25 million in cash and 23.6 million shares of our common stock, subject to post closing adjustments. In addition, we have provided a bridge financing to Reliant in the amount of $5.0 million. The proposed transaction is expected to close during the fourth quarter of 2008. Please refer to the Company s Registration Statement on Form S-4 and related amendments thereafter for a description of the reasons for entering into the merger, risk factors associated with the merger, as well as details of the transaction and registration of shares for the merger.

Significant Business Trends

We derive revenue primarily from the sale of ThermaTips and other consumables and sales of our ThermaCool system. For the years ended December 31, 2006 and 2007 and the nine months ended September 30, 2007 and 2008, we derived 73%, 71%, 70% and 73% respectively, of our revenue from ThermaTip and other consumable sales, and 24%, 26%, 27% and 24% respectively, of our revenue from ThermaCool system sales. The balance of our revenue is derived from product service and shipping. In February 2007, we introduced and began shipment of the ThermaCool NXT, our next generation system. The ThermaCool NXT is designed to save time, reduce procedure cost, simplify the treatment experience and improve patient comfort compared to our prior generator. Since the introduction of the ThermaCool NXT generator, customer demand for upgrade from the older generation product was higher than expected. During the nine months ended September 30, 2007, we sold 491 systems, which included sales of 277 systems to new customers and sales of 214 systems as upgrades to existing customers. During the nine months ended September 30, 2008, we sold 439 systems, which included sales of 218 systems to new customers and sales of 221 systems as upgrades to existing customers. We expect to sell approximately 300 ThermaCool systems to new customers worldwide in 2008. During 2007, we launched four new procedures and associated treatment tips, including *Hands by Thermage, Lips by Thermage*, the premium ThermaTip STC for skin tightening and contouring, and ThermaTip DC for deep contouring and body shaping. In March 2008, we introduced the *Cellulite Procedure by Thermage* and its associated treatment tip, ThermaTip CL. As a result of the introduction of new treatment tips in 2007

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and 2008, we have seen a gradual increase in the average selling price of our treatment tips. During the first quarter of 2008 we introduced the Partner Plan to our U.S. customers. The Partner Plan is a six-month plan that provides a set number of monthly treatment tips and consumable products at a fixed monthly price. Treatment tips and consumables derived from sales under the Partner Plan in the nine months ended September 30, 2008 totaled approximately 55% of the U.S. ThermaTips and other consumables revenue.

We market the ThermaCool system, including our single-use ThermaTips in the United States to physicians, primarily dermatologists and plastic surgeons, through a direct sales force, and internationally in 84 countries through a network of 36 distributors. Our sales force trains physicians on the proper use of the ThermaCool system and maintains frequent interaction with these customers to promote repeat sales of our disposable ThermaTip products. In the years ended December 31, 2006 and 2007 and the nine months ended September 30, 2007 and 2008, we derived 52%, 52%, 52% and 51%, respectively, of our revenue from sales of our products and services within the United States, and 48%, 48%, 48% and 49%, respectively, of our total sales outside of the United States. We believe that a significant portion of our business will continue to come from international sales through increased penetration in countries we currently sell our ThermaCool system, combined with expansion into new international markets. The percentages of our revenue by region are presented in the table below:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
United States	51%	53%	51%	52%
Asia Pacific	27%	22%	25%	21%
Europe/Middle East	13%	15%	14%	17%
Rest of the world	9%	10%	10%	10%
Total net revenue	100%	100%	100%	100%

During the last quarter of 2007, we began to execute our plans to expand our U.S. sales force to better address customer needs. Our plan included expansion of our U.S. sales force by about 50% in headcount and its segmentation into two groups, with about two-thirds of the sales force focusing on existing customers on sales of treatment tips, upgrades and training, and the remainder focusing on securing new accounts. Consequently, we expect a proportionately larger increase in sales and marketing expenses to promote revenue growth and geographic expansion. We continue to expect our operating expenses to increase in the future for research and development of new products and technologies, and increased general and administrative expenses to support our overall business and for regulatory compliance requirements.

Future operating results are difficult to predict accurately. We anticipate that our quarterly results of operations may fluctuate for the foreseeable future due to several factors, including the timing of introduction and the degree of acceptance of future product offerings, unanticipated interruptions and expenses related to our manufacturing operations, and the performance of our direct sales force and international distributors.

Significant Industry Factors

The growth of our business relies on current economic conditions and their impact on the growth of the industry, our ability to continue to develop new products and applications based on innovative technologies, obtain and maintain regulatory clearances for our products, protect our proprietary technology, and successfully market and distribute our products. Our industry is characterized by seasonally lower demand during the third calendar quarter of the year, when both physicians and prospective patients take summer vacations. Additionally, our industry is highly competitive and our success depends on our ability to compete successfully. Our business is sensitive to a number of factors that influence the levels of consumer spending, including political and economic conditions such as recessionary environments, the level of disposable consumer income, consumer debt, interest rates and consumer confidence. Declines in consumer spending on aesthetic procedures could have an adverse effect on our operating results. We have in the past noticed brief fluctuations both in demand for our products and in demand for our Thermage procedure, as well as in traffic to our website, following media coverage and promotional campaigns. We experience frequent positive, negative and neutral media coverage throughout a fiscal quarter. Our sales are also impacted by other factors outside of our control, such as prior patient and practicing physician recommendations. Consequently, while we believe that media exposure and other factors outside of our direct control play a role in our long-term success, to date we have not been able to quantify the impact of particular media exposure or media exposure in general, and have not observed any material effect, positive or negative, on our quarterly financial results of operations. A detailed discussion of these and other factors that impact our business is provided in the Risk Factors section in this Quarterly Report on Form 10-Q.

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Results of Operations

Three and Nine Months Ended September 30, 2007 and 2008

Net Revenue. Revenue is derived from the sale of single-use ThermaTips and other consumables, ThermaCool system sales, and service and other revenue. Net revenue decreased $0.9 million, or 6%, from $13.9 million to $13.0 million for the three months ended September 30, 2007 and 2008, respectively. The decrease in sales from the year-ago quarter was primarily due to a comparatively weakening of global economic conditions, and tightening of the credit market that resulted in a slowdown in customer purchasing decisions during the quarter ended September 30, 2008. Sales of ThermaCool systems decreased $0.4 million, or 13% from $3.3 million to $2.9 million for the three months ended September 30, 2007 and 2008, respectively. The decrease in sales was primarily due to the decrease in units sold, coupled with a decrease in average selling price due to a higher proportion of upgrade units sold. Total units of systems sold during the quarter ended September 30, 2008 were 111, which included 56 new units and 55 upgrade units. Sales of ThermaTips and other consumable products decreased $0.4 million, or 4% from $10.2 million to $9.8 million for the three months ended September 30, 2007 and 2008, respectively. The decrease in revenue was primarily due to a decrease in units sold, which was partially offset by an increase in average selling price of ThermaTips, driven by the recently launched premium ThermaTip STC for skin tightening and contouring, the ThermaTip DC for deep contouring and body shaping and the newly launched ThermaTip CL for Cellulite. Revenue from these recently launched premium tips represented approximately 62% of total sales of ThermaTips and consumables during the quarter ended September 30, 2008.

Net revenue increased $0.6 million, or 1%, from $46.5 million to $47.1 million for the nine months ended September 30, 2007 and 2008, respectively. Sales of ThermaTips and other consumable products increased $1.8 million, or 6% from $32.6 million to $34.4 million for the nine months ended September 30, 2007 and 2008, respectively. The increase in revenue in ThermaTips and other consumable products was due primarily to an increase in average selling price, driven by sales of recently launched higher priced premium tips, as well as sales of ThermaTips under the Partner Plan, partially offset by a decrease in units sold. Sales of ThermaCool systems decreased $1.2 million, or 9%, from $12.7 million to $11.5 million for the nine months ended September 30, 2007 and 2008, respectively. The decrease in systems sales was from a decrease in units sold, partially offset by higher average selling price, due to a higher mix of sales of systems to the U.S., which carries a higher selling price than international sales.

Cost of Revenue. Our cost of revenue consists primarily of material, labor and manufacturing overhead expenses. Gross margin was 75.0% of revenue in the third quarter of 2008, compared with 77.6% of revenue in the third quarter of 2007. The decrease in gross margin as a percent of revenue in 2008 compared to 2007 was primarily due to lower average selling price in systems, higher cost of consumables and lower volume of production during the third quarter.

Gross margin was 75.2% of revenue in the nine months ended September 30, 2008, compared with 74.0% of revenue in the comparable period in 2007. The increase in gross margin as a percent of revenue in 2008 was due to higher average selling price of tips, and a higher mix of product sales of the higher margin tips, which was partially offset by more sales of lower margin upgrade units.

Sales and Marketing. Sales and marketing expenses consist primarily of personnel costs and costs related to customer-attended workshops and user meetings, trade shows and advertising, as well as marketing and customer service expenses. Sales and marketing expenses for the quarters ended September 30, 2007 and September 30, 2008 was $6.0 million. Sales and marketing expenses increased $1.1 million, or 6% from $19.2 million to $20.3 million in the nine months ended September 30, 2007 and 2008, respectively. The increase in 2008 was primarily attributable to increased headcount and related personnel and travel and entertainment expenses of $1.9 million as a result of our expansion of the U.S. sales force, which was partially offset by lower discretionary marketing expenses of $0.5 million and lower stock-based compensation expenses of $0.2 million.

Research and Development. Research and development expenses consist primarily of personnel costs, clinical and regulatory costs, material costs and regulatory and quality assurance costs not directly related to the manufacturing of our products. Research and development expenses decreased $0.1 million, or 4%, from $2.3 million to $2.2 million for the three months ended September 30, 2007 and 2008, respectively. Increased spending on research and development material costs was partially offset by lower stock-based compensation expenses. Research and development expenses increased $0.1 million, or 2% from $7.0 million to $7.1 million in the first nine months of 2007 and 2008, respectively. Compared to the first nine months of 2007, higher spending on clinical studies and supplies in 2008, as well as employee and employee related costs were partially offset by lower stock-based compensation expenses.

General and Administrative. General and administrative expenses consist primarily of personnel costs, legal and accounting fees, information technology costs, human resources costs and other general operating expenses. General and administrative expenses decreased by $0.1 million, or 4%, from $2.7 million to $2.6 million for the three months ended September 30, 2007 and 2008, respectively. Decreased spending in legal fees and professional fees associated with compliance, as well as lower stock-based compensation expenses were partially offset by merger integration costs associated with our pending acquisition of Reliant Technologies, Inc.

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General and administrative expenses in the first nine months of 2008 was $10.2 million, an increase of $2.0 million, or 25%, compared with $8.2 million in the first nine months of 2007. During the first quarter of 2008, we reached an advanced stage of negotiations with a potential acquisition target and had performed significant due diligence on the project before negotiations were terminated. We incurred approximately $1.0 million in outside advisory fees pursuing this acquisition. The remaining increase from the prior year period was due to an increase of $0.8 million in professional fees associated with compliance, and an increase of $0.2 million in legal fees incurred related to defense costs and new patent filings and increased employee related expenses, partially offset by lower stock-based compensation expenses.

Interest and Other Income. Interest and other income consist primarily of interest income generated from our cash and cash equivalent balances and from notes receivable balance. Interest and other income were $0.7 million in the quarter ended September 30, 2007 and $0.6 million in the quarter ended September 30, 2008. These amounts were $1.8 million for the nine months ended September 30, 2007 and 2008.

Loss on Investments. During the quarter ended September 30, 2008, a security in our investment portfolio suffered a substantial loss in fair market value. We determined that such loss in fair market value was other than temporary , and as a result, we recorded approximately $0.9 million other than temporary impairment loss on investments in the quarter ended September 30, 2008.

Provision for Income Taxes. The provision for income taxes for all periods presented represented AMT taxes and additions to FIN 48 reserves. For the nine months ended September 30, 2008, we did not recognize any tax benefits in relation to the loss before income taxes as we maintained a full valuation allowance for deferred taxes.

Stock-Based Compensation

For the three and nine months ended September 30, 2007 and 2008, employee and non-employee stock-based compensation expense has been allocated as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Cost of revenue	$ 47	$ 78	$ 143	$ 217
Sales and marketing	352	441	1,124	1,357
Research and development	80	226	296	780
General and administrative	408	477	1,226	1,351
Total stock-based compensation expense	$ 887	$ 1,222	$ 2,789	$ 3,705

Liquidity and Capital Resources

On September 30, 2008, we had working capital of $49.7 million, which consists primarily of $21.2 million in cash and cash equivalents and $24.7 million in marketable investments.

Net Cash Provided by (Used in) Operating Activities. We generated cash from operations of $1.4 million in the nine months ended September 30, 2008, compared with net cash provided of $3.9 million in the same period a year ago. During 2008, $3.4 million net cash was provided from net loss after adjusting for non-cash items. Such amount was used to fund changes in assets and liabilities. During the nine months ended September 30, 2008, cash was used to fund an increase of $1.1 million in accounts receivable, as well as to fund a decrease of $1.3 million in accrued and other liabilities. The increase in accounts receivable was due to a higher percentage of sales volume that occurred towards in the latter part of the quarter, as well as the impact of providing 30 days payment terms to certain U.S. customers under our Infinity Program in 2008. The decrease in accrued and other liabilities was primarily due to payment of annual bonus and professional fees. During the nine months ended September 30, 2007, $6.5 million of net cash was provided from net income after adjusting for non-cash items, which was partially offset by $2.6 million of net cash used in changes in assets and liabilities. Cash used in changes in assets and liabilities was primarily from $1.3 million of increased accounts receivable, the result of increased revenue; $2.0 million of increased inventory to support the business; offset by $0.7 million decrease in prepaid and other current assets and $0.4 million increase in deferred revenue, a result of deferral of revenue on sales of our predecessor generators with rights to upgrade to the ThermaCool NXT generator.

Net Cash Provided by (Used in) Investing Activities. Net cash provided by investing activities in 2008 of $5.5 million was due to $11.5 million net sales of marketable investments, partially offset by acquisition of property and equipment. In connection with our proposed merger with

Reliant Technologies, Inc., we began to liquidate our marketable investments. In addition, we provided a $5.0 million bridge loan to Reliant and incurred $0.3 million in merger and acquisition costs. Net cash used in investing activities in 2007 was due to acquisition of property and equipment. The Company began to purchase marketable investments during the third quarter of 2007.

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Net Cash Provided by Financing Activities. Net cash provided by financing activities was $0.7 million in the nine months ended September 30, 2008 compared with $0.8 million in the nine months ended September 30, 2007. During the first nine months of 2008, cash was provided by proceeds from exercise of stock options and employee stock purchase plan. In addition to cash received from exercise of stock options and employee stock purchase plan, during the nine months ended September 30, 2007, cash was used for payment of capitalized IPO costs of $0.4 million.

We believe that our current cash, cash equivalents, and investments, along with the cash we expect to generate from operations, will be sufficient to meet our anticipated cash needs for the proposed merger with Reliant and for working capital and capital expenditures for at least the next 12 months. Our future liquidity requirements may increase beyond currently expected levels if we fail to achieve sustained profitability or if unanticipated expenses or other uses of our cash arise. For example, in connection with the planned acquisition of Reliant, we may become required to repay, or may choose to repay, outstanding obligations of Reliant under a credit facility between Reliant and Pinnacle Ventures. As of June 30, 2008, Reliant had approximately $5.8 million of secured indebtedness under a loan agreement with Pinnacle Ventures. In order to meet our liquidity needs, we may be required to seek additional equity and/or debt financing. Additional financing may not be available on a timely basis on terms acceptable to us, particularly in the short-term due to the current credit and equity market funding environments. If adequate funds are not available, we may have to delay development of new products or reduce marketing, customer support or other resources devoted to our products. Any of these factors could harm our business and financial condition.

Off-Balance Sheet Arrangements

We do not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. In addition, we do not have any undisclosed borrowings or debt, and we have not entered into any synthetic leases. We are, therefore, not materially exposed to any financing, liquidity, market or credit risk that could arise if we engaged in such relationships.

Recent Accounting Pronouncements

In December 2007, the FASB issued Statement No. 141 (revised), *Business Combinations* (SFAS No. 141(R)). The statement changes the accounting for business combinations including the measurement of acquirer shares issued in consideration for a business combination, the recognition of contingent consideration, the accounting for pre-acquisition gain and loss contingencies, the recognition of capitalized in-process research and development, the accounting for acquisition-related restructuring cost accruals, the treatment of acquisition related transaction costs and the recognition of changes in the acquirer s income tax valuation allowance. SFAS 141(R) is effective for fiscal years beginning after December 15, 2008, with early adoption prohibited. We are evaluating the impact that the statement will have, if any, on our financial statements.

In December 2007, the FASB issued Statement No. 160, *Non-controlling Interests in Consolidated Financial Statements, an amendment of ARB No. 51* (SFAS 160). The standard changes the accounting for non-controlling (minority) interests in consolidated financial statements including the requirements to classify non-controlling interests as a component of consolidated stockholders equity, and the elimination of minority interest accounting in results of operations with earnings attributable to non-controlling interests reported as part of consolidated earnings. Additionally, SFAS 160 revises the accounting for both increases and decreases in a parent s controlling ownership interest. SFAS 160 is effective for fiscal years beginning after December 15, 2008, with early adoption prohibited. We are evaluating the impact that the statement will have, if any, on our financial statements.

In February 2008, the FASB issued FASB Staff Position FAS 157-2, which deferred the effective date of SFAS No. 157 for one year, effective for fiscal years beginning after November 15, 2008, as it relates to non-financial assets and liabilities. We have not determined the effect, if any, the adoption of this statement will have on our results of operations or financial position.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133* (SFAS No. 161). SFAS No. 161 establishes, among other things, the disclosure requirements for derivative instruments and for hedging activities. This statement amends and expands the disclosure requirements of SFAS No. 133 with the intent to provide users of financial statements with an enhanced understanding of: a. How and why an entity uses derivative instruments, b. How derivative instruments and related hedged items are accounted for under SFAS No. 133 and its related interpretations, and c. How derivative instruments and related hedged items affect an entity s financial position, financial performance and cash flows. SFAS No. 161 is effective for fiscal years beginning after November 15, 2008, with early adoption encouraged. We have not determined, the effect, if any, the adoption of this statement will have on our results of operations or financial position.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our exposure to credit and interest rate risk relates primarily to our investment portfolio. Our investment portfolio primarily includes fixed rate debt instruments of corporate issuers, fixed rate Euro bonds and certificates of deposit. A change in prevailing interest rates may cause the fair value of our investments to fluctuate. For example, if we hold a security that was issued with a fixed interest rate at the then-prevailing rate and the prevailing rate rises, the fair value of the principal amount of our investment will probably decline. Assuming a hypothetical increase in interest rates of one percentage point, the fair value of our total investment portfolio as of September 30, 2008 would have potentially declined by $175,000. To minimize the exposure due to adverse shifts in interest rates, we maintain investments at a weighted average maturity of generally one year or less. Due to the short-term nature of these investments, we believe we have no material exposure to interest rate risk arising from our investments.

During the quarter ended September 30, 2008, a security in our investment portfolio suffered a substantial loss in fair market value. We determined that such loss in fair market value was other than temporary , and as a result, we recorded approximately $0.9 million other than temporary impairment loss on investments in the quarter ended September 30, 2008. We also recorded approximately $1.4 million in unrealized losses related to our investment portfolio in the nine months ended September 30, 2008. The current extraordinary disruption and readjustment in the financial markets expose us to investment risks, including the risks that the value and liquidity of our investments could further deteriorate and the issuers of the securities we hold could be subject to credit rating downgrades. There is no assurance that our investment portfolio will not suffer further losses in the future.

Although currently all of our sales and purchases are denominated in U.S. dollars, future fluctuations in the value of the U.S. dollar may affect the price competitiveness of our products. We do not believe, however, that we currently have significant direct foreign currency exchange rate risk and have not hedged exposures denominated in foreign currencies.

ITEM 4T. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures. Our management evaluated, with the participation of our Chief Executive Officer and our Chief Financial Officer, the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) of the Exchange Act of 1934, as amended) as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to management as appropriate to allow for timely decisions regarding required disclosure.

Changes in Internal Control Over Financial Reporting. There was no change in our internal control over financial reporting (as defined in Rule 13a-15(f) of the Exchange Act) that occurred during the period covered by this Quarterly Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

We advised Alma Lasers, Ltd. and Alma Lasers, Inc. (together, Alma) as early as February 2006 that its Accent product infringed numerous Thermage patents.

On April 26, 2007, Alma filed a lawsuit against us in the United States District Court for the District of Delaware requesting declaratory judgment that Alma s Accent product does not infringe Thermage s patents and that Thermage s patents are invalid. We believe that we have meritorious defenses in this action and intend to defend the action vigorously.

On June 20, 2007, we filed patent infringement counterclaims against Alma in the United States District Court for the District of Delaware asserting that Alma s Accent XL and Harmony systems infringe ten Thermage U.S. patents. The counterclaims were amended on December 10, 2007 to include a claim of infringement of an eleventh Thermage patent. In addition to damages and attorney fees, we are asking the Court to enjoin Alma from further infringement. During May, June and July 2008, Alma filed with the United States Patent and Trademark Office requests that all of the 11 patents asserted by Thermage be reexamined and the United States Patent and Trademark Office has granted these reexamination requests. We believe the U.S. Patent Office will reaffirm the validity of our patents. We do not believe the final disposition of these matters will have a material adverse effect on our financial statements and future cash flows.

ITEM 1A. RISK FACTORS

Risks Related to Our Business

If there is not sufficient patient demand for Thermage procedures, practitioner demand for our ThermaCool systems, including our single-use ThermaTips, could drop, resulting in unfavorable operating results.

Most procedures performed using our ThermaCool systems are elective procedures, the cost of which must be borne by the patient, and are not reimbursable through government or private health insurance. The decision to undergo a Thermage procedure is thus driven by consumer demand. Our business is sensitive to a number of factors that influence the level of consumer spending, including political and economic conditions such as recessionary environments, current economic conditions and access to credit markets, the levels of disposable consumer income, consumer debt, interest rates and consumer confidence. Declines in consumer spending on aesthetic procedures could have an adverse effect on our operating results. Consumer demand may be influenced by a number of factors, such as:

- our sales and marketing efforts directed toward consumers, as to which we have limited experience and resources;
- the extent to which physicians recommend our procedures to their patients;
- the cost, safety and effectiveness of a Thermage procedure versus alternative treatments; and
- general consumer sentiment about the benefits and risks of aesthetic procedures.

As widely reported, current uncertainty in the global economic conditions resulting from the recent disruption in credit markets pose a risk to the overall economy that could impact customer demand for our products, as well as our ability to manage normal commercial relationships with our customers and suppliers. If the current situation continues or deteriorates further, our business could be negatively impacted, including reduced demand for our products from a slow-down in the general economy, or supplier or customer disruptions resulting from tighter credit markets. Our financial performance could be materially harmed in the event that any of the above factors discourage patients from seeking Thermage procedures.

Any acquisitions that we make could disrupt our business and harm our financial condition.

Our growth strategy includes evaluation of potential strategic acquisitions of complementary businesses, products or technologies. We may also consider joint ventures and other collaborative projects. We incurred approximately $1.0 million pursuing such a strategic acquisition in the three months ended March 31, 2008. During the quarter ended September 30, 2008, we incurred merger and acquisition transaction costs of approximately $1.6 million related to our acquisition of Reliant Technologies, Inc. We have also incurred integration costs related to the planned acquisition. We may incur similar expenses in future periods as we continue with our integration plan, as well as expenses associated with evaluation of other potential strategic transactions. Such expenditures could negatively impact our financial performance in future periods.

On July 7, 2008, we and Reliant Technologies, Inc. (Reliant) jointly announced that we had entered into a definitive merger agreement under which we will acquire Reliant for approximately $25 million in cash and 23.6 million shares of Thermage common stock, subject to post closing adjustments. In addition, we have agreed to provide bridge financing to Reliant in the amount of $5 million. The proposed transaction will require stockholders approval and is expected to close during the fourth quarter of 2008. Please refer to the Registration Statement filed on Form S-4 on August 11, 2008 and related amendments thereafter for a description of the risk factors associated with the merger.

We may not be able to successfully integrate the combined business, products or technologies. In addition, the integration of such acquisition and management of any collaborative project may divert management s time and resources from our core business and disrupt our operations. We have not acquired companies or products in the past. If we decide to expand our product offerings, we may spend time and money on projects that do not increase our revenue. Any cash acquisition we pursue would diminish funds available to us for other uses, and any stock acquisition would dilute our stockholders ownership. While we from time to time evaluate potential collaborative projects and acquisitions of businesses, products and technologies, and anticipate continuing to make these evaluations, besides the proposed transaction with Reliant, we have no present understandings, commitments or agreements with respect to any other acquisitions or collaborative projects.

Our financial results may fluctuate unpredictably, making it difficult to forecast future performance.

Our limited operating history makes it difficult for us to predict future performance. Historically, the demand for our ThermaCool system has varied from quarter to quarter. A number of factors, over which we have limited or no control, may contribute to fluctuations in our financial results, such as:

delays in receipt of anticipated purchase orders;

seasonal variations in patient demand for aesthetic procedures;

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- the potential impact of general economic conditions on the demand for aesthetic procedures;
- performance of our independent distributors;
- positive or negative media coverage of our ThermaCool system, the Thermage procedure or products of our competitors or our industry;
- our ability to obtain further regulatory clearances or approvals;
- delays in, or failure of, product and component deliveries by our subcontractors and suppliers;
- changes in the length of the sales process;
- customer response to the introduction of new product offerings; and
- fluctuations in foreign currency.

We are totally dependent upon the success of our ThermaCool system, which has a limited commercial history. If the ThermaCool system fails to increase market acceptance, our business will suffer.

We introduced our ThermaCool system in 2002, and expect that sales of our ThermaCool system, including our line of single-use ThermaTips, will account for substantially all of our revenue for the foreseeable future. We expect to continue to expand our line of ThermaTips for new applications. This may not occur when expected, or at all, which would negatively affect our anticipated revenue. Our ThermaCool system may not significantly penetrate current or new markets. If demand for the ThermaCool system does not increase as we anticipate, or declines, our business, financial condition and results of operations will be harmed.

We may not be able to achieve sustainable profitability even if we are able to generate significant revenue.

While we have had five consecutive quarters of profitable results through the end of 2007, we incurred a loss in the first quarter ended March 31, 2008 and the third quarter ended September 30, 2008. We were profitable during the second quarter ended June 30, 2008. In the past, we have expanded our business and increased our expenses in order to grow revenue. We expect this trend to continue for the foreseeable future. For example, in order to promote revenue growth and geographic expansion, during the fourth quarter of 2007, we began to execute a plan to increase our U.S. sales force by about 50% in headcount, which we substantially achieved by the first quarter of 2008. We will have to increase our revenue while effectively managing our expenses in order to achieve sustained profitability. Our failure to achieve sustained profitability could negatively impact the market price of our common stock.

Our success depends on growing physician adoption of our ThermaCool system and continued use of our ThermaTips.

Our target physician customers typically already own one or more aesthetic device products. Our ability to grow our business and convince physicians to purchase our ThermaCool system depends on the success of our clinical and sales and marketing efforts. Our business model involves both a capital equipment purchase of our ThermaCool system and continued purchases by our customers of single-use ThermaTips. This may be a novel business model for many potential customers who may be used to competing products that are either exclusively capital equipment, such as many laser-based systems, or that are exclusively single-use products, such as Botox or dermal fillers. We must be able to demonstrate that the cost of our ThermaCool system and the revenue that the physician can derive from performing procedures using our product are compelling when compared to the cost and revenue associated with alternative products. When marketing to plastic surgeons, we must also, in some cases, overcome a bias against non-invasive aesthetic procedures. If we are unable to increase physician adoption of our ThermaCool system and use of our ThermaTips, our financial performance will be adversely affected.

We may fail to effectively build and manage our sales force or to market and distribute our ThermaCool system.

We rely on a direct sales force to sell our ThermaCool system in the United States. During the fourth quarter of 2007, we began to expand and realign our U.S. sales force to better address customer needs. We began to execute our plan to increase our U.S. sales force by about 50% in headcount and realign resources into two groups, with about two-thirds of the sales force focusing on existing customers on sales of treatment tips, upgrades and training, and the remainder focusing on securing new accounts. As the Company grows, we expect to grow or realign, if necessary, our sales organization to meet our anticipated sales objectives. There are significant risks involved in building and managing our sales organization, including risks related to our ability to:

- hire qualified individuals as needed;
- provide adequate training for the effective sale of our ThermaCool system; and
- retain and motivate our sales employees.

In addition, sales to non-traditional practitioners of aesthetic procedures is a key element of our growth strategy. However, our sales force historically has sold primarily to dermatologists and plastic surgeons. Also, our ThermaCool system competes with products that are well-established in the market. Accordingly, it is difficult for us to predict how well our sales force will perform. Our failure to adequately address these risks could have a material adverse effect on our ability to sell our ThermaCool system, causing our revenue to be lower than expected and harming our results of operations.

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We may not be successful in selling and marketing our new products.

The commercial success of the products and technologies we develop will depend upon the acceptance of these products by physicians and their patients. It is difficult for us to predict how successful recently introduced products and procedures, or products we are currently developing, will be over the long term. If the products we develop do not gain market acceptance, our revenues and operating results could suffer. In addition, we expect to face significant competition in our new products, in some cases from companies that are more established, market more widely known products and have greater resources than we do. We may not be able to differentiate our new products sufficiently from our competitors products to achieve significant market penetration. As a result of these factors, we may incur significant sales and marketing expenses for our new products without achieving commercial success, which could harm our business and our competitive position.

We are involved in intellectual property litigation, which could be costly and time consuming, and may impact our future business and financial performance.

We advised Alma Lasers Ltd. and Alma Lasers, Inc. (together Alma) as early as February 2006 that its Accent product infringed numerous Thermage patents. A number of these patents are the same as those at issue in our 2004 litigation against Syneron, which was settled in 2005 with Syneron acknowledging the validity of these patents in a paid license. In April 2007, Alma filed a complaint in federal court in Delaware seeking a declaratory judgment of non-infringement, and invalidity of nine of Thermage s U.S. patents. On June 20, 2007, we filed an answer to this complaint and counterclaims, alleging that Alma infringed one or more claims of ten of Thermage s U.S. patents. Our counterclaims were subsequently amended on December 10, 2007 to include a claim of infringement of an eleventh Thermage patent. Among other things, our counterclaim alleges that both Alma s Harmony and Accent XL systems infringe our patents. In addition to damages and attorney fees, we have asked the court to enjoin Alma from engaging in further infringement. Alma has responded to all our counterclaims by denying infringement and alleging invalidity of all 11 U.S. patents asserted by us. The litigation is active and discovery is ongoing. During May, June and July 2008, Alma filed with the United States Patent and Trademark Office requests that all of the patents asserted by us be reexamined, and the U.S. Patent Office has granted these reexamination requests. We believe that the United States Patent and Trademark Office will reaffirm the validity of our patents. Our intellectual property has not been tested at trial. If we initiate litigation to protect our rights, we run the risk of having our patents invalidated, which would undermine our competitive position.

Litigation related to infringement and other intellectual property claims, with or without merit, is unpredictable, can be expensive and time-consuming and could divert management s attention from our core business. If we lose this kind of litigation, a court could require us to pay substantial damages, and prohibit us from using technologies essential to our ThermaCool system, any of which would have a material adverse effect on our business, results of operations and financial condition. We do not know whether necessary licenses would be available to us on satisfactory terms, or whether we could redesign our ThermaCool system or processes to avoid infringement.

Our industry has been characterized by frequent intellectual property litigation. Our competitors or other patent holders may assert that our ThermaCool system and the methods we employ are covered by their patents. If our ThermaCool system or methods are found to infringe, we could be prevented from marketing our ThermaCool system. In addition, we do not know whether our competitors or potential competitors have applied for, or will apply for or obtain, patents that will prevent, limit or interfere with our ability to make, use, sell, import or export our ThermaCool system. Competing products may also appear in other countries in which our patent coverage might not exist or be as strong. If we lose a foreign patent lawsuit, we could be prevented from marketing our ThermaCool system in one or more countries.

In addition, we may hereafter become involved in litigation to protect our trademark rights associated with our company name or the names used with our ThermaCool system. Names used with our ThermaCool system and procedures may be claimed to infringe names held by others or to be ineligible for proprietary protection. If we have to change the name of our company or ThermaCool system, we may experience a loss in goodwill associated with our brand name, customer confusion and a loss of sales.

Intellectual property rights may not provide adequate protection for our ThermaCool system, which may permit third parties to compete against us more effectively.

We rely on patent, copyright, trade secret and trademark laws and confidentiality agreements to protect our technology and ThermaCool system. As of September 30, 2008, we had 32 issued U.S. patents and 21 issued foreign patents outside of the United States, mostly covering our ThermaCool system. Some of our system components are not, and in the future may not be, protected by patents. Additionally, our patent applications may not issue as patents or, if issued, may not issue in a form that will be advantageous to us. Any patents we obtain may be challenged, invalidated or legally circumvented by third parties. Consequently, competitors could market products and use manufacturing processes that are substantially similar to, or superior to, ours. We may not be able to prevent the unauthorized disclosure or use of our technical knowledge or other trade secrets by consultants, vendors, former employees or current employees, despite the existence generally of confidentiality agreements and other contractual restrictions. Monitoring

unauthorized uses and disclosures of our intellectual property is difficult, and we do not know whether the steps we have taken to protect our intellectual property will be effective. Moreover, we do not have patent rights in all foreign countries in which a market may exist, and where we have applied for foreign patent rights, the laws of many foreign countries will not protect our intellectual property rights to the same extent as the laws of the United States.

In addition, competitors could purchase our ThermaCool system and attempt to replicate some or all of the competitive advantages we derive from our development efforts, willfully infringe our intellectual property rights, design around our protected technology or develop their own competitive technologies that fall outside of our intellectual property rights. If our intellectual property is not adequately protected so as to protect our market against competitors products and methods, our competitive position could be adversely affected, as could our business.

We may be required to raise additional capital and or debt financing on unfavorable terms.

Our future liquidity requirements may increase beyond currently expected levels if we fail to achieve sustained profitability or if unanticipated expenses or other uses of cash arise. For example, in connection with our planned acquisition of Reliant Technologies, Inc. (Reliant), we may become required to repay, or may choose to replay outstanding obligations of Reliant under a credit facility between Reliant and Pinnacle Ventures. In order to meet our liquidity needs, we may be required to seek additional equity and/or debt financing. Additional financing may not be available on a timely basis on terms acceptable to us, or at all, particularly in the short-term due to the current credit and equity market funding environments. If adequate funds are not available, we may have to delay development of new products or reduce marketing, customer support or other resources devoted to our products. Any of these factors could harm our business and financial condition.

Our marketable investments may be subject to loss.

During the quarter ended September 30, 2008, a security in our investment portfolio suffered a substantial loss in fair market value. We determined that such loss in fair market value was other than temporary , and as a result, we recorded approximately $0.9 million other than temporary impairment loss on investments in the quarter ended September 30, 2008. We also recorded approximately $1.4 million in unrealized losses related to our investment portfolio in the nine months ended September 30, 2008. The current extraordinary disruption and readjustment in the financial markets expose us to investment risks, including the risks that the value and liquidity of our investments could further deteriorate and the issuers of the securities we hold could be subject to credit rating downgrades. There is no assurance that our investment portfolio will not suffer further losses in the future.

Performing clinical studies on, and collecting data from, the Thermage procedure is inherently subjective, and we have limited data regarding the efficacy of our ThermaCool system. If future data is not positive or consistent with our prior experience, rates of physician adoption will likely be harmed.

We believe that in order to significantly grow our business, we will need to conduct future clinical studies of the effectiveness of the ThermaCool system. Clinical studies of aesthetic wrinkle treatments and cellulite are subject to a number of limitations. First, these studies do not involve well-established objective standards for measuring the effectiveness of treatment. Subjective, before and after, evaluation of the extent of change in the patient s appearance, performed by a medical professional or by the patient, is the most common method of evaluating effectiveness. A clinical study may conclude that a treatment is effective even if the change in appearance is subtle and not long-lasting. Second, as with other non-invasive, energy-based devices, the effect of the Thermage procedure varies from patient to patient and can be influenced by a number of factors, including the area of the body being treated, the age and skin laxity of the patient and operator technique.

Most published studies of our ThermaCool system have investigated the tissue-tightening effect of our monopolar RF technology in procedures on the face, using a single treatment with our first generation 1.0 cm^2 ThermaTip and our prior procedure protocol, which involved the use of fewer energy pulses at a higher power than our current procedure protocol. We have not conducted any head-to-head clinical studies that compare results from treatment with our ThermaCool system to surgery or treatment with other aesthetic devices. Without head-to-head studies against competing alternative treatments, which we have no current plans to conduct, potential customers may not find clinical studies of our technology sufficiently compelling to purchase our ThermaCool system. If we decide to pursue additional studies in the future, they could be expensive and time consuming, and the data collected may not produce favorable or compelling results. If the results of such studies do not meet physicians expectations, our ThermaCool system may not become widely adopted, physicians may recommend alternative treatments for their patients, and our business may be harmed.

The failure of our ThermaCool system to meet patient expectations or the occurrence of unpleasant side effects from the Thermage procedure could impair our financial performance.

Our future success depends upon patients having a positive experience with the Thermage procedure in order to increase physician demand for our products, as a result of both individual patients repeat business and as a result of word-of-mouth referrals. We believe that patients may be dissatisfied with the Thermage procedure if they find it to be too painful. Furthermore, Thermage patients may experience temporary swelling or reddening of the skin as a procedure side effect. In rare instances patients may receive

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burns, blisters, skin discoloration or skin depressions. Experiencing excessive pain, any of these side effects or adverse events could discourage a patient from having a Thermage procedure or discourage a patient from having additional procedures or referring Thermage procedures to others. In order to generate repeat and referral business, we also believe that patients must be satisfied with the effectiveness of the Thermage procedure. Results obtained from a Thermage procedure are subjective and may be subtle. A Thermage treatment may produce results that may not meet patients expectations. If patients are not satisfied with the procedure or feel that it is too expensive for the results obtained, our reputation and future sales will suffer.

To successfully market and sell our ThermaCool system internationally, we must address many issues with which we have limited experience.

International sales accounted for 48% of our revenue for the year ended December 31, 2007, and 49% of our revenue for the nine months ended September 30, 2008. We believe that a significant portion of our business will continue to come from international sales through increased penetration in countries where we currently sell our ThermaCool system, combined with expansion into new international markets. However, international sales are subject to a number of risks, including:

- difficulties in staffing and managing our international operations;
- difficulties in penetrating markets in which our competitors products are more established;
- reduced or no protection for intellectual property rights in some countries;
- export restrictions, trade regulations and foreign tax laws;
- fluctuating foreign currency exchange rates;
- foreign certification and regulatory clearance or approval requirements;
- difficulties in developing effective marketing campaigns for unfamiliar, foreign countries;
- customs clearance and shipping delays;
- political and economic instability; and
- preference for locally produced products.

If one or more of these risks were realized, it could require us to dedicate significant resources to remedy the situation, and if we are unable to find a solution, our revenue may decline.