

NEWFIELD EXPLORATION CO /DE/  
Form 10-Q  
May 06, 2015

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-Q  
(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES  
EXCHANGE ACT OF 1934  
For the Quarterly Period Ended March 31, 2015  
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: 1-12534

NEWFIELD EXPLORATION COMPANY  
(Exact name of registrant as specified in its charter)  
Delaware  
(State or other jurisdiction of  
incorporation or organization)

72-1133047  
(I.R.S. Employer  
Identification Number)

4 Waterway Square Place  
Suite 100  
The Woodlands, Texas 77380  
(Address and Zip Code of principal executive offices)

(281) 210-5100  
(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  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

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

(Do not check if a smaller reporting company)

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

As of May 1, 2015, there were 162,800,912 shares of the registrant's common stock, par value \$0.01 per share, outstanding.

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NEWFIELD EXPLORATION COMPANY  
CONSOLIDATED BALANCE SHEET

(In millions, except share data)

(Unaudited)

	March 31, 2015	December 31, 2014
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$783	\$14
Restricted cash	3	—
Accounts receivable, net	354	439
Inventories	27	33
Derivative assets	425	431
Other current assets	18	23
Total current assets	1,610	940
Oil and gas properties — full cost method (\$729 and \$677 were excluded from amortization at March 31, 2015 and December 31, 2014, respectively)	15,983	16,384
Less — accumulated depreciation, depletion and amortization	(8,380	) (8,152 )
Total oil and gas properties, net	7,603	8,232
Other property and equipment, net	176	182
Derivative assets	224	190
Long-term investments	22	26
Other assets	43	28
Total assets	\$9,678	\$9,598
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$62	\$32
Accrued liabilities	606	880
Advances from joint owners	48	34
Asset retirement obligations	2	3
Derivative liabilities	1	8
Deferred taxes	143	144
Total current liabilities	862	1,101
Other liabilities	45	45
Derivative liabilities	2	—
Long-term debt	3,146	2,892
Asset retirement obligations	183	183
Deferred taxes	1,202	1,484
Total long-term liabilities	4,578	4,604
Commitments and contingencies (Note 13)		
Stockholders' equity:		
Preferred stock (\$0.01 par value, 5,000,000 shares authorized; no shares issued)	—	—
Common stock (\$0.01 par value, 200,000,000 shares authorized at March 31, 2015 and December 31, 2014; 163,001,991 and 137,603,643 shares issued at March 31, 2015 and December 31, 2014, respectively)	2	1
Additional paid-in capital	2,401	1,576
	(11	) (10 )

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Treasury stock (at cost, 304,944 and 275,069 shares at March 31, 2015 and December 31, 2014, respectively)

Accumulated other comprehensive gain (loss)	(1	)	(1	)
Retained earnings	1,847		2,327	
Total stockholders' equity	4,238		3,893	
Total liabilities and stockholders' equity	\$9,678		\$9,598	

The accompanying notes to consolidated financial statements are an integral part of this statement.

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NEWFIELD EXPLORATION COMPANY  
CONSOLIDATED STATEMENT OF OPERATIONS

(In millions, except per share data)  
(Unaudited)

	Three Months Ended March 31,		
	2015	2014	
Oil, gas and NGL revenues	\$349	\$571	
Operating expenses:			
Lease operating	75	74	
Transportation and processing	49	37	
Production and other taxes	13	28	
Depreciation, depletion and amortization	237	192	
General and administrative	63	56	
Ceiling test and other impairments	792	—	
Other	4	2	
Total operating expenses	1,233	389	
Income (loss) from operations	(884	) 182	
Other income (expense):			
Interest expense	(44	) (51	)
Capitalized interest	7	13	
Commodity derivative income (expense)	153	(96	)
Other, net	8	2	
Total other income (expense)	124	(132	)
Income (loss) from continuing operations before income taxes	(760	) 50	
Income tax provision (benefit):			
Current	3	3	
Deferred	(283	) 20	
Total income tax provision (benefit)	(280	) 23	
Income (loss) from continuing operations	(480	) 27	
Income (loss) from discontinued operations, net of tax	—	257	
Net income (loss)	\$(480	) \$284	
Earnings (loss) per share:			
Basic:			
Income (loss) from continuing operations	\$(3.30	) \$0.19	
Income (loss) from discontinued operations	—	1.89	
Basic earnings (loss) per share	\$(3.30	) \$2.08	
Diluted:			
Income (loss) from continuing operations	\$(3.30	) \$0.19	
Income (loss) from discontinued operations	—	1.88	
Diluted earnings (loss) per share	\$(3.30	) \$2.07	
Weighted-average number of shares outstanding for basic earnings (loss) per share	145	136	
Weighted-average number of shares outstanding for diluted earnings (loss) per share	145	137	

The accompanying notes to consolidated financial statements are an integral part of this statement.



NEWFIELD EXPLORATION COMPANY  
 CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

(In millions)  
 (Unaudited)

	Three Months Ended March 31,	
	2015	2014
Net income (loss)	\$(480	) \$284
Other comprehensive income (loss):		
Unrealized gain (loss) on investments, net of tax	—	—
Other comprehensive income (loss), net of tax	—	—
Comprehensive income (loss)	\$(480	) \$284

The accompanying notes to consolidated financial statements are an integral part of this statement.



NEWFIELD EXPLORATION COMPANY  
CONSOLIDATED STATEMENT OF CASH FLOWS

(In millions)

(Unaudited)

	Three Months Ended March 31,	
	2015	2014
Cash flows from operating activities:		
Net income (loss)	\$(480	) \$284
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation, depletion and amortization	237	224
Deferred tax provision (benefit)	(283	) 161
Stock-based compensation	15	11
Unrealized (gain) loss on derivative contracts	(32	) 57
Ceiling test and other impairments	792	—
Gain on sale of Malaysia business	—	(388
Other, net	6	(4
Changes in operating assets and liabilities:		
(Increase) decrease in accounts receivable	38	51
(Increase) decrease in inventories	2	(6
(Increase) decrease in restricted cash	(3	) —
(Increase) decrease in other current assets	4	(7
(Increase) decrease in other assets	4	—
Increase (decrease) in accounts payable and accrued liabilities	(105	) (6
Increase (decrease) in advances from joint owners	14	(13
Increase (decrease) in other liabilities	(4	) 1
Net cash provided by (used in) operating activities	205	365
Cash flows from investing activities:		
Additions to oil and gas properties	(511	) (553
Proceeds from sales of oil and gas properties	29	10
Proceeds received from sale of Malaysia business, net	—	809
Additions to other property and equipment	(4	) (8
Redemptions of investments	—	39
Net cash provided by (used in) investing activities	(486	) 297
Cash flows from financing activities:		
Proceeds from borrowings under credit arrangements	701	562
Repayments of borrowings under credit arrangements	(1,147	) (1,211
Proceeds from issuance of senior notes	691	—
Debt issue costs	(8	) —
Proceeds from issuances of common stock, net	815	—
Purchases of treasury stock, net	(1	) (1
Other	(1	) —
Net cash provided by (used in) financing activities	1,050	(650
Increase (decrease) in cash and cash equivalents	769	12
Cash and cash equivalents, beginning of period	14	95
Cash and cash equivalents, end of period	\$783	\$107

The accompanying notes to consolidated financial statements are an integral part of this statement.



NEWFIELD EXPLORATION COMPANY  
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

(In millions)

(Unaudited)

	Common Stock		Treasury Stock		Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Gain (Loss)	Total Stockholders' Equity
	Shares	Amount	Shares	Amount				
Balance, December 31, 2014	137.6	\$1	(0.3 )	\$(10 )	\$1,576	\$2,327	\$ (1 )	\$3,893
Issuances of common stock	25.4	1			814			815
Stock-based compensation					11			11
Treasury stock, net			—	(1 )	—			(1 )
Net income (loss)						(480 )		(480 )
Balance, March 31, 2015	163.0	\$2	(0.3 )	\$(11 )	\$2,401	\$1,847	\$ (1 )	\$4,238

The accompanying notes to consolidated financial statements are an integral part of this statement.

NEWFIELD EXPLORATION COMPANY  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

1. Organization and Summary of Significant Accounting Policies:

Organization and Principles of Consolidation

We are an independent energy company engaged in the exploration, development and production of crude oil, natural gas and natural gas liquids (NGLs). Our principal domestic areas of operation include the Mid-Continent, the Rocky Mountains and the onshore Gulf Coast regions of the United States. In addition, we have offshore oil developments in China.

Our consolidated financial statements include the accounts of Newfield Exploration Company, a Delaware corporation, and its subsidiaries. We proportionately consolidate our interests in oil and natural gas exploration and production ventures and partnerships in accordance with industry practice. All significant intercompany balances and transactions have been eliminated. Unless otherwise specified or the context otherwise requires, all references in these notes to "Newfield," "we," "us," "our" or the "Company" are to Newfield Exploration Company and its subsidiaries.

These unaudited consolidated financial statements reflect, in the opinion of our management, all adjustments, consisting only of normal and recurring adjustments, necessary to fairly state our financial position as of and results of operations for the periods presented. These financial statements have been prepared in accordance with the instructions to Form 10-Q and, therefore, do not include all disclosures required for financial statements prepared in conformity with accounting principles generally accepted in the United States of America. Interim period results are not necessarily indicative of results of operations or cash flows for a full year.

These consolidated financial statements and notes should be read in conjunction with our audited consolidated financial statements and the notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2014.

Discontinued Operations

The results of our Malaysia operations are reflected separately as discontinued operations in the consolidated statement of operations on a line immediately after "Income (loss) from continuing operations." See Note 16, "Discontinued Operations," for additional disclosures, as well as information regarding the sale of our Malaysia business, which closed in February 2014.

Risks and Uncertainties

As an independent oil and natural gas producer, our revenue, profitability and future rate of growth are substantially dependent on prevailing prices for oil, natural gas and NGLs. Historically, the energy markets have been very volatile, and there can be no assurance that commodity prices will not be subject to wide fluctuations in the future. A substantial or extended decline in commodity prices could have a material adverse effect on our financial position, results of operations, cash flows, access to capital and on the quantities of oil, natural gas and NGL reserves that we can economically produce. It is possible for any of these effects to occur in the near term, given the recent decline in commodity pricing.

Use of Estimates

The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America requires our management to make estimates and assumptions that affect the reported amounts of assets and liabilities; disclosure of contingent assets and liabilities at the date of the financial statements; the reported amounts of revenues and expenses during the reporting period; and the quantities and values of proved oil, natural gas and NGL reserves used in calculating depletion and assessing impairment of our oil and gas properties. Actual results could differ significantly from these estimates. Our most significant estimates are associated with the quantities of proved oil, natural gas and NGL reserves, the timing and amount of transfers of our unevaluated properties into our amortizable full cost pool and the fair value of both our derivative positions and our stock-based compensation liability awards.

#### Reclassifications

Certain reclassifications have been made to prior years' reported amounts in order to conform to the current year presentation. These reclassifications did not impact our net income (loss), stockholders' equity or cash flows.

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NEWFIELD EXPLORATION COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

(Unaudited)

Restricted Cash

Restricted cash of \$3 million on our consolidated balance sheet at March 31, 2015 represents amounts held in escrow accounts to satisfy plug and abandonment obligations for our China operations. These amounts are restricted as to their current use and will be released when we have satisfied all plugging and abandonment obligations in our China field. Consistent with our other plug and abandonment activities, changes in restricted cash is included in cash flows from operating activities in our consolidated statement of cash flows.

Oil and Gas Properties

We use the full cost method of accounting for our oil and gas producing activities. Under this method, all costs incurred in the acquisition, exploration and development of oil and gas properties, including salaries, benefits, interest and other internal costs directly attributable to these activities, are capitalized into cost centers that are established on a country-by-country basis. We capitalized approximately \$32 million and \$54 million of interest and direct internal costs during the three-month periods ended March 31, 2015 and 2014, respectively.

Proceeds from the sale of oil and gas properties are applied to reduce the costs in the applicable cost center unless the reduction would significantly alter the relationship between capitalized costs and proved reserves, in which case a gain or loss is recognized.

Capitalized costs and estimated future development costs are amortized using a unit-of-production method based on proved reserves associated with the applicable cost center. For each cost center, the net capitalized costs of oil and gas properties are limited to the lower of the unamortized cost or the cost center ceiling. A particular cost center ceiling is equal to the sum of:

the present value (10% per annum discount rate) of estimated future net revenues from proved reserves using oil, natural gas and NGL reserve estimation requirements, which require use of the unweighted average first-day-of-the-month commodity prices for the prior 12 months, adjusted for market differentials (SEC pricing), applicable to our reserves (including the effects of hedging contracts that are designated for hedge accounting, if any); plus  
the cost of properties not included in the costs being amortized, if any; less  
related income tax effects.

If net capitalized costs of oil and gas properties exceed the cost center ceiling, we are subject to a non-cash ceiling test writedown to the extent of such excess. If required, a ceiling test writedown reduces earnings and stockholders' equity in the period of occurrence and, holding other factors constant, results in lower depreciation, depletion and amortization expense in future periods.

The risk that we will be required to writedown the carrying value of our oil and gas properties increases when oil, natural gas and NGL prices decrease significantly for a prolonged period of time or if we have substantial downward revisions in our estimated proved reserves. At March 31, 2015, the ceiling value of our reserves was calculated based upon SEC pricing of \$3.88 per MMBtu for natural gas and \$82.60 per barrel for oil. Using these prices, our ceiling for the U.S. did not exceed the net capitalized costs of oil and gas properties resulting in a ceiling test writedown of approximately \$788 million (\$496 million after tax). The cost center ceiling with respect to the China full cost pool exceeded the net capitalized costs of oil and gas properties by approximately \$200 million, net of tax, and as such, no

ceiling test writedown was required.

The continued decline of SEC pricing for oil and natural gas reserves since March 31, 2015 will likely result in a U.S. ceiling test writedown in the second quarter of 2015.

#### New Accounting Requirements

In April 2015, the Financial Accounting Standards Board (FASB) issued guidance regarding the presentation of debt issuance costs in the financial statements and requires that debt issuance costs be presented as a reduction of the carrying value of the financial liability and not as a separate asset. The guidance requires retrospective adjustment to the balance sheet presentation and disclosures applicable for a change in an accounting principle. The guidance is effective for interim and annual periods beginning after December 15, 2015. We expect to adopt this guidance on or before the effective date.

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## NEWFIELD EXPLORATION COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

(Unaudited)

In May 2014, the FASB issued guidance regarding the accounting for revenue from contracts with customers. The guidance may be applied retrospectively or using a modified retrospective approach to adjust retained earnings. The guidance is effective for interim and annual periods beginning on or after December 15, 2016. On April 1, 2015, the FASB proposed a deferral of the effective date by one year, which is not final until the FASB completes its due process requirements. We are currently evaluating the impact of this guidance on our financial statements.

## 2. Earnings Per Share:

The following is the calculation of basic and diluted weighted-average shares outstanding and earnings per share (EPS) for the indicated periods:

	Three Months Ended March 31,	
	2015	2014
	(In millions, except per share data)	
Income (numerator):		
Income (loss) from continuing operations	\$(480 )	\$27
Income (loss) from discontinued operations	—	257
Net income (loss)	\$(480 )	\$284
Weighted-average shares (denominator):		
Weighted-average shares — basic	145	136
Dilution effect of stock options and unvested restricted stock and restricted stock units outstanding at end of period <sup>(1)(2)</sup>	—	1
Weighted-average shares — diluted	145	137
Earnings (loss) per share:		
Basic:		
Income (loss) from continuing operations	\$(3.30 )	\$0.19
Income (loss) from discontinued operations	—	1.89
Basic earnings (loss) per share	\$(3.30 )	\$2.08
Diluted:		
Income (loss) from continuing operations	\$(3.30 )	\$0.19
Income (loss) from discontinued operations	—	1.88
Diluted earnings (loss) per share	\$(3.30 )	\$2.07

The effect of 2.4 million unvested restricted stock or restricted stock units and stock options has not been included in the calculation of shares outstanding for diluted EPS for the quarter ended March 31, 2015, as their effect would have been anti-dilutive. Had we recognized income from continuing operations for the quarter, incremental shares attributable to the assumed vesting of unvested restricted stock and restricted stock units and the assumed exercise of outstanding stock options would have increased diluted weighted-average shares outstanding by 1.3 million shares for the three months ended March 31, 2015.

(2) Excludes 1.5 million shares of unvested restricted stock or restricted stock units and stock options for the three months ended March 31, 2014, respectively, because including the effect would have been anti-dilutive.





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## NEWFIELD EXPLORATION COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

(Unaudited)

## 3. Equity Offering:

During the first quarter of 2015, we issued 25.3 million additional shares of common stock through a public equity offering. We received proceeds of approximately \$815 million, which were used primarily to repay all borrowings under our credit facility and money market lines of credit.

## 4. Inventories:

At March 31, 2015, the crude oil inventory from our China operations consisted of approximately 144,000 barrels of crude oil valued at cost of approximately \$5 million. At December 31, 2014, the crude oil inventory from our China operations consisted of approximately 240,000 barrels of crude oil valued at cost of approximately \$8 million and is included under the caption "Inventories" on our consolidated balance sheet. Cost for purposes of the carrying value of oil inventory is the sum of related production costs and depletion expense.

## 5. Oil and Gas Assets:

## Property and Equipment

Property and equipment consisted of the following:

	March 31, 2015 (In millions)	December 31, 2014
Oil and gas properties:		
Subject to amortization	\$15,254	\$15,707
Not subject to amortization	729	677
Gross oil and gas properties	15,983	16,384
Accumulated depreciation, depletion and amortization	(8,380)	(8,152)
Net oil and gas properties	\$7,603	\$8,232
Other property and equipment:		
Furniture, fixtures and equipment	\$143	\$144
Gathering systems and equipment	115	114
Accumulated depreciation and amortization	(82)	(76)
Net other property and equipment	\$176	\$182

Oil and gas properties not subject to amortization as of March 31, 2015, consisted of the following:

	Costs Incurred In				Total
	2015	2014	2013	2012 and Prior	
	(In millions)				
Acquisition costs	\$41	\$182	\$158	\$91	\$472
Exploration costs	78	82	—	—	160
Fee mineral interests	—	—	1	23	24
Capitalized interest	7	52	14	—	73
Total oil and gas properties not subject to amortization	\$126	\$316	\$173	\$114	\$729

### Granite Wash Asset Sale

In September 2014, we closed on the sale of our Granite Wash assets, located primarily in Texas, for approximately \$588 million, subject to customary post-closing purchase price adjustments. The sale of our Granite Wash assets did not significantly alter the relationship between capitalized costs and proved reserves, and as such, all proceeds were recorded as adjustments to our domestic full cost pool with no gain or loss recognized. These consolidated financial statements include the results of our Granite Wash operations through the date of sale.

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NEWFIELD EXPLORATION COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

(Unaudited)

6. Derivative Financial Instruments:

Commodity Derivative Instruments

We utilize derivative strategies that consist of either a single derivative instrument or a combination of instruments to manage the variability in cash flows associated with the forecasted sale of our future domestic oil and natural gas production. While the use of derivative instruments may limit or partially reduce the downside risk of adverse commodity price movements, their use also may limit future income from favorable commodity price movements.

In addition to the derivative strategies outlined in our Annual Report on Form 10-K for the year ended December 31, 2014, we also implemented a derivative strategy beginning in the first quarter of 2015 that is associated with our derivative positions for oil swaps with short puts that achieve maximum value once the market price falls below the short puts. During the first quarter of 2015, we purchased call options that effectively lock in the maximum value for a portion of our corresponding oil swaps with short puts. We elected to defer the premiums of \$3 million related to these calls until contract settlement. Excluding the effect of the deferred premium, if the settlement price is above the call strike price, the counterparty is required to make a payment to us.

Our oil and gas derivative contracts are settled based upon reported prices on the NYMEX. The estimated fair value of these contracts is based upon various factors, including closing exchange prices on the NYMEX, over-the-counter quotations, estimated volatility, non-performance risk adjustments using credit default swaps and time to maturity. The calculation of the fair value of options requires the use of an option-pricing model. See Note 9, "Fair Value Measurements."

At March 31, 2015, we had outstanding derivative positions as set forth in the tables below.

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## NEWFIELD EXPLORATION COMPANY

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

(Unaudited)

## Crude Oil

Period and Type of Instrument	Volume in MBbls	NYMEX Contract Price Per Bbl			Collars		Estimated Fair Value Asset (Liability) (In millions)
		Swaps (Weighted Average)	Purchased Calls (Weighted Average)	Sold Puts (Weighted Average) <sup>(1)</sup>	Floors (Weighted Average)	Ceilings (Weighted Average)	
2015:							
Fixed-price swaps	1,555	\$90.00	\$ —	\$ —	\$—	\$—	\$60
Fixed-price swaps with sold puts:	11,554						
Fixed-price swaps		90.00	—	—	—	—	429
Sold puts		—	—	71.57	—	—	(229 )
Collars with sold puts:	550						
Collars		—	—	—	90.00	104.00	21
Sold puts		—	—	75.00	—	—	(13 )
2016:							
Fixed-price swaps with sold puts:	10,060						
Fixed-price swaps		89.98	—	—	—	—	316
Sold puts		—	—	74.14	—	—	(187 )
Collars with sold puts:	6,220						
Collars		—	—	—	90.00	96.15	198
Sold puts		—	—	75.00	—	—	(120 )
Purchased calls	732	—	70.00	—	—	—	2
2017:							
Fixed-price swaps with sold puts:	4,468		\$(2,262,584)	\$1,566,060			

During the first three months of 2017, operations provided \$0.1 million of cash, as compared to the same period in 2016 in which operations used \$1.5 million of cash. During the first three months of 2017, net cash provided by operating activities consisted of our net loss of \$1.4 million, which included non-cash charges for depreciation and amortization of \$1.0 million and share-based compensation of \$0.2 million, and a net cash inflow of \$0.3 million from changes in working capital (principally driven by a reduction in accounts receivable of \$2.0 million, partially offset by a decrease in accounts payable and accrued expenses of \$1.3 million and an increase in inventory of \$0.4 million). The decrease in accounts receivable was driven by collection of past due amounts of approximately \$0.8 million during the three months ended March 31, 2017, and lower revenue during that same period compared to the three months ended December 31, 2016.

During the first three months of 2016, net cash used in operating activities consisted of our net loss of \$1.5 million and a net cash outflow of \$1.3 million from changes in working capital (principally driven by a reduction in accounts payable and accrued expenses of \$0.7 million, an increase in other assets of \$0.4 million and an increase of \$0.3 million in accounts receivable, partially offset by non-cash charges for depreciation and amortization of \$0.9 million, and share-based compensation of \$0.3 million).

Our cash used in investing activities for the three months ended March 31, 2017 and 2016 included purchases of equipment and capitalized costs associated with the prosecution of patents. Cash used in investing activities included \$0.2 million of fixed asset additions and \$0.1 million of capitalized intellectual property costs for the three months ended March 31, 2017 compared to fixed asset additions of \$0.1 million and capitalized intellectual property costs of \$0.1 million for the three months ended March 31, 2016.

Net cash used in financing activities during the three months ended March 31, 2017 and 2016 included the repayment of the long term debt and repayments of capital lease obligations. In the aggregate, these activities resulted in net cash outflows of \$0.5 million for each of the first three months of 2017 and 2016.

#### Off-Balance Sheet Arrangements

We have no material off-balance sheet arrangements as defined in Regulation S-K Item 303(a)(4)(ii).

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**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Market risk represents the risk of loss that may impact our financial position due to adverse changes in financial market prices and rates. We do not hold or issue financial instruments for trading purposes or have any derivative financial instruments. Our exposure to market risk is limited to interest rate fluctuations due to changes in the general level of U.S. interest rates.

**Interest Rate Risk**

We do not use derivative financial instruments as a hedge against interest rate fluctuations, and, as a result, interest income earned on our cash and cash equivalents and short-term investments is subject to changes in interest rates. However, we believe that the impact of these fluctuations does not have a material effect on our financial position due to the immediately available liquidity or short-term nature of these financial instruments.

We are exposed to interest rate fluctuations as a result of our term loans with SVB having a variable interest rate. We do not currently use derivative instruments to alter the interest rate characteristics of our debt. For the principal amount of \$3.8 million outstanding under the term loans as of March 31, 2017, a change in the interest rate by one percentage point for one year would result in a change in our annual interest expense of \$38,000.

Although we believe that this measure is indicative of our sensitivity to interest rate changes, it does not adjust for potential changes in our credit quality, composition of our balance sheet and other business developments that could affect our interest rate exposure. Accordingly, no assurances can be given that actual results would not differ materially from the potential outcome simulated by this estimate.

**Foreign Currency Exchange Rate Risk**

As of March 31, 2017, all payments made under our research contracts have been denominated in U.S. dollars. Our product sales to foreign customers are also generally denominated in U.S. dollars, and we generally do not receive payments in foreign currency. As such, we are not directly exposed to significant currency gains or losses resulting from fluctuations in foreign exchange rates.

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ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

We maintain “disclosure controls and procedures,” as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), which are controls and other procedures that are designed to provide reasonable assurance that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms. Disclosure controls and procedures also include, without limitation, controls and procedures designed to provide reasonable assurance that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company’s management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure.

Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. In addition, the design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with policies or procedures may deteriorate. Because of the inherent limitations in a control system, misstatements due to error or fraud may occur and not be detected.

Under the supervision and with the participation of our management, including our principal executive officer and our principal financial officer, we evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report. Based on this evaluation, our principal executive officer and our principal financial officer have concluded that, as of March 31, 2017, our disclosure controls and procedures were effective at the reasonable assurance level.

Changes in Internal Control over Financial Reporting

No change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) occurred during the three months ended March 31, 2017 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.



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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

In June 2015, we received a letter of final determination from the Defense Contract Management Agency ("DCMA") regarding the allowability of certain costs we included in our billings under cost-plus type research contracts during 2007. In conjunction with the DCMA's determination of those costs as expressly unallowable under the provisions of the Federal Acquisition Regulations, the DCMA assessed penalties and interest to us totaling \$1.1 million. In July 2015, we filed an appeal of the assessed penalties and interest with the Armed Services Board of Contract Appeals ("ASBCA"). A hearing was held with respect to this appeal in January 2017, and a decision has not yet been reached by ASBCA. In April 2017, we made a settlement offer of \$150,000 to DCMA, and we have accrued that amount in our financial statements as of March 31, 2017. We have not yet received a response to our offer from DCMA, and the appeals process remains ongoing.

For additional information regarding our legal proceedings, please refer to our Annual Report on Form 10-K for the year ended December 31, 2016, as filed with the SEC on March 20, 2017.

ITEM 1A. RISK FACTORS

You should carefully consider the risks described below before deciding whether to invest in our common stock. The risks described below are not the only ones we face. Additional risks not presently known to us or that we currently believe are immaterial may also impair our business operations and financial results. If any of the following risks actually occurs, our business, financial condition or results of operations could be adversely affected. In such case, the trading price of our common stock could decline and you could lose all or part of your investment. Our filings with the SEC also contain forward-looking statements that involve risks or uncertainties. Our actual results could differ materially from those anticipated or contemplated by these forward-looking statements as a result of a number of factors, including the risks we face described below, as well as other variables that could affect our operating results. Past financial performance should not be considered to be a reliable indicator of future performance, and investors should not use historical trends to anticipate results or trends in future periods.

RISKS RELATING TO OUR BUSINESS GENERALLY

Our technology is subject to a license from Intuitive Surgical, Inc., which is revocable in certain circumstances. Without this license, we cannot continue to market, manufacture or sell our fiber-optic products.

As a part of the sale of certain assets to Intuitive Surgical, Inc. ("Intuitive") in 2014, we entered into a license agreement with Intuitive pursuant to which we received rights to use all of our transferred technology outside the field of medicine and in respect of our existing non-shape sensing products in certain non-robotic medical fields. This license back to us is revocable if after notice and certain time periods, we were to (i) challenge the validity or enforceability of the transferred patents and patent applications, (ii) commercialize our fiber optical shape sensing and localization technology in the field of medicine (except to perform on a development and supply project for Hansen Medical, Inc.), (iii) violate our obligations related to our ability to sublicense in the field of medicine or (iv) violate our confidentiality obligations in a manner that advantages a competitor in the field of medicine and not cure such violation. Maintaining this license is necessary for us to conduct our fiber-optic products business, both for our telecom products and our ODISI sensing products. If this license were to be revoked by Intuitive, we would no longer be able to market, manufacture or sell these products which would severely limit our ability to continue operations.

We depend on third-party vendors for specialized components in our manufacturing operations, making us vulnerable to supply shortages and price fluctuations that could harm our business.

We primarily rely on third-party vendors for the manufacture of the specialized components used in our products. The highly specialized nature of our supply requirements poses risks that we may not be able to locate additional sources of the specialized components required in our business. For example, there are few manufacturers who produce the special lasers used in our optical test equipment. Our reliance on these vendors subjects us to a number of risks that

could negatively affect our

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ability to manufacture our products and harm our business, including interruption of supply. Although we are now manufacturing tunable lasers in low-rate initial production, we expect our overall reliance on third-party vendors to continue. Any significant delay or interruption in the supply of components, or our inability to obtain substitute components or materials from alternate sources at acceptable prices and in a timely manner could impair our ability to meet the demand of our customers and could harm our business.

We depend upon outside contract manufacturers for a portion of the manufacturing process for some of our products. Our operations and revenue related to these products could be adversely affected if we encounter problems with these contract manufacturers.

Many of our products are manufactured internally. However, we also rely upon contract manufacturers to produce the finished portion of some of our optoelectronic components and certain lasers. Our reliance on contract manufacturers for these products makes us vulnerable to possible capacity constraints and reduced control over delivery schedules, manufacturing yields, manufacturing quality control and costs. If the contract manufacturer for our products were unable or unwilling to manufacture our products in required volumes and at high quality levels or to continue our existing supply arrangement, we would have to identify, qualify and select an acceptable alternative contract manufacturer or move these manufacturing operations to internal manufacturing facilities. An alternative contract manufacturer may not be available to us when needed or may not be in a position to satisfy our quality or production requirements on commercially reasonable terms, including price. Any significant interruption in manufacturing our products would require us to reduce the supply of products to our customers, which in turn would reduce our revenue, harm our relationships with the customers of these products and cause us to forego potential revenue opportunities. As a provider of contract research to the U.S. government, we are subject to federal rules, regulations, audits and investigations, the violation or failure of which could adversely affect our business.

We must comply with and are affected by laws and regulations relating to the award, administration and performance of U.S. government contracts. Government contract laws and regulations affect how we do business with our government customers and, in some instances, impose added costs on our business. A violation of a specific law or regulation could result in the imposition of fines and penalties, termination of our contracts or debarment from bidding on contracts. In some instances, these laws and regulations impose terms or rights that are more favorable to the government than those typically available to commercial parties in negotiated transactions. For example, the U.S. government may terminate any of our government contracts and, in general, subcontracts, at their convenience, as well as for default based on performance.

In addition, U.S. government agencies, including the Defense Contract Audit Agency and the Department of Labor, routinely audit and investigate government contractors. These agencies review a contractor's performance under its contracts, cost structure and compliance with applicable laws, regulations and standards. The U.S. government also may review the adequacy of, and a contractor's compliance with, its internal control systems and policies, including the contractor's purchasing, property, estimating, compensation and management information systems. Any costs found to be improperly allocated to a specific contract will not be reimbursed, while such costs already reimbursed must be refunded. If an audit uncovers the inclusion of certain claimed costs deemed to be expressly unallowable, or improper or illegal activities, we may be subject to civil and criminal penalties and administrative sanctions, including termination of contracts, forfeiture of profits, suspension of payments, fines and suspension or prohibition from doing business with the U.S. government. In addition, our reputation could suffer serious harm if allegations of impropriety were made against us. In June 2015, we received a determination from the Defense Contract Management Agency ("DCMA") of expressly unallowable costs included in our claimed costs for the 2007 contract year. As a result of that determination, DCMA assessed us penalties, interest and over billings of \$1.1 million. We have appealed that assessment, and our appeal is currently pending. In April 2017, we also made a settlement offer of \$150,000 to DCMA, but we have not yet received a response. Depending on the outcome of this appeal and the response to our settlement offer, we could be required to make payments that have a material adverse effect on our financial position. In addition to the risk of government audits and investigations, U.S. government contracts and grants impose requirements on contractors and grantees relating to ethics and business practices, which carry civil and criminal penalties including monetary fines, assessments, loss of the ability to do business with the U.S. government and certain other criminal penalties.

We may also be prohibited from commercially selling certain products that we develop under our Technology Development segment or related products based on the same core technologies if the U.S. government determines that the commercial availability of those products could pose a risk to national security. For example, certain of our wireless technologies have been classified as secret by the U.S. government and as a result we cannot sell them commercially. Any of these determinations would limit our ability to generate product sales and license revenues.

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We rely and will continue to rely on contracts and grants awarded under the SBIR program for a significant portion of our revenues. A finding by the SBA that we no longer qualify to receive SBIR awards could adversely affect our business.

We compete as a small business for some of our government contracts. Our revenues derived from the SBIR program account for a significant portion of our consolidated total revenues, and contract research, including SBIR contracts, will remain a significant portion of our consolidated total revenues for the foreseeable future. For the three months ended March 31, 2017 and 2016, revenues generated under the SBIR program represented 29% and 23%, respectively, of our total revenues.

We may not continue to qualify to participate in the SBIR program or to receive new SBIR awards from federal agencies. In order to qualify for SBIR contracts and grants, we must meet certain size and ownership eligibility criteria. These eligibility criteria are applied as of the time of the award of a contract or grant. A company can be declared ineligible for a contract award as a result of a size challenge filed with the SBA by a competitor or a federal agency.

In order to be eligible for SBIR contracts and grants, under current SBA rules we must be more than 50% owned and controlled by individuals who are U.S. citizens or permanent resident aliens, and/or other small business concerns (each of which is more than 50% owned and controlled by individuals who are U.S. citizens or permanent resident aliens) or certain qualified investment companies. In the event our institutional ownership significantly increases, either because of increased buying by institutions or selling by individuals, we could lose eligibility for new SBIR contracts and grants.

Also, in order to be eligible for SBIR contracts and grants, the number of our employees, including those of any entities that are considered to be affiliated with us, cannot exceed 500. As of March 31, 2017, we had approximately 240 full-time employees. In determining whether we are affiliated with any other entity, the SBA may analyze whether another entity controls or has the power to control us. Carilion Clinic is our largest institutional stockholder. Since early 2011, a formal size determination by the SBA that focused on whether or not Carilion is or was our affiliate has been outstanding. Although we do not believe that Carilion has or had the power to control our company, we cannot assure you that the SBA will interpret its regulations in our favor on this question. If the SBA were to make a determination that we are or were affiliated with Carilion, we would exceed the size limitations, as Carilion has over 500 employees. In that case, we would lose eligibility for new SBIR contracts and grants and other awards that are set aside for small businesses based on the criterion of number of employees, and the relevant government agency would have the discretion to suspend performance on existing SBIR grants. The loss of our eligibility to receive SBIR awards would have a material adverse impact on our revenues, cash flows and our ability to fund our growth. Moreover, as our business grows, it is foreseeable that we will eventually exceed the SBIR size limitations, in which case we may be required to seek alternative sources of revenues or capital.

A decline in government research contract awards or government funding for existing or future government research contracts, including SBIR contracts, could adversely affect our revenues, cash flows and ability to fund our growth. Technology Development segment revenues, which consist primarily of government-funded research, accounted for 33% and 27% of our consolidated total revenues for the three months ended March 31, 2017 and 2016, respectively. As a result, we are vulnerable to adverse changes in our revenues and cash flows if a significant number of our research contracts and subcontracts were to be simultaneously delayed or canceled for budgetary, performance or other reasons. For example, the U.S. government may cancel these contracts at any time without cause and without penalty or may change its requirements, programs or contract budget, any of which could reduce our revenues and cash flows from U.S. government research contracts. Our revenues and cash flows from U.S. government research contracts and subcontracts could also be reduced by declines or other changes in U.S. defense, homeland security and other federal agency budgets. In addition, we compete as a small business for some of these contracts, and in order to maintain our eligibility to compete as a small business, we, together with any affiliates, must continue to meet size and revenue limitations established by the U.S. government.

Our contract research customer base includes government agencies, corporations and academic institutions. Our customers are not obligated to extend their agreements with us and may elect not to do so. Also, our customers'

priorities regarding funding for certain projects may change and funding resources may no longer be available at previous levels.

In addition, the Budget Control Act commits the U.S. government to reduce the federal deficit by \$1.2 trillion over ten years through a combination of automatic, across-the-board spending cuts and caps on discretionary spending. This “sequestration” under the Budget Control Act, which is split equally between defense and non-defense programs, went into effect on March 1, 2013. Any spending cuts required by “sequestration” could have a material adverse effect on our Technology Development revenues and, consequently, our results of operations. While the exact manner in which this “sequestration” may impact our business remains unclear, funding for programs in which we participate could be reduced, delayed or canceled. Our ability to obtain new contract awards also could be negatively affected.

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In addition to contract cancellations and changes in agency budgets, our future financial results may be adversely affected by curtailment of or restrictions on the U.S. government's use of contract research providers, including curtailment due to government budget reductions and related fiscal matters or any legislation or resolution limiting the number or amount of awards we may receive. These or other factors could cause U.S. defense and other federal agencies to conduct research internally rather than through commercial research organizations or direct awards to other organizations, to reduce their overall contract research requirements or to exercise their rights to terminate contracts. Alternatively, the U.S. government may discontinue the SBIR program or its funding altogether. Also, SBIR regulations permit increased competition for SBIR awards from companies that may not have previously been eligible, such as those backed by venture capital operating companies, hedge funds and private equity firms. Any of these developments could limit our ability to obtain new contract awards and adversely affect our revenues, cash flows and ability to fund our growth.

Our failure to attract, train and retain skilled employees or members of our senior management and to obtain necessary security clearances for such persons or maintain a facility security clearance would adversely affect our business and operating results.

The availability of highly trained and skilled technical and professional personnel is critical to our future growth and profitability. Competition for scientists, engineers, technicians and professional personnel is intense and our competitors aggressively recruit key employees. In the past, we have experienced difficulties in recruiting and hiring these personnel as a result of the tight labor market in certain fields. Any difficulty in hiring or retaining qualified employees, combined with our growth strategy and future needs for additional experienced personnel, particularly in highly specialized areas such as nanomaterial manufacturing and fiber optic sensing technologies, may make it more difficult to meet all of our needs for these employees in a timely manner. Although we intend to continue to devote significant resources to recruit, train and retain qualified employees, we may not be able to attract and retain these employees, especially in technical fields in which the supply of experienced qualified candidates is limited, or at the senior management level. Any failure to do so would have an adverse effect on our business. Any loss of key personnel could have a material adverse effect on our ability to meet key operational objectives, such as timely and effective project milestones and product introductions, which in turn could adversely affect our business, results of operations and financial condition.

We provide certain services to the U.S. government that require us to maintain a facility security clearance and for certain of our employees and our board chairman to hold security clearances. In general, the failure for necessary persons to obtain or retain sufficient security clearances, any loss by us of a facility security clearance or any public reprimand related to security matters could result in a U.S. government customer terminating an existing contract or choosing not to renew a contract or prevent us from bidding on or winning certain new government contracts.

In addition, our future success depends in a large part upon the continued service of key members of our senior management team. We do not maintain any key-person life insurance policies on our officers. The loss of any members of our management team or other key personnel could seriously harm our business.

Our business is subject to the cyclical nature of the markets in which we compete and any future downturn may reduce demand for our products and revenue.

Many factors beyond our control affect our business, including consumer confidence in the economy, interest rates, fuel prices and the general availability of credit. The overall economic climate and changes in Gross National Product growth have a direct impact on some of our customers and the demand for our products. We cannot be sure that our business will not be adversely affected as a result of an industry or general economic downturn.

Our customers may reduce capital expenditures and have difficulty satisfying liquidity needs because of continued turbulence in the U.S. and global economies, resulting in reduced sales of our products and harm to our financial condition and results of operations.

In particular, our historical results of operations have been subject to substantial fluctuations, and we may experience substantial period-to-period fluctuations in future results of operations. Any future downturn in the markets in which we compete could significantly reduce the demand for our products and therefore may result in a significant reduction in revenue or increase the volatility of the price of our common stock. Our revenue and results of operations may be adversely affected in the future due to changes in demand from customers or cyclical changes in the markets utilizing

our products.

In addition, the telecommunications industry has, from time to time, experienced, and may again experience, a pronounced downturn. To respond to a downturn, many service providers may slow their capital expenditures, cancel or delay new developments, reduce their workforces and inventories and take a cautious approach to acquiring new equipment and technologies from original equipment manufacturers, which would have a negative impact on our business. Weakness in the

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global economy or a future downturn in the telecommunications industry may cause our results of operations to fluctuate from quarter-to-quarter and year-to-year, harm our business, and may increase the volatility of the price of our common stock.

Customer acceptance of our products is dependent on our ability to meet changing requirements, and any decrease in acceptance could adversely affect our revenue.

Customer acceptance of our products is significantly dependent on our ability to offer products that meet the changing requirements of our customers, including telecommunication, military, medical and industrial corporations, as well as government agencies. Any decrease in the level of customer acceptance of our products could harm our business.

Our products must meet exacting specifications, and defects and failures may occur, which may cause customers to return or stop buying our products.

Our customers generally establish demanding specifications for quality, performance and reliability that our products must meet. However, our products are highly complex and may contain defects and failures when they are first introduced or as new versions are released. Our products are also subject to rough environments as they are integrated into our customer products for use by the end customers. If defects and failures occur in our products, we could experience lost revenue, increased costs, including warranty expense and costs associated with customer support, delays in or cancellations or rescheduling of orders or shipments, product returns or discounts, diversion of management resources or damage to our reputation and brand equity, and in some cases consequential damages, any of which would harm our operating results. In addition, delays in our ability to fill product orders as a result of quality control issues may negatively impact our relationship with our customers. We cannot assure you that we will have sufficient resources, including any available insurance, to satisfy any asserted claims.

Rapidly changing standards and regulations could make our products obsolete, which would cause our revenue and results of operations to suffer.

We design products to conform to our customers' requirements and our customers' systems may be subject to regulations established by governments or industry standards bodies worldwide. Because some of our products are designed to conform to current specific industry standards, if competing or new standards emerge that are preferred by our customers, we would have to make significant expenditures to develop new products. If our customers adopt new or competing industry standards with which our products are not compatible, or the industry groups adopt standards or governments issue regulations with which our products are not compatible, our existing products would become less desirable to our customers and our revenue and results of operations would suffer.

The markets for many of our products are characterized by changing technology which could cause obsolescence of our products, and we may incur substantial costs in delivering new products.

The markets for many of our products are characterized by changing technology, new product introductions and product enhancements, and evolving industry standards. The introduction or enhancement of products embodying new technology or the emergence of new industry standards could render existing products obsolete, and result in a write down to the value of our inventory, or result in shortened product life cycles. Accordingly, our ability to compete is in part dependent on our ability to continually offer enhanced and improved products.

The success of our new product offerings will depend upon several factors, including our ability to:

- accurately anticipate customer needs;
- innovate and develop new technologies and applications;
- successfully commercialize new technologies in a timely manner;
- price products competitively and manufacture and deliver products in sufficient volumes and on time; and
- differentiate our product offerings from those of our competitors.

Some of our products are used by our customers to develop, test and manufacture their products. We therefore must anticipate industry trends and develop products in advance of the commercialization of our customers' products. In developing any new product, we may be required to make a substantial investment before we can determine the commercial viability of the new product. If we fail to accurately foresee our customers' needs and future activities, we may invest heavily in research and development of products that do not lead to significant revenues.

Our inability to find new customers or retain existing customers could harm our business.

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Our business is reliant on our ability to find new customers and retain existing customers. In particular, customers normally purchase certain of our products and incorporate them into products that they, in turn, sell in their own markets on an ongoing basis. As a result, the historical sales of these products have been dependent upon the success of our customers' products and the future performance of our business is dependent upon our success in finding new customers and receiving new orders from existing customers.

In several markets, the quality and reliability of our products are a major concern for our customers, not only upon the initial manufacture of the product, but for the life of the product. Many of our products are used in remote locations for higher value assembly, making servicing of our products unfeasible. Any failure of the quality or reliability of our products could harm our business.

If our customers do not qualify our products or if their customers do not qualify their products, our results of operations may suffer.

Most of our customers do not purchase our HSOR and optoelectronics products prior to qualification of the products and satisfactory completion of factory audits and vendor evaluation. Our existing products, as well as each new product, must pass through varying levels of qualification with our customers. In addition, because of the rapid technological changes in some markets, a customer may cancel or modify a design project before we begin large-scale manufacturing and receiving revenues from the customer. It is unlikely that we would be able to recover the expenses for cancelled or unutilized custom design projects. It is difficult to predict with any certainty whether our customers will delay or terminate product qualification or the frequency with which customers will cancel or modify their projects. Any such delay, cancellation or modification could have a negative effect on our results of operations. In addition, once a customer qualifies a particular supplier's product or component, these potential customers design the product into their system, which is known as a design-in win. Suppliers whose products or components are not designed in are unlikely to make sales to that customer until at least the adoption of a future redesigned system. Even then, many customers may be reluctant to incorporate entirely new products into their new systems, as doing so could involve significant additional redesign efforts and increased costs. If we fail to achieve design-in wins in potential customers' qualification processes, we will likely lose the opportunity for significant sales to those customers for a lengthy period of time.

If the end user customers that purchase systems from our customers fail to qualify or delay qualifications of any products sold by our customers that contain our products, our business could be harmed. The qualification and field testing of our customers' systems by end user customers is long and unpredictable. This process is not under our control or that of our customers and, as a result, the timing of our sales may be unpredictable. Any unanticipated delay in qualification of one of our customers' products could result in the delay or cancellation of orders from our customers for products included in their equipment, which could harm our results of operations.

Customer demand for our products is difficult to accurately forecast and, as a result, we may be unable to optimally match production with customer demand, which could adversely affect our business and financial results.

We make planning and spending decisions, including determining the levels of business that we will seek and accept, production schedules, inventory levels, component procurement commitments, personnel needs and other resource requirements, based on our estimates of customer requirements. The short-term nature of commitments by many of our customers and the possibility of unexpected changes in demand for their products reduce our ability to accurately estimate future customer requirements. On occasion, customers may require rapid increases in production, which can strain our resources, cause our manufacturing to be negatively impacted by materials shortages, necessitate higher or more restrictive procurement commitments, increase our manufacturing yield loss and scrapping of excess materials, and reduce our gross margin. We may not have sufficient capacity at any given time to meet the volume demands of our customers, or one or more of our suppliers may not have sufficient capacity at any given time to meet our volume demands. Conversely, a downturn in the markets in which our customers compete can cause, and in the past have caused, our customers to significantly reduce or delay the amount of products ordered or to cancel existing orders, leading to lower utilization of our facilities. Because many of our costs and operating expenses are relatively fixed, reduction in customer demand due to market downturns or other reasons would have a negative effect on our gross margin, operating income and cash flow.

Customer orders and forecasts are subject to cancellation or modification at any time which could result in higher manufacturing costs.

Our sales are made primarily pursuant to standard purchase orders for delivery of products. However, by industry practice, some orders may be canceled or modified at any time. When a customer cancels an order, they are responsible for all finished goods, all costs, direct and indirect, incurred by us, as well as a reasonable allowance for anticipated profits. No

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assurance can be given that we will receive these amounts after cancellation. Furthermore, uncertainty in customer forecasts of their demands and other factors may lead to delays and disruptions in manufacturing, which could result in delays in product shipments to customers and could adversely affect our business.

Fluctuations and changes in customer demand are common in our business. Such fluctuations, as well as quality control problems experienced in manufacturing operations, may cause delays and disruptions in our manufacturing process and overall operations and reduce output capacity. As a result, product shipments could be delayed beyond the shipment schedules requested by our customers or could be canceled, which would negatively affect our sales, operating income, strategic position at customers, market share and reputation. In addition, disruptions, delays or cancellations could cause inefficient production which in turn could result in higher manufacturing costs, lower yields and potential excess and obsolete inventory or manufacturing equipment. In the past, we have experienced such delays, disruptions and cancellations.

The results of our operations could be adversely affected by economic and political conditions and the effects of these conditions on our customers' businesses and levels of business activity.

Global economic and political conditions affect our customers' businesses and the markets they serve. A severe or prolonged economic downturn or a negative or uncertain political climate could adversely affect our customers' financial conditions and the timing or levels of business activity of our customers and the industries we serve. This may reduce the demand for our products or depress pricing for our products and have a material adverse effect on our results of operations. Changes in global economic conditions could also shift demand to products or services for which we do not have competitive advantages, and this could negatively affect the amount of business we are able to obtain. In addition, if we are unable to successfully anticipate changing economic and political conditions, we may be unable to effectively plan for and respond to those changes, and our business could be negatively affected as a result. We have a history of losses, and because our strategy for expansion may be costly to implement, we may experience continuing losses and may never achieve or maintain profitability or positive cash flow.

We realized a net loss of \$1.4 million and \$1.5 million for the three months ended March 31, 2017 and 2016, respectively. We expect to continue to incur significant expenses as we pursue our strategic initiatives, including increased expenses for research and development, sales and marketing and manufacturing. We may also grow our business in part through acquisitions of additional companies and complementary technologies which could cause us to incur greater than anticipated transaction expenses, amortization or write-offs of intangible assets and other acquisition-related expenses. As a result, we may incur net losses for the foreseeable future, and these losses could be substantial. At a certain level, continued net losses could impair our ability to comply with NASDAQ continued listing standards, as described further below.

Our ability to generate additional revenues and to become profitable will depend on our ability to execute our key growth initiative regarding the development, marketing and sale of HSOR and sensing products, develop and commercialize innovative technologies, expand our contract research capabilities and sell the products that result from those development initiatives. We are unable to predict when or if we will be able to achieve profitability. If our revenues do not increase, or if our expenses increase at a greater rate than our revenues, we will continue to experience losses. Even if we do achieve profitability, we may not be able to sustain or increase our profitability on a quarterly or annual basis.

We have obtained capital by borrowing money under term loans and we might require additional capital to support and expand our business; our term loan has various loan covenants with which we must comply.

We intend to continue to make investments to support our business growth, including developing new products, enhancing our existing products, obtaining important regulatory approvals, enhancing our operating infrastructure, completing our development activities and building our commercial scale manufacturing facilities. To the extent that we are unable to become or remain profitable and to finance our activities from continuing operations, we may require additional funds to support these initiatives and to grow our business.

If we are successful in raising additional funds through issuances of equity or convertible debt securities, our existing stockholders could suffer significant dilution, including as the result of the issuance of warrants in connection with the financing, and any new equity securities we issue could have rights, preferences and privileges superior to those of our existing common stock. Furthermore, such financings may jeopardize our ability to apply for SBIR grants or qualify

for SBIR contracts or grants, and our dependence on SBIR grants may restrict our ability to raise additional outside capital. If we raise additional funds through debt financings, these financings may involve significant cash payment obligations and covenants that restrict our ability to operate our business and make distributions to our stockholders. We have term loans with Silicon Valley Bank ("SVB"), which requires us to observe certain financial and operational covenants, including maintenance of a minimum cash balance of \$5.0 million, protection and registration of intellectual

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property rights, and certain customary negative covenants, as well as other customary events of default. If any event of default occurs SVB may declare due immediately all borrowings under our term loans and foreclose on the collateral. Furthermore, an event of default would result in an increase in the interest rate on any amounts outstanding.

If we are unable to obtain adequate financing or financing terms satisfactory to us when we require it, our ability to continue to support our business growth and to respond to business challenges could be significantly limited.

Our nanotechnology-enabled products are new and may be, or may be perceived as being, harmful to human health or the environment.

While we believe that none of our current products contain chemicals known by us to be hazardous or subject to environmental regulation, it is possible that our current or future products, particularly carbon-based nanomaterials, may become subject to environmental or other regulation. We intend to develop and sell carbon-based nanomaterials as well as nanotechnology-enabled products, which are products that include nanomaterials as a component to enhance those products' performance. Nanomaterials and nanotechnology-enabled products have a limited historical safety record. Because of their size or shape or because they may contain harmful elements, such as gadolinium and other rare-earth metals, our products could pose a safety risk to human health or the environment. These characteristics may also cause countries to adopt regulations in the future prohibiting or limiting the manufacture, distribution or use of nanomaterials or nanotechnology-enabled products. Such regulations may inhibit our ability to sell some products containing those materials and thereby harm our business or impair our ability to develop commercially viable products.

The subject of nanotechnology has received negative publicity and has aroused public debate. Government authorities could, for social or other purposes, prohibit or regulate the use of nanotechnology. Ethical and other concerns about nanotechnology could adversely affect acceptance of our potential products or lead to government regulation of nanotechnology-enabled products.

We face and will face substantial competition in several different markets that may adversely affect our results of operations.

We face and will face substantial competition from a variety of companies in several different markets. As we focus on developing marketing and selling fiber optic sensing products, we may also face substantial and entrenched competition in that market.

Many of our competitors have longer operating histories, greater name recognition, larger customer bases and significantly greater financial, sales and marketing, manufacturing, distribution, technical and other resources than we do. These competitors may be able to adapt more quickly to new or emerging technologies and changes in customer requirements. In addition, current and potential competitors have established or may establish financial or strategic relationships among themselves or with existing or potential customers or other third parties. Accordingly, new competitors or alliances among competitors could emerge and rapidly acquire significant market share. We cannot assure you that we will be able to compete successfully against current or new competitors, in which case our revenues may fail to increase or may decline.

Intense competition in our markets could result in aggressive business tactics by our competitors, including aggressively pricing their products or selling older inventory at a discount. If our current or future competitors utilize aggressive business tactics, including those described above, demand for our products could decline, we could experience delays or cancellations of customer orders, or we could be required to reduce our sales prices.

Decreases in average selling prices of our products may increase operating losses and net losses, particularly if we are not able to reduce expenses commensurately.

The market for optical components and subsystems continues to be characterized by declining average selling prices resulting from factors such as increased price competition among optical component and subsystem manufacturers, excess capacity, the introduction of new products and increased unit volumes as manufacturers continue to deploy network and storage systems. In recent years, we have observed a significant decline of average selling prices, primarily in the telecommunications market. We anticipate that average selling prices will continue to decrease in the future in response to product introductions by competitors or by us, or in response to other factors, including price pressures from significant customers. In order to sustain profitable operations, we must, therefore, reduce the cost of our current designs or continue to develop and introduce new products on a timely basis that incorporate features that

can be sold at higher average selling prices. Failure to do so could cause our sales to decline and operating losses to increase.

Our cost reduction efforts may not keep pace with competitive pricing pressures. To remain competitive, we must continually reduce the cost of manufacturing our products through design and engineering changes. We may not be successful in redesigning our products or delivering our products to market in a timely manner. We cannot assure you that any redesign



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will result in sufficient cost reductions enabling us to reduce the price of our products to remain competitive or positively contribute to operating results.

Shifts in product mix may result in declines in gross profit.

Our gross profit margins vary among our product platforms, and are generally highest on our test & measurement instruments. Our overall gross profit may fluctuate from period to period as a result of a variety of factors including shifts in product mix, the introduction of new products, and decreases in average selling prices for older products. If our customers decide to buy more of our products with low gross profit margins or fewer of our products with high gross profit margins, our total gross profits could be harmed.

**Risks Relating to our Operations and Business Strategy**

If we cannot successfully transition our revenue mix from contract research revenues to product sales and license revenues, we may not be able to fully execute our business model or grow our business.

Our business model and future growth depend on our ability to transition to a revenue mix that contains significantly larger product sales and revenues from the provision of services or from licensing. Product sales and these revenues potentially offer greater scalability than contract research revenues. Our current plan is to increase our sales of commercial products, our licensing revenues and our provision of non-research services to customers so as to represent a larger percentage of our total revenues. If we are unable to develop and grow our product sales and revenues from the provision of services or from licensing to augment our contract research revenues, however, our ability to execute our business model or grow our business could suffer. There can be no assurance that we will be able to achieve increased revenues in this manner.

Failure to develop, introduce and sell new products or failure to develop and implement new technologies, could adversely impact our financial results.

Our success will depend on our ability to develop and introduce new products that customers choose to buy. The new products the market requires tend to be increasingly complex, incorporating more functions and operating at faster speeds than old products. If we fail to introduce new product designs or technologies in a timely manner or if customers do not successfully introduce new systems or products incorporating our products, our business, financial condition and results of operations could be materially harmed.

If we are unable to manage growth effectively, our revenues and net loss could be adversely affected.

We may need to expand our personnel resources to grow our business effectively. We believe that sustained growth at a higher rate will place a strain on our management as well as on our other human resources. To manage this growth, we must continue to attract and retain qualified management, professional, scientific and technical and operating personnel. If we are unable to recruit a sufficient number of qualified personnel, we may be unable to staff and manage projects adequately, which in turn may slow the rate of growth of our contract research revenues or our product development efforts.

We may not be successful in identifying market needs for new technologies or in developing new products.

Part of our business model depends on our ability to correctly identify market needs for new technologies. We intend to identify new market needs, but we may not always have success in doing so in part because our contract research largely centers on identification and development of unproven technologies, often for new or emerging markets.

Furthermore, we must identify the most promising technologies from a sizable pool of projects. If our commercialization strategy process fails to identify projects with commercial potential or if management does not ensure that such projects advance to the commercialization stage, we may not successfully commercialize new products and grow our revenues.

Our growth strategy requires that we also develop successful commercial products to address market needs. We face several challenges in developing successful new products. Many of our existing products and those currently under development are technologically innovative and require significant and lengthy product development efforts. These efforts include planning, designing, developing and testing at the technological, product and manufacturing-process levels. These activities require us to make significant investments. Although there are many potential applications for our technologies, our resource constraints require us to focus on specific products and to forgo other opportunities. We expect that one or more of the potential products we choose to develop will not be technologically feasible or will not achieve commercial acceptance, and we cannot predict which, if any, of our products we will successfully develop or

commercialize. The technologies we research and develop are new and steadily changing and advancing. The products that are derived from these technologies may not be

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applicable or compatible with the state of technology or demands in existing markets. Our existing products and technologies may become uncompetitive or obsolete if our competitors adapt more quickly than we do to new technologies and changes in customers' requirements. Furthermore, we may not be able to identify if and when new markets will open for our products given that future applications of any given product may not be readily determinable, and we cannot reasonably estimate the size of any markets that may develop. If we are not able to successfully develop new products, we may be unable to increase our product revenues.

We face risks associated with our international business.

We currently conduct business internationally and we might considerably expand our international activities in the future. Our international business operations are subject to a variety of risks associated with conducting business internationally, including:

- having to comply with U.S. export control regulations and policies that restrict our ability to communicate with non-U.S. employees and supply foreign affiliates and customers;
- changes in or interpretations of foreign regulations that may adversely affect our ability to sell our products, perform services or repatriate profits to the United States;
- the imposition of tariffs;
- hyperinflation or economic or political instability in foreign countries;
- imposition of limitations on, or increase of withholding and other taxes on remittances and other payments by foreign subsidiaries or joint ventures;
- conducting business in places where business practices and customs are unfamiliar and unknown;
- the imposition of restrictive trade policies;
- the imposition of inconsistent laws or regulations;
- the imposition or increase of investment and other restrictions or requirements by foreign governments;
- uncertainties relating to foreign laws and legal proceedings;
- having to comply with a variety of U.S. laws, including the Foreign Corrupt Practices Act ("FCPA"); and
- having to comply with licensing requirements.

We do not know the impact that these regulatory, geopolitical and other factors may have on our international business in the future.

We may dispose of or discontinue existing product lines and technology developments, which may adversely impact our future results.

On an ongoing basis, we evaluate our various product offerings and technology developments in order to determine whether any should be discontinued or, to the extent possible, divested. In addition, if we are unable to generate the amount of cash needed to fund the future operations of our business, we may be forced to sell one or more of our product lines or technology developments.

We cannot guarantee that we have correctly forecasted, or that we will correctly forecast in the future, the right product lines and technology developments to dispose or discontinue or that our decision to dispose of or discontinue various investments, products lines and technology developments is prudent if market conditions change. In addition, there are no assurances that the discontinuance of various product lines will reduce operating expenses or will not cause us to incur material charges associated with such decision. Furthermore, the discontinuance of existing product lines entails various risks, including the risk that we will not be able to find a purchaser for a product line or the purchase price obtained will not be equal to at least the book value of the net assets for the product line. Other risks include managing the expectations of, and maintaining good relations with, our historical customers who previously purchased products from a disposed or discontinued product line, which could prevent us from selling other products to them in the future. We may also incur other significant liabilities and costs associated with disposal or discontinuance of product lines, including employee severance costs and excess facilities costs.

We may be liable for damages based on product liability claims relating to defects in our products, which might be brought against us directly, or against our customers in their end-use markets. Such claims could result in a loss of customers in addition to substantial liability in damages.

Our products are complex and undergo quality testing as well as formal qualification, both by our customers and by us. However, defects may occur from time to time. Our customers' testing procedures may be limited to evaluating our products under likely and foreseeable failure scenarios and over varying amounts of time. For various reasons, such as the occurrence of performance problems that are unforeseeable in testing or that are detected only when products age or are operated under peak stress conditions, our products may fail to perform as expected long after customer acceptance. Failures could result from

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faulty components or design, problems in manufacturing or other unforeseen reasons. As a result, we could incur significant costs to repair or replace defective products under warranty, particularly when such failures occur in installed systems. In addition, we may in certain circumstances honor warranty claims after the warranty has expired or for problems not covered by warranty in order to maintain customer relationships. Any significant product failure could result in lost future sales of the affected product and other products, as well as customer relations problems, litigation and damage to our reputation.

In addition, many of our products are embedded in, or deployed in conjunction with, our customers' products, which incorporate a variety of components, modules and subsystems and may be expected to interoperate with modules produced by third parties. As a result, not all defects are immediately detectable, and, when problems occur, it may be difficult to identify the source of the problem. These problems may cause us to incur significant damages or warranty and repair costs, divert the attention of our engineering personnel from internal product development efforts and cause significant customer relations problems or loss of customers, all of which would harm our business.

Furthermore, many of our products may provide critical performance attributes to our customers' products that will be sold to end users who could potentially bring product liability suits in which we could be named as a defendant. The sale of these products involves the risk of product liability claims. If a person were to bring a product liability suit against one of our customers, this customer may attempt to seek contribution from us. A person may also bring a product liability claim directly against us. A successful product liability claim or series of claims against us in excess of our insurance coverage for payments, for which we are not otherwise indemnified, could have a material adverse effect on our financial condition or results of operations.

We could be negatively affected by a security breach, either through cyber-attack, cyber-intrusion or other significant disruption of our IT networks and related systems.

We face the risk, as does any company, of a security breach, whether through cyber-attack or cyber-intrusion over the internet, malware, computer viruses, attachments to e-mails, persons inside our organization or persons with access to systems inside our organization, or other significant disruption of our IT networks and related systems. The risk of a security breach or disruption, particularly through cyber-attack or cyber-intrusion, including by computer hackers, foreign governments and cyber terrorists, has increased as the number, intensity and sophistication of attempted attacks and intrusions from around the world have increased.

As a technology company, and particularly as a government contractor, we may face a heightened risk of a security breach or disruption from threats to gain unauthorized access to our proprietary, confidential or classified information on our IT networks and related systems. These types of information and IT networks and related systems are critical to the operation of our business and essential to our ability to perform day-to-day operations, and, in some cases, are critical to the operations of certain of our customers. In addition, as certain of our technological capabilities become widely known, it is possible that we may be subjected to cyber-attack or cyber-intrusion as third parties seek to gain improper access to information regarding these capabilities and cyber-attacks or cyber-intrusion could compromise our confidential information or our IT networks and systems generally, as it is not practical as a business matter to isolate all of our confidential information and trade secrets from email and internet access. There can be no assurance that our security efforts and measures will be effective or that attempted security breaches or disruptions would not be successful or damaging.

A security breach or other significant disruption involving these types of information and IT networks and related systems could disrupt the proper functioning of these networks and systems and therefore our operations, compromise our confidential information and trade secrets, or damage our reputation among our customers and the public generally. Any of these developments could have a negative impact on our results of operations, financial condition and cash flows.

### Risks Relating to our Regulatory Environment

Our operations are subject to domestic and foreign laws, regulations and restrictions, and noncompliance with these laws, regulations and restrictions could expose us to fines, penalties, suspension or debarment, which could have a material adverse effect on our profitability and overall financial position.

Our operations, particularly our international sales, subject us to numerous U.S. and foreign laws and regulations, including, without limitation, regulations relating to imports, exports (including the Export Administration

Regulations and the International Traffic in Arms Regulations), technology transfer restrictions, anti-boycott provisions, economic sanctions and the FCPA. The number of our various emerging technologies, the development of many of which has been funded by the Department of Defense, presents us with many regulatory challenges. Failure by us or our sales representatives or consultants to comply with these laws and regulations could result in administrative, civil, or criminal liabilities and could result in suspension of our export privileges, which could have a material adverse effect on our business. Changes in regulation or

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political environment may affect our ability to conduct business in foreign markets including investment, procurement and repatriation of earnings.

Environmental regulations could increase operating costs and additional capital expenditures and delay or interrupt operations.

The photonics industry, as well as the semiconductor industry, are subject to governmental regulations for the protection of the environment, including those relating to air and water quality, solid and hazardous waste handling, and the promotion of occupational safety. Various federal, state and local laws and regulations require that we maintain certain environmental permits. While we believe that we have obtained all necessary environmental permits required to conduct our manufacturing processes, if we are found to be in violation of these laws, we could be subject to governmental fines and liability for damages resulting from such violations.

Changes in the aforementioned laws and regulations or the enactment of new laws, regulations or policies could require increases in operating costs and additional capital expenditures and could possibly entail delays or interruptions of our operations.

If our manufacturing facilities do not meet Federal, state or foreign country manufacturing standards, we may be required to temporarily cease all or part of our manufacturing operations, which would result in product delivery delays and negatively impact revenues.

Our manufacturing facilities are subject to periodic inspection by regulatory authorities and our operations will continue to be regulated by the FDA for compliance with Good Manufacturing Practice requirements contained in the quality systems regulations. We are also required to comply with International Organization for Standardization ("ISO"), quality system standards in order to produce certain of our products for sale in Europe. If we fail to continue to comply with Good Manufacturing Practice requirements or ISO standards, we may be required to cease all or part of our operations until we comply with these regulations. Obtaining and maintaining such compliance is difficult and costly. We cannot be certain that our facilities will be found to comply with Good Manufacturing Practice requirements or ISO standards in future inspections and audits by regulatory authorities. In addition, if we cannot maintain or establish manufacturing facilities or operations that comply with such standards or do not meet the expectations of our customers, we may not be able to realize certain economic opportunities in our current or future supply arrangements.

Medical products are subject to various international regulatory processes and approval requirements. If we do not obtain and maintain the necessary international regulatory approvals for any such potential products, we may not be able to market and sell our medical products in foreign countries.

To be able to market and sell medical products in other countries, we must obtain regulatory approvals and comply with the regulations of those countries. These regulations, including the requirements for approvals and the time required for regulatory review, vary from country to country. Obtaining and maintaining foreign regulatory approvals are expensive, and we cannot be certain that we will have the resources to be able to pursue such approvals or whether we would receive regulatory approvals in any foreign country in which we plan to market our products. For example, the European Union requires that manufacturers of medical products obtain the right to affix the CE mark to their products before selling them in member countries of the European Union, which we have not yet obtained and may never obtain. If we fail to obtain regulatory approval in any foreign country in which we plan to market our products, our ability to generate revenues will be harmed.

We are subject to additional significant foreign and domestic government regulations, including environmental and health and safety regulations, and failure to comply with these regulations could harm our business.

Our facilities and current and proposed activities involve the use of a broad range of materials that are considered hazardous under applicable laws and regulations. Accordingly, we are subject to a number of foreign, federal, state and local laws and regulations relating to health and safety, protection of the environment and the storage, use, disposal of, and exposure to, hazardous materials and wastes. We could incur costs, fines and civil and criminal penalties, personal injury and third party property damage claims, or could be required to incur substantial investigation or remediation costs, if we were to violate or become liable under environmental, health and safety laws. Moreover, a failure to comply with environmental laws could result in fines and the revocation of environmental permits, which could prevent us from conducting our business. Liability under environmental laws can be joint and

several and without regard to fault. There can be no assurance that violations of environmental and health and safety laws will not occur in the future as a result of the inability to obtain permits, human error, equipment failure or other causes. Environmental laws could become more stringent over time, imposing greater compliance costs and increasing risks and penalties associated with violations, which could harm our business. Accordingly, violations of

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present and future environmental laws could restrict our ability to expand facilities, pursue certain technologies, and could require us to acquire costly equipment or incur potentially significant costs to comply with environmental regulations.

Compliance with foreign, federal, state and local environmental laws and regulations represents a small part of our present budget. If we fail to comply with any such laws or regulations, however, a government entity may levy a fine on us or require us to take costly measures to ensure compliance. Any such fine or expenditure may adversely affect our development. We cannot predict the extent to which future legislation and regulation could cause us to incur additional operating expenses, capital expenditures or restrictions and delays in the development of our products and properties.

### Risks Relating to our Intellectual Property

Our proprietary rights may not adequately protect our technologies.

Our commercial success will depend in part on our obtaining and maintaining patent, trade secret, copyright and trademark protection of our technologies in the United States and other jurisdictions as well as successfully enforcing this intellectual property and defending it against third-party challenges. We will only be able to protect our technologies from unauthorized use by third parties to the extent that valid and enforceable intellectual property protections, such as patents or trade secrets, cover them. In particular, we place considerable emphasis on obtaining patent and trade secret protection for significant new technologies, products and processes. The degree of future protection of our proprietary rights is uncertain because legal means afford only limited protection and may not adequately protect our rights or permit us to gain or keep our competitive advantage. The degree of future protection of our proprietary rights is also uncertain for products that are currently in the early stages of development because we cannot predict which of these products will ultimately reach the commercial market or whether the commercial versions of these products will incorporate proprietary technologies.

Our patent position is highly uncertain and involves complex legal and factual questions. Accordingly, we cannot predict the breadth of claims that may be allowed or enforced in our patents or in third-party patents. For example:

- we or our licensors might not have been the first to make the inventions covered by each of our pending patent applications and issued patents;
- we or our licensors might not have been the first to file patent applications for these inventions;
- others may independently develop similar or alternative technologies or duplicate any of our technologies;
- it is possible that none of our pending patent applications or the pending patent applications of our licensors will result in issued patents;
- patents may issue to third parties that cover how we might practice our technology;
- our issued patents and issued patents of our licensors may not provide a basis for commercially viable technologies, may not provide us with any competitive advantages, or may be challenged and invalidated by third parties; and
- we may not develop additional proprietary technologies that are patentable.

Patents may not be issued for any pending or future pending patent applications owned by or licensed to us, and claims allowed under any issued patent or future issued patent owned or licensed by us may not be valid or sufficiently broad to protect our technologies. Moreover, protection of certain of our intellectual property may be unavailable or limited in the United States or in foreign countries, and we have not sought to obtain foreign patent protection for certain of our products or technologies due to cost, concerns about enforceability or other reasons. Any issued patents owned by or licensed to us now or in the future may be challenged, invalidated, or circumvented, and the rights under such patents may not provide us with competitive advantages. In addition, competitors may design around our technology or develop competing technologies. Intellectual property rights may also be unavailable or limited in some foreign countries, and in the case of certain products no foreign patents were filed or can be filed. This could make it easier for competitors to capture or increase their market share with respect to related technologies. We could incur substantial costs to bring suits in which we may assert our patent rights against others or defend ourselves in suits brought against us. An unfavorable outcome of any litigation could have a material adverse effect on our business and results of operations.

We also rely on trade secrets to protect our technology, especially where we believe patent protection is not appropriate or obtainable. However, trade secrets are difficult to protect. We regularly attempt to obtain confidentiality agreements and contractual provisions with our collaborators, employees and consultants to protect our trade secrets and proprietary know-how. These agreements may be breached or may not have adequate remedies for such breach. While we use reasonable efforts to protect our trade secrets, our employees, consultants, contractors or scientific and other advisors, or those of our strategic partners, may unintentionally or willfully disclose our information to competitors. If we were to enforce a claim that a third party had illegally obtained and was using our trade secrets, our enforcement efforts would be expensive and time consuming, and the outcome would be unpredictable. In addition, courts outside the United States are sometimes unwilling to protect trade

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secrets. Moreover, if our competitors independently develop equivalent knowledge, methods and know-how, it will be more difficult for us to enforce our rights and our business could be harmed.

If we are not able to defend the patent or trade secret protection position of our technologies, then we will not be able to exclude competitors from developing or marketing competing technologies and we may not generate enough revenues from product sales to justify the cost of developing our technologies and to achieve or maintain profitability. We also rely on trademarks to establish a market identity for our company and our products. To maintain the value of our trademarks, we might have to file lawsuits against third parties to prevent them from using trademarks confusingly similar to or dilutive of our registered or unregistered trademarks. Also, we might not obtain registrations for our pending trademark applications, and we might have to defend our registered trademark and pending trademark applications from challenge by third parties. Enforcing or defending our registered and unregistered trademarks might result in significant litigation costs and damages, including the inability to continue using certain trademarks.

Third parties may claim that we infringe their intellectual property, and we could suffer significant litigation or licensing expense as a result.

Various U.S. and foreign issued patents and pending patent applications, which are owned by third parties, exist in our technology areas. Such third parties may claim that we infringe their patents. Because patent applications can take several years to result in a patent issuance, there may be currently pending applications, unknown to us, which may later result in issued patents that our technologies may infringe. For example, we are aware of competitors with patents in technology areas applicable to our optical test equipment products. Such competitors may allege that we infringe these patents. There could also be existing patents of which we are not aware that our technologies may inadvertently infringe. We have from time to time been, and may in the future be, contacted by third parties, including patent assertion entities or intellectual property advisors, about licensing opportunities that also contain claims that we are infringing on third party patent rights. If third parties assert these claims against us, we could incur extremely substantial costs and diversion of management resources in defending these claims, and the defense of these claims could have a material adverse effect on our business, financial condition and results of operations. Even if we believe we have not infringed on a third party's patent rights, we may have to settle a claim on unfavorable terms because we cannot afford to litigate the claim. In addition, if third parties assert claims against us and we are unsuccessful in defending against these claims, these third parties may be awarded substantial damages as well as injunctive or other equitable relief against us, which could effectively block our ability to make, use, sell, distribute or market our products and services in the United States or abroad.

Commercial application of nanotechnologies in particular, or technologies involving nanomaterials, is new and the scope and breadth of patent protection is uncertain. Consequently, the patent positions of companies involved in nanotechnologies have not been tested, and there are complex legal and factual questions for which important legal principles will be developed or may remain unresolved. In addition, it is not clear whether such patents will be subject to interpretations or legal doctrines that differ from conventional patent law principles. Changes in either the patent laws or in interpretations of patent laws in the United States and other countries may diminish the value of our nanotechnology-related intellectual property. Accordingly, we cannot predict the breadth of claims that may be allowed or enforced in our nanotechnology-related patents or in third party patents. In the event that a claim relating to intellectual property is asserted against us, or third parties not affiliated with us hold pending or issued patents that relate to our products or technology, we may seek licenses to such intellectual property or challenge those patents. However, we may be unable to obtain these licenses on commercially reasonable terms, if at all, and our challenge of the patents may be unsuccessful. Our failure to obtain the necessary licenses or other rights could prevent the sale, manufacture or distribution of our products and, therefore, could have a material adverse effect on our business, financial condition and results of operations.

A substantial portion of our technology is subject to retained rights of our licensors, and we may not be able to prevent the loss of those rights or the grant of similar rights to third parties.

A substantial portion of our technology is licensed from academic institutions, corporations and government agencies. Under these licensing arrangements, a licensor may obtain rights over the technology, including the right to require us to grant a license to one or more third parties selected by the licensor or that we provide licensed technology or material to third parties for non-commercial research. The grant of a license for any of our core technologies to a third

party could have a material and adverse effect on our business. In addition, some of our licensors retain certain rights under the licenses, including the right to grant additional licenses to a substantial portion of our core technology to third parties for non-commercial academic and research use. It is difficult to monitor and enforce such non-commercial academic and research uses, and we cannot predict whether the third-party licensees would comply with the use restrictions of such licenses. We have incurred and could incur substantial expenses to enforce our rights against them. We also may not fully control the ability to assert or defend those patents or other intellectual property which we have licensed from other entities, or which we have licensed to other entities.

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In addition, some of our licenses with academic institutions give us the right to use certain technology previously developed by researchers at these institutions. In certain cases we also have the right to practice improvements on the licensed technology to the extent they are encompassed by the licensed patents and are within our field of use. Our licensors may currently own and may in the future obtain additional patents and patent applications that are necessary for the development, manufacture and commercial sale of our anticipated products. We may be unable to agree with one or more academic institutions from which we have obtained licenses whether certain intellectual property developed by researchers at these academic institutions is covered by our existing licenses. In the event that the new intellectual property is not covered by our existing licenses, we would be required to negotiate a new license agreement. We may not be able to reach agreement with current or future licensors on commercially reasonable terms, if at all, or the terms may not permit us to sell our products at a profit after payment of royalties, which could harm our business.

Some of our patents may cover inventions that were conceived or first reduced to practice under, or in connection with, U.S. government contracts or other federal funding agreements. With respect to inventions conceived or first reduced to practice under a federal funding agreement, the U.S. government may retain a non-exclusive, non-transferable, irrevocable, paid-up license to practice or have practiced for or on behalf of the United States the invention throughout the world. We may not succeed in our efforts to retain title in patents, maintain ownership of intellectual property or in limiting the U.S. government's rights in our proprietary technologies and intellectual property when an issue exists as to whether such intellectual property was developed in the performance of a federal funding agreement or developed at private expense.

If we fail to obtain the right to use the intellectual property rights of others which are necessary to operate our business, and to protect their intellectual property, our business and results of operations will be adversely affected. In the past, we have licensed certain technologies for use in our products. In the future, we may choose, or be required, to license technology or intellectual property from third parties in connection with the development of our products. We cannot assure you that third-party licenses will be available on commercially reasonable terms, if at all. Our competitors may be able to obtain licenses, or cross-license their technology, on better terms than we can, which could put us at a competitive disadvantage. Also, we often enter into confidentiality agreements with such third parties in which we agree to protect and maintain their proprietary and confidential information, including at times requiring our employees to enter into agreements protecting such information. There can be no assurance that the confidentiality agreements will not be breached by any of our employees or that such third parties will not make claims that their proprietary information has been disclosed.

## **RISKS RELATING TO OUR COMMON STOCK**

If there are substantial sales of our common stock, or the perception that such sales may occur, our stock price could decline.

If any of our stockholders were to sell substantial amounts of our common stock, the market price of our common stock may decline, which might make it more difficult for us to sell equity or equity-related securities in the future at a time and price that we deem appropriate. Substantial sales of our common stock, or the perception that such sales may occur, may have a material adverse effect on the prevailing market price of our common stock.

Carilion Clinic holds approximately 3.5 million shares of our common stock (including approximately 1.3 million shares issuable to Carilion upon conversion of shares of Series A Convertible Preferred Stock that Carilion holds). All of these shares have been registered for sale on a Form S-3 registration statement and, accordingly, may generally be freely sold by Carilion at any time. Any sales of these shares, or the perception that future sales of shares may occur by Carilion or any of our other significant stockholders, may have a material adverse effect on the market price of our stock. Any such continuing material adverse effect on the market price of our stock could impair our ability to comply with NASDAQ's continuing listing standards in respect of our minimum stock price, as further described below.

We may become involved in securities class action litigation that could divert management's attention and harm our business and our insurance coverage may not be sufficient to cover all costs and damages.

The stock market has from time to time experienced significant price and volume fluctuations that have affected the market prices for the common stock of technology companies. These broad market fluctuations may cause the market

price of our common stock to decline. In the past, following periods of volatility in the market price of a particular company's securities, securities class action litigation has often been brought against that company. Securities class litigation also often follows certain significant business transactions, such as the sale of a business division or a change in control transaction. We

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may become involved in this type of litigation in the future. Litigation often is expensive and diverts management's attention and resources, which could adversely affect our business.

We may not be able to comply with all applicable listing requirements or standards of The NASDAQ Capital Market and NASDAQ could delist our common stock.

Our common stock is listed on The NASDAQ Capital Market. In order to maintain that listing, we must satisfy minimum financial and other continued listing requirements and standards. One such requirement is that we maintain a minimum bid price of at least \$1.00 per share for our common stock. Although we currently comply with the minimum bid requirement, in the recent past, our minimum bid price has fallen below \$1.00 per share, and it could again do so in the future. If our bid price falls below \$1.00 per share for 30 consecutive business days, we will receive a deficiency notice from NASDAQ advising us that we have 180 days to regain compliance by maintaining a minimum bid price of at least \$1.00 for a minimum of ten consecutive business days. Under certain circumstances, NASDAQ could require that the minimum bid price exceed \$1.00 for more than ten consecutive days before determining that a company complies.

In the event that our common stock is not eligible for continued listing on NASDAQ or another national securities exchange, trading of our common stock could be conducted in the over-the-counter market or on an electronic bulletin board established for unlisted securities such as the Pink Sheets or the OTC Bulletin Board. In such event, it could become more difficult to dispose of, or obtain accurate price quotations for, our common stock, and there would likely also be a reduction in our coverage by security analysts and the news media, which could cause the price of our common stock to decline further. Also, it may be difficult for us to raise additional capital if we are not listed on a major exchange.

Our common stock price has been volatile and we expect that the price of our common stock will fluctuate substantially in the future, which could cause you to lose all or a substantial part of your investment.

The public trading price for our common stock is volatile and may fluctuate significantly. Since January 1, 2009, our common stock has traded between a high of \$5.00 per share and a low of \$0.26 per share. Among the factors, many of which we cannot control, that could cause material fluctuations in the market price for our common stock are:

- sales of our common stock by our significant stockholders, or the perception that such sales may occur;
- changes in earnings estimates, investors' perceptions, recommendations by securities analysts or our failure to achieve analysts' earnings estimates;
- changes in our status as an entity eligible to receive SBIR contracts and grants;
- quarterly variations in our or our competitors' results of operations;
- general market conditions and other factors unrelated to our operating performance or the operating performance of our competitors;
- announcements by us, or by our competitors, of acquisitions, new products, significant contracts, commercial relationships or capital commitments;
- pending or threatened litigation;
- any major change in our board of directors or management or any competing proxy solicitations for director nominees;
- changes in governmental regulations or in the status of our regulatory approvals;
- announcements related to patents issued to us or our competitors;
- a lack of, limited or negative industry or securities analyst coverage;
- discussions of our company or our stock price by the financial and scientific press and online investor communities;
- and
- general developments in our industry.

In addition, the stock prices of many technology companies have experienced wide fluctuations that have often been unrelated to the operating performance of those companies. These factors may materially and adversely affect the market price of our common stock.

If our internal control over financial reporting is found not to be effective or if we make disclosure of existing or potential material weaknesses in those controls, investors could lose confidence in our financial reports, and our stock price may be adversely affected.

Section 404 of the Sarbanes-Oxley Act of 2002 requires us to include an internal control report with our Annual Report on Form 10-K. That report must include management's assessment of the effectiveness of our internal control over financial reporting as of the end of the fiscal year.



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We evaluate our existing internal control over financial reporting based on the framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. During the course of our ongoing evaluation of the internal controls, we may identify areas requiring improvement, and may have to design enhanced processes and controls to address issues identified through this review. Remedying any deficiencies, significant deficiencies or material weaknesses that we identify may require us to incur significant costs and expend significant time and management resources. We cannot assure you that any of the measures we implement to remedy any such deficiencies will effectively mitigate or remedy such deficiencies. Investors could lose confidence in our financial reports, and our stock price may be adversely affected, if our internal controls over financial reporting are found not to be effective by management or if we make disclosure of existing or potential significant deficiencies or material weaknesses in those controls.

Anti-takeover provisions in our amended and restated certificate of incorporation and bylaws and Delaware law could discourage or prevent a change in control, even if an acquisition would be beneficial to our stockholders, which could affect our stock price adversely and prevent attempts by our stockholders to replace or remove our current management.

Our amended and restated certificate of incorporation and bylaws and Delaware law contain provisions that might delay or prevent a change in control, discourage bids at a premium over the market price of our common stock and adversely affect the market price of our common stock and the voting and other rights of the holders of our common stock. These provisions include:

- a classified board of directors serving staggered terms;
- advance notice requirements to stockholders for matters to be brought at stockholder meetings;
- a supermajority stockholder vote requirement for amending certain provisions of our amended and restated certificate of incorporation and bylaws; and
- the right to issue preferred stock without stockholder approval, which could be used to dilute the stock ownership of a potential hostile acquirer.

We are also subject to provisions of the Delaware General Corporation law that, in general, prohibit any business combination with a beneficial owner of 15% or more of our common stock for three years unless the holder's acquisition of our stock was approved in advance by our board of directors or certain other conditions are satisfied. The existence of these provisions could adversely affect the voting power of holders of common stock and limit the price that investors might be willing to pay in the future for shares of our common stock.

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ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

(a) Unregistered Sales of Equity Securities during the Three Months Ended March 31, 2017

Common Stock Dividend Payable to Carilion

We issued 1,321,514 shares of Series A Preferred Stock, par value \$0.001 per share, to Carilion Clinic in January 2010, which shares were issued in reliance on the exemptions from registration under the Securities Act provided by Sections 3(a)(9) and 4 (a)(2) thereof. The Series A Preferred Stock accrues dividends at the rate of \$0.2815 per share per annum, payable quarterly in arrears. Accrued dividends are payable in shares of our common stock, with the number of shares being equal to the quotient of (i) the cumulative aggregate balance of accrued but unpaid dividends on each share of Series A Preferred Stock divided by (ii) the conversion price of the Series A Preferred Stock, which is currently \$4.69159 per share. For the period from January 12, 2010, the original issue date of the Series A Preferred Stock, through March 31, 2017, the Series A Preferred Stock issued to Carilion has accrued \$1,047,538 in dividends. The accrued dividend as of March 31, 2017 will be paid by the issuance of 572,224 shares of our common stock, which we will issue at Carilion's written request. As the Series A Preferred Stock was issued in reliance on the exemption provided by Section 3(a)(9), the shares of common stock payable as dividends will also be exempt from registration in reliance on Section 3(a)(9) of the Securities Act.

(b) Use of Proceeds from Sale of Registered Equity Securities

Not applicable.

(c) Purchases of Equity Securities by the Registrant

On June 9, 2016, we announced that our board of directors approved a stock repurchase program, authorizing the repurchase of up to \$2.0 million of our common stock. We did not make any purchases of stock under this program during the three months ended March 31, 2017. As of March 31, 2017, we had \$1,751,191 available for future purchases. Unless extended, the stock repurchase program expires on May 31, 2017.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

ITEM 5. OTHER INFORMATION

None.

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ITEM 6. EXHIBITS

The exhibits listed on the Exhibit Index hereto are filed or incorporated by reference (as stated therein) as part of this Quarterly Report on Form 10-Q.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Luna Innovations Incorporated

Date: May 11, 2017 By: /s/ Dale Messick

Dale Messick

Chief Financial Officer

(principal financial and accounting officer and duly authorized officer)

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EXHIBIT INDEX

Exhibit Number	Description
10.1*	2017 Senior Management Incentive Compensation Plan
31.1	Certification of the Principal Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of the Principal Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1**	Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2**	Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101	The following materials from the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 2017, formatted in XBRL (eXtensible Business Reporting Language): (i) Consolidated Balance Sheets at March 31, 2017 and December 31, 2016, (ii) Consolidated Statements of Operations for the three months ended March 31, 2017 and 2016, (iii) Consolidated Statements of Cash Flows for the three months ended March 31, 2017 and 2016 and (iv) Notes to Unaudited Consolidated Financial Statements.

\* Confidential treatment has been requested with respect to portions of this exhibit, indicated by asterisks, which has been filed separately with the Securities and Exchange Commission.

These certifications are being furnished solely to accompany this quarterly report pursuant to 18 U.S.C.

\*\* Section 1350, and are not being filed for purposes of Section 18 of the Securities Exchange Act of 1934 and are not to be incorporated by reference into any filing of the registrant, whether made before or after the date hereof, regardless of any general incorporation language in such filing.