CRYOLIFE INC
Form 10-Q
October 28, 2014

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, 2014**

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: 1-13165

CRYOLIFE, INC.

(Exact name of registrant as specified in its charter)

Florida (State or other jurisdiction of incorporation or organization)	**59-2417093** (I.R.S. Employer Identification No.)
1655 Roberts Boulevard, NW, Kennesaw, Georgia (Address of principal executive offices)	**30144** (Zip Code)

(770) 419-3355

(Registrant s telephone number, including area code)

Not Applicable

(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 x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes x No ¨

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

Large accelerated filer ¨	Accelerated filer 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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Class	**Outstanding at October 23, 2014**
Common Stock, $.01 par value per share	27,942,146 Shares

Part I FINANCIAL INFORMATION

Item 1. Financial Statements.

CRYOLIFE, INC. AND SUBSIDIARIES

SUMMARY CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME

(IN THOUSANDS, EXCEPT PER SHARE DATA)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	**2013**	**2014**	**2013**
	(Unaudited)		(Unaudited)	
Revenues:				
Products	$ 20,405	$ 18,833	$ 60,210	$ 56,824
Preservation services	16,664	17,417	47,280	48,411
Other				71
Total revenues	**37,069**	**36,250**	**107,490**	**105,306**
Cost of products and preservation services:				
Products	4,167	3,544	12,099	10,730
Preservation services	9,103	9,357	26,735	26,472
Total cost of products and preservation services	**13,270**	**12,901**	**38,834**	**37,202**
Gross margin	**23,799**	**23,349**	**68,656**	**68,104**
Operating expenses:				
General, administrative, and marketing	18,882	16,532	55,116	51,441
Research and development	1,902	2,252	6,607	5,976
Total operating expenses	**20,784**	**18,784**	**61,723**	**57,417**
Operating income	**3,015**	**4,565**	**6,933**	**10,687**
Interest expense	65	55	110	159
Interest income	(1)	(1)	(49)	(3)
Other expense (income), net	4	(121)	(206)	120
Income before income taxes	**2,947**	**4,632**	**7,078**	**10,411**
Income tax expense	621	1,463	1,532	3,265

Net income	**$ 2,326**	**$ 3,169**	**$ 5,546**	**$ 7,146**
Income per common share:				
Basic	**$ 0.08**	**$ 0.11**	**$ 0.20**	**$ 0.26**
Diluted	**$ 0.08**	**$ 0.11**	**$ 0.19**	**$ 0.25**
Dividends declared per common share	**$ 0.0300**	**$ 0.0275**	**$ 0.0875**	**$ 0.0800**
Weighted-average common shares outstanding:				
Basic	27,367	26,985	27,414	26,857
Diluted	28,268	27,699	28,345	27,499
Net income	**$ 2,326**	**$ 3,169**	**$ 5,546**	**$ 7,146**
Other comprehensive (loss) income	(80)	17	(73)	38
Comprehensive income	**$ 2,246**	**$ 3,186**	**$ 5,473**	**$ 7,184**

See accompanying Notes to Summary Consolidated Financial Statements.

CRYOLIFE, INC. AND SUBSIDIARIES

SUMMARY CONSOLIDATED BALANCE SHEETS

(IN THOUSANDS)

	September 30, 2014 (Unaudited)	December 31, 2013
ASSETS		
Current assets:		
Cash and cash equivalents	$ 29,823	$ 37,643
Restricted cash and securities	923	5,350
Receivables, net	21,595	18,307
Deferred preservation costs	25,869	27,297
Inventories	13,162	9,771
Deferred income taxes	5,767	5,162
Prepaid expenses and other	5,491	2,797
Total current assets	**102,630**	**106,327**
Property and equipment, net	12,160	12,171
Restricted cash	5,000	
Goodwill	11,365	11,365
Patents, net	1,892	1,934
Trademarks and other intangibles, net	19,453	19,985
Notes receivable	2,000	2,000
Deferred income taxes	16,183	16,885
Other	4,478	4,016
Total assets	**$ 175,161**	**$ 174,683**
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 5,389	$ 5,514
Accrued compensation	4,528	4,886
Accrued procurement fees	4,874	5,427
Accrued expenses and other	4,795	4,579
Deferred income	410	316
Total current liabilities	**19,996**	**20,722**
Contingent consideration	1,392	1,884
Other	6,911	7,330

Total liabilities	**28,299**	**29,936**
Commitments and contingencies		
Shareholders equity:		
Preferred stock		
Common stock (issued shares of 29,027 in 2014 and 28,244 in 2013)	290	282
Additional paid-in capital	133,143	128,585
Retained earnings	21,835	18,741
Accumulated other comprehensive (loss) income	(66)	7
Treasury stock at cost (shares of 991 in 2014 and 413 in 2013)	(8,340)	(2,868)
Total shareholders equity	**146,862**	**144,747**
Total liabilities and shareholders equity	**$ 175,161**	**$ 174,683**

See accompanying Notes to Summary Consolidated Financial Statements.

CRYOLIFE, INC. AND SUBSIDIARIES

SUMMARY CONSOLIDATED STATEMENTS OF CASH FLOWS

(IN THOUSANDS)

	Nine Months Ended September 30, 2014	Nine Months Ended September 30, 2013
	(Unaudited)	
Net cash flows from operating activities:		
Net income	$ 5,546	$ 7,146
Adjustments to reconcile net income to net cash from operating activities:		
Depreciation and amortization	4,468	4,413
Non-cash compensation	2,736	2,357
Deferred income taxes	97	960
Other non-cash adjustments to income	(641)	1,133
Changes in operating assets and liabilities:		
Receivables	(3,288)	(4,143)
Deferred preservation costs and inventories	(2,123)	570
Prepaid expenses and other assets	(3,156)	(745)
Accounts payable, accrued expenses, and other liabilities	(306)	(384)
Net cash flows provided by operating activities	**3,333**	**11,307**
Net cash flows from investing activities:		
Capital expenditures	(3,225)	(3,241)
Other	(1,582)	(159)
Net cash flows used in investing activities	**(4,807)**	**(3,400)**
Net cash flows from financing activities:		
Cash dividends paid	(2,452)	(2,202)
Proceeds from exercise of stock options and issuance of common stock	1,409	852
Repurchases of common stock	(4,584)	(1,523)
Other	(677)	(407)
Net cash flows used in financing activities	**(6,304)**	**(3,280)**
Effect of exchange rate changes on cash	(42)	43

(Decrease) increase in cash and cash equivalents		**(7,820)**		**4,670**
Cash and cash equivalents, beginning of period		37,643		13,009
Cash and cash equivalents, end of period	**$**	**29,823**	**$**	**17,679**

See accompanying Notes to Summary Consolidated Financial Statements.

CRYOLIFE, INC. AND SUBSIDIARIES

NOTES TO SUMMARY CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

1. Basis of Presentation

The accompanying summary consolidated financial statements include the accounts of CryoLife, Inc. and its subsidiaries (CryoLife, the Company, we, or us). All significant intercompany accounts and transactions have been eliminated in consolidation. The accompanying Summary Consolidated Balance Sheet as of December 31, 2013 has been derived from audited financial statements. The accompanying unaudited summary consolidated financial statements as of and for the three and nine months ended September 30, 2014 and 2013 have been prepared in accordance with (i) accounting principles generally accepted in the U.S. for interim financial information and (ii) the instructions to Form 10-Q and Rule 10-01 of Regulation S-X of the U.S. Securities and Exchange Commission (SEC). Accordingly, such statements do not include all of the information and disclosures required by accounting principles generally accepted in the U.S. for a complete presentation of financial statements. In the opinion of management, all adjustments (including those of a normal, recurring nature) considered necessary for a fair presentation have been included. Operating results for the three and nine months ended September 30, 2014 are not necessarily indicative of the results that may be expected for the year ending December 31, 2014. These summary consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in CryoLife s Annual Report on Form 10-K for the year ended December 31, 2013.

2. Financial Instruments

The following is a summary of the Company s financial instruments measured at fair value (in thousands):

September 30, 2014	**Level 1**	**Level 2**	**Level 3**	**Total**
Cash equivalents:				
Money market funds	$ 7,018	$	$	$ 7,018
U.S. Treasury debt securities	15,000			15,000
Restricted securities:				
Money market funds	923			923
Total assets	$ 22,941	$	$	$ 22,941
Long-term liabilities:				
Contingent consideration	$	$	$ (1,392)	$ (1,392)
Total liabilities	$	$	$ (1,392)	$ (1,392)

December 31, 2013	**Level 1**	**Level 2**	**Level 3**	**Total**
Cash equivalents:				
Money market funds	$ 5,349	$	$	$ 5,349
Certificates of deposit	749			749
Restricted securities:				
Money market funds	350			350

Total assets	$	6,448	$		$		$	6,448
Long-term liabilities:								
Contingent consideration	$		$		$	(1,884)	$	(1,884)
Total liabilities	$		$		$	(1,884)	$	(1,884)

The Company used prices quoted from its investment management companies to determine the Level 1 valuation of its investments in money market funds, U.S. Treasury debt securities, and certificates of deposit. The Company recorded a contingent consideration liability, classified as Level 3, as a result of its acquisition of Hemosphere, Inc. (Hemosphere) in May 2012. Refer to Note 5 for further discussion of the Level 3 contingent consideration liability.

Changes in fair value of Level 3 liabilities are listed below (in thousands):

		Contingent Consideration
Balance as of December 31, 2013	$	1,884
Gain on remeasurement of contingent consideration		(492)
Balance as of September 30, 2014	$	1,392

3. Cash Equivalents and Restricted Cash and Securities

The following is a summary of cash equivalents and restricted cash and securities (in thousands):

September 30, 2014		**Cost Basis**		**Unrealized Holding Gains**		**Estimated Market Value**
Cash equivalents:						
Money market funds	$	7,018	$		$	7,018
U.S. Treasury debt securities		15,000				15,000
Restricted cash and securities:						
Cash		5,000				5,000
Money market funds		923				923

December 31, 2013		**Cost Basis**		**Unrealized Holding Gains**		**Estimated Market Value**
Cash equivalents:						
Money market funds	$	5,349	$		$	5,349
Certificates of deposit		749				749
Restricted cash and securities:						
Cash		5,000				5,000
Money market funds		350				350

As of September 30, 2014 and December 31, 2013 $923,000 and $350,000, respectively, of the Company s money market funds were designated as short-term restricted securities due to a contractual commitment to hold the securities as pledged collateral relating primarily to international tax obligations. As of September 30, 2014 $5.0 million of the Company s cash was designated as long-term restricted cash due to a financial covenant requirement under the Company s amended and restated credit agreement with General Electric Capital Corporation (GE Capital), as discussed in Note 11. This restriction lapses upon expiration of the credit agreement with GE Capital on September 26, 2019. As of December 31, 2013 $5.0 million of the Company s cash was designated as short-term restricted cash under the Company s credit agreement with GE Capital prior to the September 26, 2014 amendment.

There were no gross realized gains or losses on cash equivalents in the three and nine months ended September 30, 2014 and 2013. As of September 30, 2014 $273,000 of the Company s restricted securities had a maturity date within three months and $650,000 had a maturity date of between three months and one year. As of December 31, 2013 $328,000 of the Company s restricted securities had a maturity date within three months and $22,000 had a maturity date between three months and one year. As of September 30, 2014 and December 31, 2013 $5.0 million of the Company s restricted cash had no maturity date.

4. ProCol Distribution Agreement

In March 2014 CryoLife acquired the exclusive worldwide distribution rights for ProCol® Vascular Bioprosthesis (ProCol) from Hancock Jaffe Laboratories, Inc. (Hancock Jaffe). The agreement between CryoLife and Hancock Jaffe (the HJ Agreement) has an initial three-year term and is renewable for two one-year periods at CryoLife s option. Per the terms of the HJ Agreement, CryoLife has the option to acquire the ProCol product line from Hancock Jaffe beginning in March 2016.

ProCol, which is approved for sale in the U.S., is a biological graft derived from a bovine mesenteric vein that provides vascular access for end-stage renal disease (ESRD) hemodialysis patients. It is intended for the creation of a bridge graft for vascular access subsequent to at least one previously failed prosthetic access graft. ProCol is complementary to the Company s

Hemodialysis Reliable Outflow Graft (HeRO® Graft), which also serves patients with ESRD. ProCol provides vascular access for earlier-stage ESRD patients, while HeRO Graft is designed for patients with limited access options and central venous obstruction.

In accordance with the terms of the HJ Agreement, CryoLife will make payments to Hancock Jaffe of up to $2.3 million during 2014, with no more than $650,000 payable in any quarter. In exchange for these payments, CryoLife will receive a designated amount of ProCol inventory for resale, including a small amount of existing commercially salable inventory, which it received in the first half of 2014, and additional inventory. Additional inventory becomes available for distribution as it is manufactured and following Hancock Jaffe s receipt of U.S. Food and Drug Administration (FDA) approval of the Premarket Approval Supplement associated with its new manufacturing facility, which it received on September 29, 2014. Subsequent to this initial inventory purchase, CryoLife can purchase additional units from Hancock Jaffe at an agreed upon transfer price.

As of September 30, 2014 the Company had made payments of $1.7 million to Hancock Jaffe, and the Company began limited distribution of ProCol in the second quarter of 2014.

5. Hemosphere Acquisition

On May 16, 2012 CryoLife acquired Hemosphere, which the Company now operates as a wholly owned subsidiary. Hemosphere is the developer and marketer of the HeRO Graft, a proprietary graft-based solution for ESRD hemodialysis patients with limited access options and central venous obstruction.

As of the Hemosphere acquisition date, CryoLife recorded a contingent consideration liability of $1.8 million in long-term liabilities on its Summary Consolidated Balance Sheet, representing the estimated fair value of the contingent consideration expected to be paid to the former shareholders of Hemosphere upon the achievement of certain revenue-based milestones. The acquisition agreement provides for a maximum of $4.5 million in future consideration payments through December 2015 based on specified sales targets.

The fair value of the contingent consideration liability was based on unobservable inputs, including management s estimates and assumptions about future revenues, and is, therefore, classified as Level 3 within the fair value hierarchy presented in Note 2. The Company will remeasure this liability at each reporting date and will record changes in the fair value of the contingent consideration liability in other expense (income), net on the Company s Summary Consolidated Statement of Operations and Comprehensive Income. Increases or decreases in the fair value of the contingent consideration liability can result from changes in discount periods and rates, as well as changes in the timing and amount of Company revenue estimates.

The Company recorded gains of $196,000 and $492,000 in the three and nine months ended September 30, 2014, respectively, and a gain of $32,000 and a loss of $46,000 in the three and nine months ended September 30, 2013, respectively, on the remeasurement of the contingent consideration liability. The gains and losses in the current and prior year periods are due to the effect of the passage of time on the fair value measurements and changes in the Company s estimates. The balance of the contingent consideration liability was $1.4 million as of September 30, 2014 and $1.9 million as of December 31, 2013.

6. ValveXchange

Preferred Stock Investment

In July 2011 the Company purchased shares of series A preferred stock of ValveXchange, Inc. (ValveXchange) for approximately $3.5 million. ValveXchange is a private medical device company that was spun off from Cleveland Clinic to develop a lifetime heart valve replacement technology platform featuring exchangeable bioprosthetic leaflets. As ValveXchange s stock is not actively traded on any public stock exchange, and as the Company s investment is in preferred stock, the Company initially accounted for this investment using the cost method. The Company initially recorded its investment as a long-term asset, investment in equity securities, on the Company s Summary Consolidated Balance Sheets.

During the fourth quarter of 2013 the Company reevaluated its investment in ValveXchange preferred stock for impairment. Based on this analysis, the Company believed that its investment in ValveXchange was fully impaired as of December 31, 2013, and the impairment was other than temporary. Therefore, in the fourth quarter of 2013 the Company recorded an other non-operating expense of $3.2 million to write-down the remaining value of its investment in ValveXchange preferred stock. As of September 30, 2014 and December 31, 2013 the carrying value of the Company s investment in ValveXchange preferred stock was zero.

Loan Agreement

The Company s agreement with ValveXchange, as amended, makes available up to $2.0 million to ValveXchange in debt financing through a revolving credit facility (the Loan). The Loan includes various affirmative and negative covenants, including financial covenant requirements, and expires on July 30, 2018, unless terminated earlier. Amounts outstanding under the Loan earn interest at an 8% annual rate and are secured by substantially all of the tangible and intangible assets of ValveXchange. The Company incurred loan origination costs, net of fees charged to ValveXchange, of approximately $117,000, which are being expensed on a straight-line basis over the expected life of the loan facility. The Company advanced $2.0 million to ValveXchange under this loan in 2012. The $2.0 million advance is recorded as long-term notes receivable on the Company s Summary Consolidated Balance Sheets as of September 30, 2014 and December 31, 2013.

During 2013 CryoLife repeatedly notified ValveXchange that ValveXchange was in default of certain loan covenants, due to various factors including ValveXchange s failure to obtain CryoLife s consent for certain convertible note financings that ValveXchange previously obtained. In April 2014, in conjunction with ValveXchange s series B preferred stock fundraising (the Series B), CryoLife and ValveXchange entered into an amendment to the Loan agreement pursuant to which CryoLife waived ValveXchange s previous Loan defaults in exchange for an agreement that 10% of any amounts raised in the Series B in excess of $1.25 million would be paid to CryoLife. As of September 30, 2014 ValveXchange had raised $1.7 million under the Series B. ValveXchange continues to seek additional funding under the Series B.

Management believes that ValveXchange will continue to need additional funds to support its short-term and long-term operations, as it is currently not selling any product. Specifically, ValveXchange will need to expand its clinical trial in order to obtain approval to distribute its product in Europe. ValveXchange does not currently have the funds necessary to finance this expansion, and without this expansion, ValveXchange is not expected to be able to generate revenues. However, even if ValveXchange is able to secure additional funds, if those funds are insufficient and ValveXchange cannot meet its business obligations, CryoLife may need to foreclose on the related collateral to secure repayment of the Loan. Although CryoLife currently believes that the value of the collateral is adequate to repay the Loan, there is no guarantee of such adequacy. ValveXchange s current liquidity position is critical, and without additional funding, ValveXchange will likely be required to cease operations during the fourth quarter of 2014. If ValveXchange is forced to cease operations or seek reorganization in bankruptcy, the Company may be unable to secure full repayment of the Loan.

Option Agreement

Concurrently with the Loan agreement described above, CryoLife entered into an option agreement with ValveXchange pursuant to which CryoLife obtained (i) the right of first refusal to acquire ValveXchange during a period that extends through the completion of initial commercialization milestones and (ii) the right to negotiate with ValveXchange for European distribution rights. As part of the Series B, CryoLife agreed to forego its rights to negotiate with ValveXchange for European distribution rights. The Company s rights may be further modified or reduced in connection with a future round of financing.

7. Medafor Matters

Investment in Medafor Common Stock

In 2009 and 2010 CryoLife purchased shares of common stock in Medafor, Inc. (Medafor). The Company initially recorded its investment using the cost method as a long-term asset, investment in equity securities, on the Company s Summary Consolidated Balance Sheets.

On October 1, 2013 C.R. Bard, Inc. (Bard) and subsidiaries completed its previously announced acquisition of the outstanding shares of Medafor common stock. The Company received an initial payment of approximately $15.4 million for its 2.4 million shares of Medafor common stock and recorded an initial gain of approximately $12.7 million on the sale in the fourth quarter of 2013. The Company could receive additional payments totaling up to $8.4 million upon the release of funds held in escrow and the satisfaction of certain contingent milestones, measurable through June 2015. In October 2014 the Company received the first of these additional payments, totaling $530,000, which will be recorded as a gain in the fourth quarter of 2014. Subsequent payments will be recorded as an additional gain if, and when, received by the Company.

Legal Action

CryoLife received a letter from Medafor in September 2012 stating that PerClot®, when introduced in the U.S. and used in accordance with the method published in CryoLife s literature and with the instructions for use, will infringe Medafor s (now Bard s) U.S. patent. CryoLife does not believe that its sales of PerClot will infringe Bard s patent.

In April 2014 the Company filed a declaratory judgment lawsuit against Bard and certain of its subsidiaries, including Medafor (collectively, Defendants), in the U.S. District Court for the District of Delaware (the Court). CryoLife requested that the Court confirm that CryoLife s anticipated sales of PerClot, when it is approved by the FDA, and certain of its derivative products, such as PerClot Topical, which has been cleared by the FDA, will not infringe any valid claim of the patent held by Bard and/or that the Bard patent is invalid.

In June 2014 CryoLife filed an amended complaint, and the Defendants filed a counterclaim for infringement in August 2014. The Defendants also filed various motions to dismiss; the Court has not ruled on these motions.

On September 19, 2014 the Defendants filed with the Court a motion for a preliminary injunction, asking the Court to enjoin CryoLife s marketing and sale of PerClot in the U.S. Discovery with respect to this motion has commenced, and the Court has set a hearing date of January 23, 2015. See also Part II, Item 1, Legal Proceedings of this Form 10-Q.

8. Deferred Preservation Costs and Inventories

Deferred preservation costs at September 30, 2014 and December 31, 2013 are comprised of the following (in thousands):

	September 30, 2014	December 31, 2013
Cardiac tissues	$ 11,372	$ 12,239
Vascular tissues	14,497	15,058
Total deferred preservation costs	$ 25,869	$ 27,297

Inventories at September 30, 2014 and December 31, 2013 are comprised of the following (in thousands):

	September 30, 2014	December 31, 2013
Raw materials and supplies	$ 7,548	$ 5,706
Work-in-process	1,265	767
Finished goods	4,349	3,298
Total inventories	$ 13,162	$ 9,771

9. Goodwill and Other Intangible Assets

Indefinite Lived Intangible Assets

As of September 30, 2014 and December 31, 2013 the carrying values of the Company s indefinite lived intangible assets are as follows (in thousands):

	September 30, 2014	December 31, 2013
Goodwill	$ 11,365	$ 11,365
Procurement contracts and agreements	2,013	2,013
Trademarks	851	841

Based on its experience with similar agreements, the Company believes that its acquired procurement contracts and agreements have an indefinite useful life, as the Company expects to continue to renew these contracts for the foreseeable future. The Company believes that its trademarks have an indefinite useful life as the Company currently anticipates that these trademarks will contribute to cash flows of the Company indefinitely.

As of September 30, 2014 and December 31, 2013 the Company s entire goodwill balance is related to its Medical Devices segment, and there has been no change from the balance recorded as of December 31, 2013.

Definite Lived Intangible Assets

As of September 30, 2014 and December 31, 2013 the gross carrying values, accumulated amortization, and approximate amortization period of the Company s definite lived intangible assets are as follows (in thousands):

September 30, 2014		**Gross Carrying Value**		**Accumulated Amortization**	**Amortization Period**
Acquired technology	$	14,020	$	3,530	11 16 Years
Patents		4,325		2,433	17 Years
Distribution and manufacturing rights and know-how		4,059		914	15 Years
Customer lists and relationships		3,370		753	13 17 Years
Non-compete agreement		381		295	10 Years
Other		467		216	1 5 Years

December 31, 2013		**Gross Carrying Value**		**Accumulated Amortization**	**Amortization Period**
Acquired technology	$	14,020	$	2,677	11 16 Years
Patents		4,348		2,414	17 Years
Distribution and manufacturing rights and know-how		3,559		714	15 Years
Customer lists and relationships		3,370		572	13 17 Years
Non-compete agreement		381		267	10 Years
Other		202		171	1 3 Years

Amortization Expense

The following is a summary of amortization expense as recorded in general, administrative, and marketing expenses on the Company s Summary Consolidated Statement of Operations and Comprehensive Income (in thousands):

	Three Months Ended September 30,				**Nine Months Ended September 30,**			
		2014		**2013**		**2014**		**2013**
Amortization expense	$	504	$	493	$	1,503	$	1,515

As of September 30, 2014 scheduled amortization of intangible assets for the next five years is as follows (in thousands):

	Remainder of 2014		**2015**		**2016**		**2017**		**2018**		**2019**
Amortization expense	$ 504	$	1,987	$	1,980	$	1,926	$	1,917	$	1,911

10. Income Taxes

Income Tax Expense

The Company s effective income tax rate was approximately 21% and 22% for the three and nine months ended September 30, 2014, respectively, as compared to 32% and 31% for the three and nine months ended September 30, 2013, respectively.

The Company s income tax rate for the three and nine months ended September 30, 2014 was favorably affected by the reduction of uncertain tax positions and by favorable deductions taken on the Company s 2013 federal tax return, which was filed in the third quarter of 2014. To a lesser extent, the Company s income tax rate was unfavorably affected by its inability to claim the research and development tax credit, which has not yet been enacted for the 2014 tax year. The Company s income tax rate in 2013 was favorably affected by the full year 2012 research and development tax credit, which was enacted in January 2013 and, therefore, reduced the Company s tax expense during the first quarter of 2013.

In June 2014 the Internal Revenue Service completed a limited scope examination of certain of the Company s federal income tax returns. At the resolution of this examination, the Company reevaluated its liabilities for uncertain tax positions, primarily related to its research and development tax credits and credit carryforwards, and, based on revised estimates and the settlement of the examination, reversed $748,000 in uncertain tax liabilities and tax expense.

Deferred Income Taxes

Deferred income taxes reflect the net tax effect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and tax return purposes. The Company generates deferred tax assets primarily as a result of book write-downs, reserves, or impairments which are not immediately deductible for tax return purposes. The Company acquired significant deferred tax assets, primarily net operating loss carryforwards, from its acquisitions of Hemosphere and Cardiogenesis Corporation in the second quarters of 2012 and 2011, respectively. The Company currently estimates that a portion of its state net operating loss carryforwards will not be recoverable and has, therefore, recorded a valuation allowance against these state net operating loss carryforwards.

As of September 30, 2014 the Company had a total of $1.5 million in valuation allowances against deferred tax assets, related to state net operating loss carryforwards, and a net deferred tax asset of $22.0 million. As of December 31, 2013 the Company had a total of $1.5 million in valuation allowances against deferred tax assets and a net deferred tax asset of $22.0 million.

11. Debt

GE Credit Agreement

On September 26, 2014 CryoLife amended and restated its credit agreement with GE Capital, extending the expiration date and amending other terms, which are discussed further below. CryoLife s amended and restated credit agreement with GE Capital (the GE Credit Agreement) provides revolving credit for working capital, permitted acquisitions, and general corporate purposes. The GE Credit Agreement has aggregate commitments of $20.0 million for revolving loans, including swing loans subject to a sublimit and letters of credit, and expires on September 26, 2019. The commitments may be reduced from time to time pursuant to the terms of the GE Credit Agreement. The GE Credit Agreement also permits CryoLife to request a term loan in an aggregate amount of up to $25.0 million to finance the purchase price of a permitted acquisition.

Amounts borrowed under the GE Credit Agreement are secured by substantially all of the tangible and intangible assets of CryoLife and its subsidiaries and bear interest, based on the Company s election, at either LIBOR or GE Capital s base rate plus the respective applicable margins. All swing loans will, however, bear interest at the base loan rate. Commitment fees are paid based on the unused portion of the facility. If an event of default occurs, the applicable interest rate will increase by 2.0% per annum. The aggregate interest rate was 4.75% and 6.5% as of September 30, 2014 and December 31, 2013, respectively. As of September 30, 2014 and December 31, 2013 the outstanding balance of the GE Credit Agreement was zero, and the remaining availability was $20.0 million.

The GE Credit Agreement places limitations on the amount that the Company may borrow and includes various affirmative and negative covenants, including financial covenants such as a requirement that CryoLife (i) not exceed a defined leverage ratio and (ii) maintain minimum earnings subject to defined adjustments as of specified dates. The agreement also (i) limits the payment of cash dividends, up to specified maximums and subject to satisfaction of specified conditions, (ii) requires that, after giving effect to a stock repurchase, the Company maintain liquidity, as defined within the agreement, of at least $20.0 million, (iii) limits acquisitions or mergers except for certain permitted acquisitions, (iv) sets specified limits on the amount the Company can pay to purchase or redeem CryoLife common stock pursuant to a stock repurchase program and to fund estimated tax liabilities incurred by officers, directors, and employees as a result of awards of stock or stock equivalents, and (v) includes customary conditions on incurring new indebtedness. As of September 30, 2014 the Company was in compliance with the covenants of the GE Credit Agreement.

As required under the terms of the GE Credit Agreement, the Company is maintaining cash and cash equivalents of at least $5.0 million in accounts in which GE Capital has a first priority perfected lien. These amounts are recorded as long-term restricted cash as of September 30, 2014 on the Company s Summary Consolidated Balance Sheet, as they are restricted for the term of the GE Credit Agreement. As of December 31, 2013 $5.0 million of the Company s cash was designated as short-term restricted cash on the Company s Summary Consolidated Balance Sheet under the Company s credit agreement with GE Capital prior to the September 26, 2014 amendment.

Interest Expense

Interest expense was $65,000 and $110,000 for the three and nine months ended September 30, 2014, respectively. Interest expense was $55,000 and $159,000 for the three and nine months ended September 30, 2013, respectively. Interest expense in all periods included interest on debt and uncertain tax positions. Interest expense for the nine months ended September 30, 2014 was favorably affected by the reversal of interest expense related to a reduction in liability for uncertain tax positions.

12. Commitments and Contingencies

Leases

In October 2014 the Company signed an agreement to lease approximately 25,000 square feet of additional office space near the Company s headquarters in suburban Atlanta, Georgia. The lease is expected to commence in February 2015 for an initial term of approximately 11 years, which the Company can renew for up to two five-year renewal periods. Payments due under this lease will total approximately $4.4 million during the initial term, after consideration of expected rent abatements and construction and moving allowances.

Liability Claims

The Company accrues its estimate of unreported product and tissue processing liability claims as a component of other long-term liabilities and records the related recoverable insurance amount as a component of other long-term assets, as appropriate. At September 30, 2014 and December 31, 2013 the Company s estimated unreported loss liability was $1.5 million. The related recoverable insurance amounts were $610,000 and $580,000 as of September 30, 2014 and December 31, 2013, respectively. Further analysis indicated that the liability as of September 30, 2014 could have been estimated to be as high as $2.7 million, after including a reasonable margin for statistical fluctuations calculated based on actuarial simulation techniques.

Employment Agreements

In July 2014 the Company s Board of Directors appointed Mr. James P. Mackin as President and Chief Executive Officer (CEO), and the Company and Mr. Mackin entered into an employment agreement, which became effective September 2, 2014. The employment agreement has an initial three-year term. Beginning on the second anniversary of the effective date, and subject to earlier termination pursuant to the agreement, the employment term will, on a daily basis, automatically extend by one day. In accordance with the agreement, on September 2, 2014, Mr. Mackin received a one-time signing bonus of $200,000, a grant of 400,000 stock options, and a performance stock award grant of 250,000 shares. The agreement also provides for a severance payment, which would become payable upon the occurrence of certain employment termination events, including termination by the Company without cause.

The Company s employment agreement, as amended, with its former President and CEO, and current Executive Chairman, Mr. Steven G. Anderson, confers benefits, which become payable upon the occurrence of certain events, including the voluntary retirement of Mr. Anderson or termination of his employment in conjunction with certain change in control events. As of both September 30, 2014 and December 31, 2013 the Company had $2.1 million in accrued expenses and other current liabilities on the Summary Consolidated Balance Sheets representing benefits payable upon Mr. Anderson s voluntary retirement, for which he is currently eligible. Mr. Anderson s employment agreement took effect on January 1, 2013 and terminates on December 31, 2016.

13. Shareholders Equity

Common Stock Repurchase

In February 2013 the Company s Board of Directors authorized the purchase of up to $15.0 million of its common stock through October 31, 2014.

In the nine months ended September 30, 2014 the Company purchased approximately 488,000 shares for an aggregate purchase price of $4.6 million. As of September 30, 2014 the Company had $8.9 million in remaining authorizations under the repurchase program. For the year ended December 31, 2013 the Company purchased approximately 253,000 shares for an aggregate purchase price of $1.5 million. These shares were recorded, at cost, as part of treasury stock on the Company s Summary Consolidated Balance Sheets.

Cash Dividends

The Company initiated a quarterly cash dividend of $0.025 per share of common stock outstanding in the third quarter of 2012 and increased this dividend to $0.0275 per share of common stock outstanding in the second quarter of 2013. In May 2014 the Board of Directors approved an increase in the quarterly cash dividend to $0.03 per share of common stock outstanding for the second quarter 2014. The Company paid dividend payments of $842,000 and $2.5 million from cash on hand for the three and nine months ended September 30, 2014, respectively, and $759,000 and $2.2 million for the three and nine months ended September 30, 2013, respectively. The dividend payments were recorded as a reduction to retained earnings on the Company s Summary Consolidated Balance Sheets.

14. Stock Compensation

Overview

The Company has stock option and stock incentive plans for employees and non-employee Directors that provide for grants of restricted stock awards (RSAs), performance stock awards (PSAs), restricted stock units (RSUs), performance stock units (PSUs), and options to purchase shares of Company common stock at exercise prices generally equal to the fair values of such stock at the dates of grant. The Company also maintains a shareholder-approved Employee Stock Purchase Plan (the ESPP) for the benefit of its employees. The ESPP allows eligible employees the right to purchase common stock on a regular basis at the lower of 85% of the market price at the beginning or end of each offering period.

Equity Grants

During the nine months ended September 30, 2014 the Compensation Committee of the Company s Board of Directors authorized awards from approved stock incentive plans of RSAs to non-employee directors, RSUs to certain employees, and RSAs, PSUs, and PSAs to certain Company officers, which, assuming that performance under the PSUs were to be achieved at target levels, together totaled 655,000 shares and had an aggregate grant date market value of $6.6 million. The PSUs granted in 2014 represent the right to receive from 50% to 150% of the target number of shares of common stock. The performance component of PSU awards granted in 2014 is based on attaining specified levels of adjusted earnings, as defined in the PSU grant documents, for the 2014 calendar year. The Company currently believes that achievement of the performance component is probable, and it will reevaluate this likelihood on a quarterly basis. The performance component of PSA award granted in 2014 is based upon attaining specified levels of adjusted earnings over any four consecutive calendar quarters during a three-year employment period, as defined in the PSA grant documents. The Company currently believes that achievement of the performance component is probable, and it will reevaluate this likelihood on a quarterly basis.

During the nine months ended September 30, 2013 the Compensation Committee of the Company s Board of Directors authorized awards from approved stock incentive plans of RSAs to non-employee directors, RSUs to certain employees, and RSAs and PSUs to certain Company officers which, assuming that performance under the PSUs were to be achieved at target levels, together totaled 395,000 shares of common stock and had an aggregate grant date market value of $2.4 million. Shares issued under the 2013 PSU awards were earned at approximately 115% of the target number of shares.

The Compensation Committee of the Company s Board of Directors authorized, from approved stock incentive plans, grants of stock options to purchase a total of 562,000 and 162,000 shares to certain Company officers during the nine months ended September 30, 2014 and 2013, respectively. The exercise prices of the options were equal to the stock prices on their respective grant dates.

Employees purchased common stock totaling 111,000 and 97,000 shares in the nine months ended September 30, 2014 and 2013, respectively, through the Company s ESPP.

Stock Compensation Expense

The following weighted-average assumptions were used to determine the fair value of options:

	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
	Stock Options	**ESPP Options**	**Stock Options**	**ESPP Options**
Expected life of options	4.20 Years	.50 Years	4.21 Years	.50 Years
Expected stock price volatility	0.55	0.38	0.55	0.34
Dividends	1.18%	1.30%	1.16%	0.99%
Risk-free interest rate	1.41%	0.07%	1.34%	0.10%

	Three Months Ended September 30, 2013		Nine Months Ended September 30, 2013	
	Stock Options	**ESPP Options**	**Stock Options**	**ESPP Options**
Expected life of options	N/A	.50 Years	4.25 Years	.50 Years
Expected stock price volatility	N/A	0.35	0.60	0.43
Dividends	N/A	1.74%	1.91%	1.61%
Risk-free interest rate	N/A	0.10%	0.70%	0.16%

The following table summarizes total stock compensation expenses prior to the capitalization of amounts into deferred preservation and inventory costs (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	**2013**	**2014**	**2013**
RSA, PSA, RSU, and PSU expense	$ 944	$ 628	$ 2,357	$ 1,891
Stock option and ESPP option expense	219	225	590	632
Total stock compensation expense	$ 1,163	$ 853	$ 2,947	$ 2,523

Included in the total stock compensation expense, as applicable in each period, were expenses related to RSAs, PSAs, RSUs, PSUs, and stock options issued in each respective year, as well as those issued in prior periods that continue to vest during the period, and compensation related to the Company s ESPP. These amounts were recorded as stock compensation expense and were subject to the Company s normal allocation of expenses to deferred preservation costs and inventory costs. The Company capitalized $71,000 and $54,000 in the three months ended September 30, 2014 and 2013, respectively, and $211,000 and $166,000 in the nine months ended September 30, 2014 and 2013, respectively, of the stock compensation expense into its deferred preservation costs and inventory costs.

As of September 30, 2014 the Company had total unrecognized compensation costs of $6.7 million related to RSAs, PSAs, RSUs, and PSUs and $2.4 million related to unvested stock options, before considering the effect of expected forfeitures. As of September 30, 2014 this expense is expected to be recognized over a weighted-average period of 2.43 years for stock options, 2.92 years for PSAs, 1.55 years for RSUs, 1.34 years for RSAs, and 0.98 years for PSUs.

15. Income Per Common Share

The following table sets forth the computation of basic and diluted income per common share (in thousands, except per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
Basic income per common share	**2014**	**2013**	**2014**	**2013**
Net income	$ 2,326	$ 3,169	$ 5,546	$ 7,146
Net income allocated to participating securities	(53)	(72)		