

ATRIX LABORATORIES INC

Form 10-K/A

November 07, 2002

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549**

**FORM 10-K/A
AMENDMENT NO. 2**

☒ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934**
For the Fiscal Year Ended December 31, 2001

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

Commission File Number 0-18231

ATRIX LABORATORIES, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

84-1043826
(I.R.S. Employer
Identification No.)

2579 Midpoint Drive Fort Collins, Colorado
(Address of principal executive office)

80525
(Zip Code)

Registrant's telephone number, including area code: (970) 482-5868

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act:

Common Stock \$.001 par value
(Title of Class)

Series A Preferred Stock Purchase Rights
(Title of Class)

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this

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Form 10-K or any amendment to this Form 10-K. [X]

The aggregate market value of voting stock held by non-affiliates of the Registrant as of March 26, 2002 was \$446,922,463.

The number of shares of the Registrant's common stock outstanding as of March 26, 2002 was 20,101,315.

DOCUMENTS INCORPORATED BY REFERENCE

The information required by Part III of this report is incorporated by reference to the Registrant's definitive Proxy Statement for the Annual Meeting of Stockholders scheduled to be held on May 5, 2002.

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EXPLANATORY NOTE

This Amendment No. 2 on Form 10-K/A amends the Registrant's Annual Report on Form 10-K for the year ended December 31, 2001, as amended by Amendment No. 1 on Form 10-K/A. This Amendment No. 2 reflects the restatement of the Registrant's consolidated financial statements discussed in Note 11 to the consolidated financial statements included in Item 14 and includes the audited financial statements of the Registrant's joint venture, Transmucosal Technologies Ltd., as previously filed in Amendment No. 1 on Form 10-K/A.

FORWARD-LOOKING INFORMATION

Statements in this Report that are not descriptions of historical facts are forward-looking statements provided under the safe harbor protection of the Private Securities Litigation Reform Act of 1995. These statements are made to enable a better understanding of our business, but because these forward-looking statements are subject to many risks, uncertainties, future developments and changes over time, actual results may differ materially from those expressed or implied by such forward-looking statements. Examples of forward-looking statements are statements about anticipated financial or operating results, financial projections, business prospects, future product performance, future research and development results, anticipated regulatory filings and approvals, and other matters that are not historical facts. Such statements often include words such as believes, expects, anticipates, intends, plans, estimates or similar expressions.

These forward-looking statements are based on the information that was currently available to us, and the expectations and assumptions that were deemed reasonable by us, at the time the statements were made. We do not undertake any obligation to update any forward-looking statements in this Report or in any of our other communications, except as required by law, and all such forward-looking statements should be read as of the time the statements were made, and with the recognition that these forward-looking statements may not be complete or accurate at a later date.

Many factors may cause or contribute to actual results or events being materially different from those expressed or implied by forward-looking statements. Although it is not possible to predict or identify all such factors, they include those set forth under Factors Affecting Our Business and Prospects below. These risk factors include, but are not limited to, the results of research and development efforts, the results of preclinical and clinical testing, the effect of regulation by the U.S. Food and Drug Administration, or FDA, and other agencies, the impact of competitive products, product development, commercialization and technology difficulties, the results of financing efforts, the effect of our accounting policies and other risks detailed in our filings with the Securities and Exchange Commission.

PART I

Item 1. Business.

Overview

We are an emerging specialty pharmaceutical company focused on advanced drug delivery. With five unique, patented, drug delivery technologies, we are currently developing a diverse portfolio of products, including proprietary oncology, pain management, growth hormone releasing peptide-1, oral interferon and dermatology products. We also form strategic alliances with large pharmaceutical and biotechnology companies utilizing our various drug delivery systems. We have significant strategic alliances with Pfizer Inc., Sanofi-Synthelabo Inc., MediGene AG, Fujisawa Healthcare, Inc., Elan International Services, Ltd., Geneva Pharmaceuticals, Inc. and CollaGenex Pharmaceuticals, Inc.

Atrix Laboratories, Inc. was incorporated in Delaware in August 1986. In November 1998, we acquired ViroTex Corporation. In June 1999, we organized our wholly owned registered subsidiary Atrix Laboratories Limited, which is based in London, England. In February 2000, we organized our wholly owned registered subsidiary Atrix Laboratories GmbH, which is based in Frankfurt, Germany, to conduct our European operations. In June 2000, we entered into a research joint venture, Transmucosal Technologies, Limited with Elan International, which is a wholly owned subsidiary of Elan Corporation, plc.

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Our Strategy

Our primary objective is to be a leading specialty pharmaceutical company focused on advanced drug delivery to improve the effectiveness of existing pharmaceuticals and new chemical entities, particularly proteins, peptides and vaccines. Key elements to our strategy include:

Expanding our portfolio of products through internal development. We intend to develop our own pharmaceutical product candidates and undertake late stage human clinical development ourselves. We are applying our drug delivery technologies to novel applications and formulations of approved pharmaceutical products to improve their delivery and effectiveness.

Maximizing the value of products by entering into late stage collaborative relationships. We believe that advancing our products through late stage development before seeking commercialization partners allows us to license our products on more favorable terms than would be available earlier in the development cycle.

Licensing our technologies to major pharmaceutical and biotechnology companies. We are focused on developing partnerships with pharmaceutical and biotechnology companies to utilize our drug delivery systems for new chemical entities and life cycle management products. We also have preclinical feasibility studies with various companies for proteins, peptides and monoclonal antibodies.

Pursuing acquisitions of complementary drug delivery technologies. We are pursuing opportunities that further strengthen our delivery technologies. We believe that if we are able to increase the number of delivery systems in our portfolio, we can increase our attractiveness as a product development partner with other pharmaceutical and biotechnology companies. In addition, we believe that pursuit of this strategy will strengthen our internal product development efforts.

Acquiring or in-licensing proprietary compounds. To expand our pipeline, we seek to identify drug candidates that may benefit from the application of our drug delivery technologies. These compounds generally have entered or are about to enter human clinical trials.

Recent Developments

The following discussion highlights significant events for our company during the year ended December 31, 2001.

Significant 2001 Events with Collaborative Partners

Sanofi-Synthelabo, Inc.

Under the terms of our agreement with Sanofi-Synthelabo, we received a \$3.0 million milestone payment in June 2001 upon the FDA acceptance of our March 2001 filing of a New Drug Application, or NDA, for our Eligard 7.5-mg one-month product, formerly known as Leuprologel One-Month Depot. We received FDA approval to market our Eligard 7.5-mg one-month product in January 2002 and expect to commence our marketing launch of Eligard 7.5-mg in the third quarter of 2002.

We submitted an NDA to the FDA in September 2001 for our Eligard 22.5-mg three-month product and in December 2001, we received an additional \$3.0 million milestone payment from Sanofi-Synthelabo upon the FDA acceptance of this filing. The combined \$6.0 million milestone payments from Sanofi will be recognized as revenue over the remaining term of the agreement using the straight-line method.

MediGene AG

In April 2001, we entered into an agreement with MediGene to market our Eligard products in Europe. Under the terms of the MediGene agreement, we received an up-front licensing fee of \$2.0 million and we may receive future additional licensing fees and milestone payments for certain clinical, regulatory and sales milestones upon approval for marketing by the European Medicine Evaluation Agency, or other

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competent authority. The \$2.0 million licensing fee from MediGene will be recognized as revenue over the term of the agreement using the straight-line method. Additionally, MediGene purchased 233,918 shares of our common stock for approximately \$3.8 million as part of the agreement and will provide funding to conduct clinical research and regulatory activities associated with seeking European marketing approvals.

In December 2001, MediGene submitted a Marketing Authorization Application, or MAA, for our Eligard 7.5-mg one month product to the German regulatory authority, Bundesinstitut für Arzneimittel und Medizinprodukte, or BfArM, as a reference member state under a mutual recognition process.

Fujisawa Healthcare, Inc.

In October 2001, we entered into a collaboration, license and supply agreement with Fujisawa Healthcare for the exclusive North American marketing and distribution rights of our Atrisorb® acne treatment product. The Fujisawa agreement provides up to \$25.0 million for an up-front licensing fee and certain milestone payments. Additionally, we may receive a royalty on sales of the Atrisorb product and a manufacturing margin. In October 2001, we received a \$2.0 million up-front licensing fee from Fujisawa Healthcare, which will be recognized as revenue over the term of the agreement using the straight-line method.

Elan International Services, Ltd.

In March 2001, BEMA -Ondansetron, an anti-emetic product using our BEMA drug delivery system, was selected as the second compound under development in the joint venture. BEMA-Ondansetron, which is for the treatment of nausea and vomiting associated with cancer chemotherapy, is currently in preclinical studies.

After we submitted an Investigational New Drug Application, or IND, to the FDA in November 2001 for BEMA-Fentanyl, this product for the treatment of chronic and breakthrough cancer pain advanced from preclinical stage of development to Phase I clinical studies.

Geneva Pharmaceuticals, Inc.

In December 2001 and January 2002, we submitted Abbreviated New Drug Applications, or ANDAs, to the FDA for approvals of two separate generic dermatology products.

Block Drug Termination Agreement

Under the terms of an August 2001 amendment to our agreement with Block Drug Corporation, we reacquired the marketing rights for our dental products for \$7.0 million, of which \$3.3 million was paid upon execution of the amendment. The balance of \$3.7 million will generally be payable over a four-year period based upon future net sales of the dental products and/or receipt of licensing fees for our dental products. In conjunction with the amendment to the Block agreement, Block paid us \$3.0 million owed for the September 2000 FDA approval and Block's first commercial sale obligation of Atrisorb® FreeFlow with Doxycycline, or Atrisorb-D, a periodontal barrier product with the antibiotic doxycycline for gingival surgery. Finally, under the August 2001 amendment, each party agreed to terminate all legal proceedings against the other party relating to the agreement.

CollaGenex Pharmaceuticals, Inc.

We licensed the exclusive U.S. marketing rights for Atridox®, Atrisorb FreeFlow GTR Barrier and Atrisorb-D GTR Barrier to CollaGenex following the reacquisition of the sales and marketing rights from Block. Under the terms of the CollaGenex agreement, we received an up-front licensing fee of \$1.0 million. Additionally, we will receive a royalty on net sales of the dental products and a manufacturing margin. As part of the transaction, we purchased 330,556 shares of CollaGenex's common stock for \$3.0 million, the proceeds of which will primarily fund a revitalized marketing campaign by CollaGenex for Atridox and the Atrisorb Barrier products. CollaGenex commenced U.S. marketing of Atridox and Atrisorb FreeFlow in November 2001 and Atrisorb-D in January 2002.

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Other Collaborations

In August 2001, we entered into a marketing agreement with F.H. Faulding & Co. Limited, ABN, trading as Faulding Pharmaceuticals, to market our Eligard products in Australia and New Zealand. The agreement includes an up-front licensing fee, certain milestone payments, royalty payments on net sales, and a manufacturing margin for the Eligard products upon approval for marketing by the Therapeutic Goods Administration of Australia and/or other competent authorities in Australia and New Zealand. Additionally, Faulding will be responsible for regulatory submissions and any studies that may be necessary to gain approval with the Australian and New Zealand authorities.

In August 2001, we entered into a feasibility study agreement with Human Genome Sciences, Inc., a pioneer in the discovery and development of genomics-based drugs, to develop a sustained-release formulation of a Human Genome Sciences new proprietary protein utilizing our Atrigel® drug delivery system. Under the terms of the agreement, Human Genome Sciences will provide funding for the development of this product.

In December 2001, we signed an exclusive marketing agreement with PharmaScience, Inc., for the marketing and distribution of our dental products in Canada.

Acquired Licensed Products in 2001

In January 2001, we purchased an exclusive option from Tulane University Health Science Center to license a patented human growth hormone releasing peptide-1 compound, or GHRP-1. We exercised this option in September 2001 and paid Tulane \$2.5 million. Possible applications of GHRP-1 include treatment of patients with AIDS or cancer, promotion of growth in children with short stature, and prevention of muscle wasting and frailty in aged individuals. Our intent is to deliver GHRP-1 for an extended period of time using our patented Atrigel drug delivery system. Additionally, under the terms of the Tulane agreement, we will pay Tulane a royalty on sales of any GHRP-1 product that may be developed and subsequently marketed. We will fund the research and development and perform most of the development effort.

We signed a licensing agreement for an oral interferon product with Amarillo Biosciences in September 2001 for \$0.5 million. We are currently developing this product for the treatment of oral warts caused by human papilloma virus in HIV-infected patients and for the treatment of Behcet's disease. Behcet's disease is an autoimmune disorder that is characterized by mouth ulcers and generally two additional hallmark symptoms. The FDA granted the oral interferon product orphan drug status for both indications in January 2000. In November 2001, we submitted an IND to the FDA to proceed into human clinical studies for the treatment of oral warts and we commenced a Phase II clinical study for this product in the first quarter of 2002.

Significant Capital Funding Events in 2001

During the year ended December 31, 2001, we sold 3,565,000 shares of our common stock at a price of \$23.00 per share under our shelf registration statement in two underwritten public offerings. The underwriters exercised their option to purchase 534,750 additional shares of our common stock in connection with our public offerings. We received net proceeds of \$87.7 million from our public offerings and the over-allotment exercises, net of issuance costs of \$6.6 million. We anticipate using the net proceeds from the offerings to broaden and strengthen our technologies, supplement our product pipeline, and further product development efforts.

Effective September 17, 2001, our Board of Directors approved a new stock repurchase program to acquire up to \$5.0 million of our common stock. The stock repurchase program expires in May 2002. During the year ended December 31, 2001, we repurchased a total of 77,500 shares of our common stock in the open market for \$1.6 million, or an average share price of \$20.11.

During the year ended December 31, 2001, we completed a series of private transactions involving the exchange of 1,725,735 shares of our common stock for \$31.0 million of our 7% Convertible Subordinated Notes.

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The following table details certain information about our pharmaceutical products and products under development:

Pharmaceutical Product Candidates	Delivery System	Indication	Status	Collaborative Partner(s)
Eligard 7.5-mg one-month	Atrigel	Prostate cancer	FDA approved Jan. 2002; Germany MAA submitted to BfArM Dec. 2001	Sanofi-Synthelabo, MediGene, Faulding
Eligard 22.5-mg three-month	Atrigel	Prostate cancer	NDA submitted to FDA Sept. 2001	Sanofi-Synthelabo, MediGene, Faulding
Eligard 30-mg four-month	Atrigel	Prostate cancer	Phase III	Sanofi-Synthelabo, MediGene, Faulding
Eligard unique dosage formulation	Atrigel	Prostate cancer	Preclinical	Sanofi-Synthelabo
Atrisone	SMP	Moderate to severe acne Treatment for burn itch Treatment of atopic dermatitis	Phase III Phase II IND submitted	Fujisawa Healthcare None None
Growth hormone releasing peptide-1	Atrigel	Growth promotion and cachexia, or muscle wasting	Preclinical	Tulane University Health Science Center
HGSI proprietary protein	Atrigel	Undisclosed compound	Preclinical	Human Genome Sciences
BEMA-Fentanyl	BEMA	Chronic and breakthrough cancer pain	Phase I Orphan drug status	Amarillo Biosciences
BEMA-Ondanestron	BEMA	Nausea and vomiting associated with cancer chemotherapy	Preclinical	Elan
BEMA-Hydrocodone	BEMA	Mild to moderate pain	Preclinical	None
BEMA-Migraine	BEMA	Migraine	Preclinical	None
Oral interferon	Lozenge	Behcet's disease Oral warts	Preclinical Phase II Orphan drug status for both	Amarillo Biosciences

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We currently market two dental drug products, two medical device dental products and two over-the-counter, or OTC, drug products. The following table provides a summary of our marketed dental and OTC products and products under development:

Dental/OTC Products	Delivery System	Indication	Status	Collaborative Partner(s)
Atridox	Atrigel	Antibiotic therapy for chronic periodontitis	Marketed Launched 1998	CollaGenex, Sidus, PharmaScience, Genmedix
Atrisorb-Doxycycline FreeFlow GTR Barrier	Atrigel	Tissue regeneration and infection reduction following periodontal surgery	Marketed Launched Jan. 2002	CollaGenex, Pharmascience
Atrisorb FreeFlow GTR Barrier	Atrigel	Tissue regeneration following periodontal surgery	Marketed Launched 1998	CollaGenex, Pharmascience
Atrisorb GTR Barrier	Atrigel	Tissue regeneration following periodontal surgery	Marketed Launched 1996	Product being phased out
Doxirobe® Gel	Atrigel	Periodontitis in companion animals	Marketed Launched 1997	Pharmacia & Upjohn Animal Health
BCP topical antibiotic and wound wash	BCP	Infection protection and minor cuts and abrasions	Future OTC products	None
Viractin® cream and gel	Other	Cold sores and fever blisters	Marketed OTC product	J.B. Williams Company
Orajel-Ultra®	MCA	Canker sores	Marketed OTC product	Del Pharmaceuticals

Pharmaceutical Product Candidates***Eligard Products***

We are developing our proprietary Eligard products for prostate cancer incorporating a leutinizing hormone-releasing hormone, or LHRH, agonist with our proprietary Atrigel drug delivery system. The Atrigel technology allows for sustained delivery of leuprolide acetate for periods ranging from one month to approximately six months.

Numerous clinical trials have demonstrated that the sustained release of a LHRH agonist decreases testosterone levels to suppress tumor growth in patients with hormone-responsive prostate cancer. The Eligard 7.5-mg one-month and the Eligard 22.5-mg three-month Phase III results revealed low testosterone levels with 100% of patients achieving and maintaining castrate suppression by the conclusion of the studies.

Our Eligard products are injected subcutaneously as a liquid with a small gauge needle. The polymers precipitate after injection, forming a solid implant in the body that slowly releases the leuprolide as the implant is bioabsorbed. We believe our Eligard products are safe and effective in treating prostate cancer and offer advantages to the patient, including a smaller needle and subcutaneous, rather than the more painful intramuscular, injection delivery.

According to the American Cancer Society, prostate cancer is the most common cancer, excluding skin cancers, in American men. It is estimated that during the year 2002, approximately 189,000 new cases of prostate cancer will be diagnosed in the United States and an estimated 30,200 men will die of the disease. Approximately one man in six will be diagnosed with prostate cancer during his lifetime.

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Eligard 7.5-mg One-Month Product

We received FDA approval of Eligard 7.5-mg one-month product in January 2002. FDA approval of our Eligard 7.5-mg one-month marketing materials, including labeling, will need to be obtained before Sanofi-Synthelabo commences marketing this product in the United States. We anticipate that the Eligard 7.5-mg one-month marketing launch will commence in the third quarter of 2002.

In December 2001, MediGene submitted an MAA, for our Eligard 7.5-mg one-month product to the German regulatory authority, BfArM, as a reference member state under a mutual recognition process. If approval is obtained in the Reference State, MediGene intends to submit a modified MAA to specific concerned member states in the European Union for marketing approval in other key countries.

Eligard 22.5-mg Three-Month Product

We submitted an NDA for Eligard 22.5-mg three-month product to the FDA in September 2001. Once the submission is accepted by the FDA for filing, the FDA begins an in-depth review of the NDA. Under the Food, Drug and Cosmetic Act, and User Fee legislation, the FDA has up to twelve months in which to review the NDA and respond to the applicant.

Eligard 30-mg Four-Month Product

In March 2001, we completed enrollment for a Phase III clinical trial of our Eligard 30-mg four-month product. The Phase III clinical trial is being conducted at 22 centers with each of the 90 patients receiving an Eligard 30-mg injection every four months over an eight-month period. We expect to submit an NDA for the Eligard 30-mg product in the second quarter of 2002.

Eligard Unique Dosage Formulation Product

Our Eligard unique dosage formulation product for prostate cancer is currently in preclinical development. If these experiments demonstrate that leuprolide acetate is delivered safely and effectively over an approximately six-month period, we expect to enter Phase III clinical trials in the third quarter of 2002.

Atrisone

We are currently developing Atrisone, our proprietary product for the treatment of acne and the itching associated with healing burn wounds. Atrisone incorporates dapsone, an anti-inflammatory and antimicrobial drug, with our proprietary SMP drug delivery system. Dapsone is a potent antibiotic with a separate anti-inflammatory activity, which reduces inflammation associated with acne. The goal for Atrisone is topical application to the acne lesion so as to reduce any potential side effects, such as anemia. After topical application, the blood levels of dapsone are 500 to 1,000 times less than found when the compound is administered orally, thus significantly reducing the potential for systemic side effects.

Enrollment for the first of two Atrisone Phase III clinical trials was completed in October 2001. The first Phase III clinical trial consisted of 500 patients at 19 centers comparing 5% dapsone applied twice a day to a vehicle control. In the first quarter of 2002, we received positive clinical data from the first Phase III clinical trial for Atrisone and we expect to commence a second Phase III clinical trial in the second quarter of 2002.

According to IMS data, the U.S. market for topical products to treat acne was \$600 million in 2000, with the combined oral and topical market at more than \$1 billion.

Additional indications of Atrisone include treatment of chronic itch associated with healed and healing burn wounds and atopic dermatitis. Positive pilot data for use in burn itch was reported in October 2001 and is currently in Phase II clinical trials. In May 2001, we submitted an IND to the FDA for the use of Atrisone in the treatment of atopic dermatitis. Atopic dermatitis is a common chronic skin condition in children and adults and is characterized by dryness, erythema and extreme itch.

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Growth Hormone Releasing Peptide-1

We are developing a sustained release GHRP-1 product utilizing our Atrigel drug delivery system. This proprietary compound promotes the pulsatile release of the body's own growth hormone from the pituitary gland. GHRP-1 represents the first of a new class of small synthetic peptides, and we believe the pulsatile delivery of growth hormone produced by GHRP-1 offers advantages over current methods of administration of growth hormone because pulsatile delivery more closely mirrors the natural physiological mechanism. We have begun preclinical studies for the GHRP-1 product. Applications for human growth hormones and/or promoting compounds include inhibition of cachexia, or extensive muscle and tissue wasting, in patients whose immune systems are compromised, such as patients with AIDS or other immune system disorders, or patients receiving cancer treatments, promotion of growth in children of short stature, and possibly prevention of muscle wasting and frailty in aged individuals. We exercised an option to license GHRP-1 from Tulane University Health Sciences Center in September 2001. GHRP-1 is currently in the preclinical stage of research and development and will utilize our Atrigel delivery technology. We anticipate submitting an IND to the FDA for this product and commencing a Phase I clinical safety study in the second quarter of 2002.

HGSI Proprietary Protein

We have entered into a feasibility study agreement with Human Genome Sciences, a pioneer in the discovery and development of genomics-based drugs, to develop a sustained-release formulation of a Human Genome Sciences new proprietary protein utilizing our Atrigel drug delivery system. Under the terms of the agreement, Human Genome Sciences will provide funding for the project.

BEMA-Fentanyl

Through our joint venture with Elan, we are developing BEMA-Fentanyl, which uses our proprietary BEMA drug delivery system with fentanyl, an opiate analgesic, for breakthrough cancer pain and potentially the management of chronic pain. The BEMA delivery system is a polymer-based system designed to deliver systemic levels of drugs rapidly across oral or vaginal mucosal tissues. The system consists of a thin, semi-soft bioerodible multi-layer disc of various polymers which adheres readily to the mucosal tissues. The BEMA disc softens upon contact with moisture and erodes away over approximately 10 to 20 minutes as it delivers the drug. In November 2001, we submitted an IND to the FDA and commenced a Phase I clinical safety study for BEMA-Fentanyl.

BEMA-Ondansetron

Through our joint venture with Elan, we are also developing an anti-emetic product using the BEMA system, for the prevention of nausea and vomiting associated with cancer chemotherapy. Preclinical studies have shown that the BEMA technology rapidly delivers the drug to the systemic circulation with sustained levels to six hours. The levels achieved in these preclinical studies were significantly higher and provided a more extended release profile than the oral dosage form.

BEMA-Hydrocodone

We are developing a BEMA-Hydrocodone product using our BEMA system with hydrocodone bitartrate, a narcotic analgesic used for the treatment of mild to moderate pain. In combination with acetaminophen or ibuprofen, products containing hydrocodone were the most prescribed generic oral drug products in 2000. These products are oral tablets requiring at least one hour or more to achieve efficacious blood levels after administration. We believe that a non-injectible drug product containing hydrocodone with a rapid onset of action would have definite advantages over these current oral products. Preclinical results with BEMA discs containing hydrocodone bitartrate have shown rapid absorption of the drug with efficacious blood levels in 15 minutes. We anticipate submitting an IND to the FDA for this product and commencing a Phase I clinical safety study in the second quarter of 2002.

BEMA-Migraine

We are exploring the development of a migraine product utilizing the BEMA drug delivery system with

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various migraine treatment compounds to provide rapid relief for migraine headaches, with a rapid onset comparable to that of injections. Imitrex (Sumatriptan) dominates the U.S. market for migraine products with sales of \$1.0 billion, according to IMS Health. A significant problem with Imitrex and other triptans on the market is their inability to provide pain relief as quickly as desired. Intramuscular injection provides rapid relief, but many patients do not favor this painful method of administration. Preclinical studies with the BEMA delivery system and a number of migraine treatment compounds have shown the potential for rapid absorption and improved bioavailability compared to oral administration. We anticipate submitting an IND to the FDA for this product and commencing a Phase I clinical safety study in the second quarter of 2002.

Oral Interferon

We are currently developing an oral interferon product for the treatment of oral warts caused by human papilloma virus in HIV-infected patients and for the treatment of Behcet's disease. Behcet's disease is an autoimmune disorder that is characterized by mouth ulcers and generally two additional hallmark symptoms. Low-dose orally administered interferon is administered as a lozenge, which dissolves slowly in the mouth. The FDA granted the oral interferon product orphan drug status for both indications in January 2000. We signed a licensing agreement for the oral interferon product with Amarillo Biosciences in September 2001. In November 2001, we submitted an IND to the FDA to proceed into human clinical studies for the treatment of oral warts and we commenced a Phase II clinical study in the first quarter of 2002.

Dental and Over-the-Counter Products

Dental Products

We have a number of approved products that target the dental market. Atridox, which combines the Atrigel system and the antibiotic doxycycline, is a minimally invasive treatment intended to control the bacteria that causes periodontal disease. Atridox was awarded the American Dental Association Seal of Acceptance which is an important symbol to dentists and consumers that signifies a dental product's safety, effectiveness and the scientific validity of its health benefits.

Our Atrisorb-D product also uses the Atrigel system with the antibiotic doxycycline to address infections following periodontal surgery and thereby improve healing. Atrisorb-D is a biodegradable polymer that utilizes the Atrigel system to aid in the guided tissue regeneration of a tooth's support following osseous flap surgery or other periodontal procedures.

In addition to these dental products, Pharmacia & Upjohn Company currently has the worldwide marketing right of our Doxirobe Gel product, a periodontal disease treatment for companion animals, which is comprised of the antibiotic doxycycline and the Atrigel system.

Net sales and royalties for our dental products in the years ended December 31, 2001, 2000 and 1999 were approximately \$2.4 million, \$4.7 million, and \$4.1 million, respectively.

Over-The-Counter Products

Over-the-counter products which are currently being marketed include Viractin Cold Sore & Fever Blister Medicine and Orajel-Ultra Mouth Sore Medicine, which utilizes our proprietary MCA drug delivery system. Viractin is marketed by J.B. Williams Company and Orajel-Ultra is marketed by Del Pharmaceuticals. We receive royalties on the sales of these two products.

The BCP delivery system, composed of polymers, solvents and active agents carefully selected for their low toxicity to skin cells, can be formulated as either film-forming gels or liquids for topical applications. BCP gels are non-greasy, non-staining formulations that can be applied to wounded or denuded skin to deliver a drug, such as an antibiotic, and then dry to form a non-constricting, protective film over the wound. The gels have the unique property of maintaining an ideal wound-healing environment by removing excess moisture from exudative wounds and transferring moisture from the gel into the wounds that are too dry. Liquid BCP formulations are designed to provide effective cleansing of topical wounds or

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denuded skin without causing further trauma to the skin, thereby promoting faster healing with minimal scarring. The first two products in development utilizing the BCP technology are a topical antibiotic preparation (with and without local anesthetic) for superficial wound healing and a wound-washing solution for cleansing dirty wounds.

Our Drug Delivery Technologies

The following chart provides a brief description of our drug delivery systems:

Technology	Description	Application
Atrigel System	Biodegradable sustained release implant for local or systemic delivery.	Delivery of drugs from weeks to months.
Bioerodible Mucoadhesive Film System (BEMA)	Bioerodible film for fast-acting local or systemic delivery	Delivery of drugs from minutes to hours through mucosal membranes.
Solvent Microparticle System (SMP)	Topical gel providing two-stage dermal delivery	Delivery of water insoluble drugs through the skin.
Mucocutaneous Absorption System (MCA)	Water resistant topical gel providing sustained delivery.	Film for either wet or dry surfaces.
Biocompatible Polymer System (BCP)	Non-cytotoxic gel/liquid for topical delivery. Non-cytotoxic means the material does not kill cells or tissue in the body.	Protective gel film for wound healing and liquid formulation for wound washing

Atrigel System

The Atrigel drug delivery system consists of biodegradable polymers, similar to those used in biodegradable sutures, dissolved in biocompatible carriers. Pharmaceuticals may be blended into this liquid delivery system at the time of manufacturing or, depending upon the product, may be added later by the physician at the time of use. When the liquid product is injected subcutaneously or intramuscularly through a small gauge needle or placed into accessible tissue sites through a cannula, displacement of the carrier with water in the tissue fluids causes the polymer to precipitate to form a solid film or implant. The drug encapsulated within the implant is then released in a controlled manner as the polymer matrix biodegrades with time. Depending upon the patient's medical needs, the Atrigel system can deliver small molecules, peptides, or proteins over a period ranging from days to months.

We believe that the Atrigel system addresses many of the limitations associated with traditional drug delivery technologies. Most drugs are administered orally or by injection at intermittent and frequent doses. These routes of administration are not optimal for several reasons, including:

destruction of the compound in the gastrointestinal system,

difficulty in maintaining uniform drug levels over time,

problems with toxicity and side effects,

high costs due to frequent administration, and

poor patient compliance.

Furthermore, innovations in biotechnology have led to an increase in the number of protein and peptide drugs under development. These therapeutics, because of their larger molecular size and susceptibility to degradation in the gastrointestinal tract, often are required to be administered by multiple injections, usually in a hospital or other clinical setting. We cannot provide assurance that future products using the Atrigel system will be successfully developed and approved by the FDA or cleared for commercial use.

We believe that the Atrigel system may provide benefits over traditional methods of drug administration such as tablets or capsules, injections and continuous infusion as a result of the following properties:

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Broad Applicability The Atrigel system is compatible with a broad range of pharmaceutical compounds, including water soluble and insoluble compounds and high and low molecular weight compounds, including peptides and proteins.

Site Specific Drug Delivery The Atrigel system can be delivered directly to a target area, thus potentially achieving higher drug concentrations at the desired site of action to minimize systemic side effects.

Systemic Drug Delivery The Atrigel system can also be used to provide sustained drug release into the systemic circulation.

Customized Continuous Release and Degradation Rates The Atrigel system can be designed to provide continuous release of incorporated pharmaceuticals over a targeted time period so as to reduce the frequency of drug administration.

Biodegradability The Atrigel system will biodegrade and does not require removal when the drug is depleted.

Ease of Application The Atrigel system can be injected or inserted as flowable compositions, such as solutions, gels, pastes, and putties, by means of ordinary needles and syringes, or can be sprayed or painted onto tissues.

Safety All current components of the Atrigel system are biocompatible and have independently established safety and toxicity profiles. The polymers used in the system are members of a class of polymers, some of which have previously been approved by the FDA for human use in other applications.

Bioerodible Mucoadhesive System

The Bioerodible Mucoadhesive, or BEMA, system is a proprietary polymer-based system designed to deliver systemic levels of drugs rapidly across oral or vaginal mucosal tissues. The semi-soft BEMA disc adheres readily to the mucosa, where it softens further on contact with moisture, rapidly becoming unnoticeable as it delivers the drug and erodes away in approximately 10 to 20 minutes. The BEMA system is versatile and can incorporate a wide variety of drugs, including proteins and peptides. The compound can be loaded into the mucoadhesive layer for delivery into the mucosal tissue, while minimizing drug release into surrounding tissues or cavities. The drug may also be loaded into the backing layer to provide more controlled release into the oral or vaginal cavity.

Various properties of the BEMA products, such as residence time, bioerosion kinetics, taste, shape and thickness can be modified to the desired level to customize drug delivery to the medical need and patient needs. The BEMA technology has potential applications in pain management, anti-migraine compounds and anti-emetics, all of which require rapid onset of action and avoidance of first-pass metabolism.

Solvent/Microparticle System

The Solvent/Microparticle, or SMP, technology consists of a two-stage system designed to provide topical delivery of highly water-insoluble drugs to the skin. The combination of dissolved drug with a microparticle suspension of the drug in a single formulation allows a controlled amount of the dissolved drug to permeate into the epidermal layer of the skin, while a high level of the microparticle drug is maintained just above the outermost layer of the skin for later delivery. The consistent microparticle size and distribution maximize drug delivery while minimizing crystal growth over the shelf life of the product.

Mucocutaneous Absorption System

The Mucocutaneous Absorption, or MCA, delivery system can be formulated as either alcohol-based gels or as aerosols for the localized delivery of drugs to the skin or mucosal tissues. The MCA formulations can be applied to dry, damp or even wet skin or mucosal surfaces. Because of the novel blend of cellulose

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polymers dissolved in alcohol, they quickly dry to form moisture-resistant films that can deliver drugs and/or promote healing. Depending on the desired application, the MCA products can be formulated to form opaque films to highlight the area of treatment, or to transparent films that are more cosmetically acceptable. The MCA formulations can be easily flavored to mask the taste of active ingredients for oral products and are compatible with liquid spray applicators.

Biocompatible Polymer System

The Biocompatible Polymer, or BCP system, composed of polymers, solvents and actives carefully selected for their low toxicity to skin cells, can be formulated as either film-forming gels or liquids for topical applications. The BCP gels are non-greasy, non-staining formulations that can be applied to wounded or denuded skin to deliver a drug, such as an antibiotic, and then dry to form a non-constricting, protective film over the wound. We believe the gels have the unique property of maintaining an ideal wound-healing environment by removing excess moisture from exudative wounds and transferring moisture from the gel into wounds that are too dry. The liquid BCP formulations are designed to provide effective cleansing of topical wounds or denuded skin without causing further trauma to the skin, thereby promoting faster healing with minimal scarring.

Research and Development

Our strategic goal is to devote substantial resources to our medical research and development efforts with the expectation of quickly moving products from the development stage to commercialization. During the year ended December 31, 2001, we continued to devote significant resources to the research and development of our Eligard and Atrisone products. Currently, we have multiple compounds in various stages of preclinical development, a number of which are being developed through partnerships with a variety of external companies. For example, we have multiple undisclosed compounds in preclinical development with Pfizer. Most of these projects are preliminary in nature and we cannot predict whether any of them will be commercialized.

We submitted an NDA to the FDA in March 2001 for the Eligard 7.5-mg one-month product and we received FDA approval to market this product in January 2002. In September 2001, we submitted an NDA for the Eligard 22.5-mg three-month product and in March 2001, we completed patient enrollment in the Eligard 30-mg four-month product Phase III clinical trials.

GHRP-1 is currently in the preclinical stage of research and development and will utilize our Atrigel delivery technology. GHRP-1 is the first of a new class of small synthetic peptides that promotes release of the patient's own growth hormone.

Atrisone for the treatment of acne is in Phase III clinical studies. In the first quarter of 2002, we received positive clinical data from the first Phase III clinical trial and we expect to commence a second Phase III clinical trial in the second quarter of 2002. We are currently in Phase II for the use of Atrisone for the treatment of chronic itch associated with healed and healing burn wounds and reported positive pilot data for use in burn itch in October 2001. In May 2001, we submitted an IND to the FDA for the use of Atrisone in the treatment of atopic dermatitis.

Through our joint venture with Elan, we are researching and developing BEMA-Fentanyl using our BEMA drug delivery system. In November 2001, we submitted an IND to the FDA for BEMA-Fentanyl and commenced a Phase I clinical safety study for BEMA-Fentanyl. Also through our joint venture with Elan, we are developing BEMA-Ondansetron, which is currently in preclinical studies.

We are developing a BEMA-Hydrocodone product using our BEMA system with hydrocodone bitartrate. Preclinical results with BEMA discs containing hydrocodone bitartrate have shown rapid absorption of the drug with efficacious blood levels in 15 minutes. We anticipate submitting an IND to the FDA for this product and commencing a Phase I clinical safety study in the second quarter of 2002.

We are exploring the development of a migraine product utilizing the BEMA drug delivery system with various migraine treatment compounds. Preclinical studies with the BEMA delivery system and a number of migraine treatment compounds have shown the potential for rapid absorption and improved

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bioavailability compared to oral administration. We anticipate submitting an IND to the FDA for this product and commencing a Phase I clinical safety study in the second quarter of 2002.

A low-dose oral interferon product for the treatment of oral warts caused by human papilloma virus in HIV-infected patients is in Phase II clinical studies, and as a treatment for Behcet's disease, it is in the preclinical stage of research and development.

We are also developing a targeted set of generic topical dermatology products with Geneva. We have completed several formulations and, in December 2001 and January 2002, we submitted ANDAs to the FDA for approvals of two separate generic dermatology products.

Our research and development expenses, including licensing fees of \$3.0 million in 2001 for GHRP-1 and oral interferon, were \$28.6 million, \$16.7 million and \$15.6 million for the years ended December 31, 2001, 2000 and 1999, respectively.

Collaborative arrangements

We form strategic alliances with major pharmaceutical and biotechnology companies utilizing our various drug delivery systems. Our significant strategic alliances include Pfizer, Sanofi-Synthelabo, MediGene, Fujisawa Healthcare, Elan, Geneva and CollaGenex.

Pfizer, Inc.

In August 2000, we executed a non-exclusive comprehensive research and worldwide licensing agreement with Pfizer to provide broad-based access to our proprietary drug delivery systems in the development of new products. Pfizer will provide funding to develop and commercialize selected compounds developed by Pfizer using our patented drug delivery technologies. We retained co-manufacturing rights and will receive royalties on the sales of products that are successfully developed and commercialized under this agreement. Pfizer purchased 447,550 shares of our common stock for \$5.0 million as part of the agreement. As of December 31, 2001, all products under the Pfizer agreement were in preclinical stages of development.

Sanofi-Synthelabo, Inc.

In December 2000, we entered into an exclusive North American marketing agreement with Sanofi-Synthelabo, for our Eligard one-, three-, and four-month prostate cancer treatment products. Under the terms of the agreement, we will manufacture the Eligard products and receive an agreed upon transfer price from Sanofi-Synthelabo as well as royalties from sales. In addition, we received an up-front licensing fee of \$8.0 million and will receive research and development support if Sanofi-Synthelabo exercises its option with respect to additional indications of the Eligard products. As part of the agreement, Sanofi purchased 824,572 shares of our common stock for \$15.0 million. Total proceeds under the Sanofi agreement provides for payments of up to \$60.0 million, including the purchase of our common stock, the licensing fees and payments for clinical, regulatory and sales milestones for the Eligard products upon approval for marketing by the FDA. For the year ended December 31, 2001, we received \$6.0 million from Sanofi for milestone payments upon FDA acceptance of our Eligard 7.5-mg one-month and Eligard 22.5-mg three-month NDA filings. In January 2002, Sanofi exercised its option to develop an Eligard unique dosage formulation product.

MediGene AG

In April 2001, we entered into an exclusive European marketing agreement with MediGene AG, a German biotechnology company, to market our Eligard one-month, three-month and four-month products. MediGene also has the right to develop the Eligard unique dosage formulation product. Under the terms of the agreement, we will manufacture the Eligard products and we will receive additional payments for certain clinical, regulatory and sales milestones and royalties from sales. Pursuant to the agreement, we received an up-front licensing fee of \$2.0 million. MediGene purchased 233,918 shares of our common stock for \$3.8 million. Additionally, MediGene will provide funding to conduct clinical, research and regulatory activities associated with seeking European marketing approvals. The MediGene agreement

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provides for payments of up to \$16.0 million including MediGene's purchase of our common stock, the licensing fee and payments for certain clinical, regulatory and sales milestones. In December 2001, MediGene submitted an MAA, for our Eligard 7.5-mg one-month product to the German regulatory authority, BfArM, as a reference member state under a mutual recognition process.

Fujisawa Healthcare, Inc.

In October 2001, we entered into a collaboration, license and supply agreement with Fujisawa, for the exclusive North American marketing and distribution rights of our Atrisone acne treatment product. The Fujisawa agreement provides for payments of up to \$25 million for an up-front licensing fee and certain milestone payments. Additionally, we will receive a royalty on net sales of the Atrisone product and a manufacturing margin. In October 2001, we received a \$2.0 million up-front licensing fee from Fujisawa.

Elan International Services, Ltd.

In July 2000, we formed a joint venture with Elan International Services, Ltd., a wholly owned subsidiary of Elan Corporation, plc, for the purpose of developing and commercializing oncology and pain management products. This joint venture, Transmucosal Technologies, Ltd., will use our patented BEMA and Atrigel drug delivery systems to deliver compounds targeted for major unmet medical needs in oncology and pain management. As a part of this agreement, we granted the joint venture an exclusive license to use our BEMA technology in these fields. The first compound selected was the opiate analgesic, fentanyl, using our BEMA drug delivery system for breakthrough cancer pain and management of chronic pain. Currently, BEMA-Fentanyl is in Phase I clinical studies. In March 2001, BEMA-Ondansetron, an anti-emetic product, was selected as the second compound under development in the joint venture. The BEMA-Ondansetron product is for the prevention of nausea and vomiting associated with cancer chemotherapy and is currently in preclinical studies. As part of our agreement, Elan may provide funding to develop this and any future selected compounds. Initially, we are the majority-owner of this joint venture.

In connection with the formation of the joint venture, Elan purchased 12,015 shares of our Series A Convertible Exchangeable Preferred Stock for \$12.0 million and 442,478 shares of our common stock for \$5.0 million, and received a five-year warrant to purchase up to one million shares of our common stock at an exercise price of \$18 per share. The Series A Convertible Exchangeable Preferred Stock is convertible at any time after July 2002, at Elan's option, into shares of our common stock at a price equivalent to \$18 per share. In the event of a merger or the sale of our common stock in an underwritten public offering, we have the option to convert the Series A Convertible Exchangeable Preferred Stock into shares of our common stock. Alternatively, Elan has the option to exchange this preferred stock for a 30.1% interest in the joint venture. This exchange option will terminate if the preferred stock is converted into our common stock unless we cause the conversion. We must redeem this preferred stock in July 2006 for either cash or shares of our common stock, at our option, in an amount or value equal to the liquidation preference.

As part of our agreement, Elan may loan us up to \$8.0 million to support our share of the joint venture's research and development costs pursuant to a convertible promissory note we issued to Elan. The convertible promissory note has a maximum principal amount of \$8.0 million and is due in July 2006. The note is convertible into shares of our common stock at a conversion price of \$14.60 per share, subject to adjustment as provided in the note agreement. As of December 31, 2001, we have not drawn any amounts under the convertible promissory note and we do not expect to draw down any amounts under this note.

Our revenues from the joint venture were \$4.1 million, \$0.3 million and \$0 for the years ended December 31, 2001, 2000 and 1999, respectively.

Geneva Pharmaceuticals, Inc.

In August 2000, we entered into a collaboration, development and supply agreement with Geneva Pharmaceuticals, Inc., a subsidiary of Novartis, to conduct research and development activities on a collaborative basis to develop designated generic topical prescription dermatology products. Under the agreement, we will be responsible for validation, formulation, development and required clinical studies of selected products. This collaboration extends to the United States, although additional territories may be added at a later date. Geneva will be responsible for market research and commercialization of the

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products. Geneva will reimburse us for 50% of the research and development expenses we incur and both parties will share equally in the net profits from the sale of the products. In December 2001 and January 2002, we submitted ANDAs to the FDA for approvals of two separate generic dermatology products.

CollaGenex Pharmaceuticals, Inc.

In August 2001, we licensed the exclusive U.S. marketing rights of our dental products to CollaGenex, following the reacquisition of the sales and marketing rights from Block. Under the terms of the CollaGenex agreement, we received \$1.0 million for an up-front licensing fee. Additionally, we will receive a royalty on product sales and a manufacturing margin. As part of the transaction, we purchased 330,556 shares of CollaGenex's common stock for \$3.0 million, the proceeds of which CollaGenex will use primarily to fund a revitalized marketing campaign for the dental products. CollaGenex commenced U.S. marketing of Atridox and Atrisorb FreeFlow in November 2001 and Atrisorb-D marketing in January 2002.

International Operations

In February 2000, our wholly owned registered subsidiary, Atrix Laboratories GmbH, based in Frankfurt, Germany, commenced operations. Atrix Laboratories GmbH was organized to conduct our European dental operations. Currently, the subsidiary has three employees whose objective is to establish business relations with international distributors for the sale of Atridox upon mutual recognition of the product in key countries. Atrix Laboratories Limited, our wholly owned registered subsidiary, is based in London, England, and was organized in June 1999. Atrix Laboratories Limited, currently holds the marketing authorization for international sales of Atridox. To date, we have received individual marketing authorizations in fourteen European countries. Our German subsidiary commenced Atridox European sales in October 2000.

In December 2001, we signed an exclusive marketing agreement with PharmaScience, Inc., for the marketing and distribution of our dental products in Canada.

MediGene submitted an MAA, for our Eligard 7.5-mg one-month product to the German regulatory authority, BfArM, as a reference member state under a mutual recognition process in December 2001. If approval is obtained in the reference member state, MediGene will submit a modified MAA to specific concerned member states in the European Union for marketing approval in other key countries.

Our revenues from foreign sources, including the joint venture with Elan, were \$5.5 million, \$1.2 and \$0.8 million for the fiscal years ended December 31, 2001, 2000 and 1999, respectively.

Patents and Trademarks

We consider patent protection and proprietary position to be significant to our business. As of December 31, 2001, we maintained 46 United States patents and 63 foreign patents, and 28 United States and 59 foreign patent applications are pending. A number of the claims contained in these patents and pending patent applications cover certain aspects of our drug delivery technologies, including the Atrigel, BEMA, SMP, MCA and BCP drug delivery technologies, and products based upon these technologies, including the Eligard, Atrisone, Atridox, Atrisorb-D, Atrisorb FreeFlow and Atrisorb GTR Barrier products.

Notwithstanding our pursuit of patent protection, others may develop delivery systems, compositions and/or methods that infringe our patent rights resulting from outright ownership or non-revocable exclusive licensure of patents which relate to our delivery systems, composition and/or methods. In that event, such delivery systems, compositions and methods may compete with our systems, compositions and methods and may adversely affect our operations. Furthermore, patent protection may not afford adequate protection against competitors with similar systems, composition or methods, and our patents may be infringed or circumvented by others. Moreover, it may be costly to pursue and to prosecute patent infringement actions against others, and such actions could hamper our business. We also rely on our unpatented proprietary knowledge. Others may be able to develop substantially equivalent proprietary knowledge or otherwise obtain access to our knowledge, and our rights under any patents may not afford sufficient protection.

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Our patents expire at various times between 2008 and 2019. The following table sets forth the number of patents expiring in each year:

Year Expiring	U.S. Patents	Foreign Patents	Total Patents
2008	7		7
2009	2	23	25
2010		17	17
2011	7		7
2012		14	14
2013	3		3
2014	6	1	7
2015	8	4	12
2016	4	1	5
2017	2	2	4
2018	6		6
2019	1	1	2
	<hr/>	<hr/>	<hr/>
Total	46	63	109
	<hr/>	<hr/>	<hr/>

In addition to patents, we also maintain several United States and numerous foreign trademark and service mark applications for registrations of our name, logo, drug delivery systems and products. These include eight U.S. and 38 foreign issued trademarks, with seven U.S. and 24 foreign applications pending.

Drug Delivery Industry

Drug delivery companies apply proprietary technologies for the improved administration of therapeutic compounds. These products could potentially provide various benefits, including better control of drug concentration in the blood, improved safety and efficacy, improved patient compliance, and ease of use. Additionally, alternative drug delivery technologies can be utilized to extend existing patent franchises, to expand markets for existing products, as well as to develop new products. The increasing need to deliver medication to patients efficiently and with fewer side effects has accelerated the pace of competition within the drug delivery industry.

We believe focusing on drug delivery for existing drugs is less risky than attempting to discover new drugs. Drug discovery is more costly and more time consuming in comparison with drug delivery of existing drugs. For instance, our clinical trials need only to demonstrate that our carrier technology delivers the drug without harming the patient or changing the clinical attributes of the drug.

In addition, focusing on drug delivery compared to drug discovery allows us to form a number of collaborations to deliver a wide variety of medicines without limiting our proprietary technology rights.

Customers

Our customers include such companies as Pfizer, Sanofi, Fujisawa and Geneva. During 2001, Transmucosal Technologies and Block accounted for 26% and 22%, respectively, of our total revenues. The distribution network for pharmaceutical products is subject to increasing consolidation. As a result, a few large distributors control a significant share of the market. In addition, the number of independent drug stores and small chains has decreased as retail co>

Proceeds from sales of and distributions from companies
3,257

15,753

Acquisitions of ownership interests in companies

—
(4,476

)

Advances and loans to companies

(4,036

)

(6,429

)

Repayment of advances and loans to companies

10,500

—

Decrease in marketable securities

1,410

10,268

Net cash provided by investing activities

11,131

15,116

Cash Flows from Financing Activities:

Issuance of Company common stock, net

—

10

Tax withholdings related to equity-based awards

(150

)

(100

)

Net cash used in financing activities

(150

)

(90

)

Net change in cash, cash equivalents and restricted cash equivalents

4,207

8,485

Cash, cash equivalents and restricted cash equivalents at beginning of period

27,087

28,394

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Cash, cash equivalents and restricted cash equivalents at end of period

\$

31,294

\$

36,879

See Notes to Consolidated Financial Statements.

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SAFEGUARD SCIENTIFICS, INC.
CONSOLIDATED STATEMENT OF CHANGES IN EQUITY
(Unaudited – In thousands)

	Total	Accumulated Deficit	Accumulated Other Comprehensive Loss	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Treasury Stock Shares	Treasury Stock Amount
Balance - December 31, 2017	\$81,796	\$(715,476)	\$ (113)	21,573	\$2,157	\$812,536	999	\$(17,308)
Net loss	(6,170)	(6,170)	—	—	—	—	—	—
Issuance of restricted stock, net of tax withholdings	(150)	—	—	—	—	(17)	13	(133)
Stock-based compensation expense	277	—	—	—	—	277	—	—
Other comprehensive income	82	—	82	—	—	—	—	—
Balance - March 31, 2018	\$75,835	\$(721,646)	\$ (31)	21,573	\$2,157	\$812,796	1,012	\$(17,441)

See Notes to Consolidated Financial Statements.

SAFEGUARD SCIENTIFICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. General

The accompanying unaudited interim Consolidated Financial Statements of Safeguard Scientifics, Inc. (“Safeguard” or the “Company”) were prepared in accordance with accounting principles generally accepted in the United States of America and the interim financial statement rules and regulations of the SEC. In the opinion of management, these statements include all adjustments (consisting only of normal recurring adjustments) necessary for a fair presentation of the Consolidated Financial Statements. The interim operating results are not necessarily indicative of the results for a full year or for any interim period. Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations relating to interim financial statements. The Consolidated Financial Statements included in this Form 10-Q should be read in conjunction with Management’s Discussion and Analysis of Financial Condition and Results of Operations included elsewhere in this Form 10-Q and with the Company’s Consolidated Financial Statements and Notes thereto included in the Company’s 2017 Annual Report on Form 10-K.

Liquidity

As of March 31, 2018, the Company had \$31.3 million of cash and cash equivalents and \$3.0 million of marketable securities for a total of \$34.3 million. As of March 31, 2018, the Company had \$41.0 million of principal outstanding on its 2018 Debentures, which the Company anticipates refinancing by the maturity date of May 15, 2018, and \$50.0 million of principal outstanding on its Credit Facility due in May 2020. The Company currently has \$25.0 million of availability under the Credit Facility.

In January 2018, Safeguard announced that, from that date forward, the Company will not deploy any capital into new partner company opportunities and will focus on supporting its existing partner companies and maximizing monetization opportunities for partner company interests to enable distributions of net proceeds to shareholders. In that context, the Company will consider initiatives including, among others: the sale of individual partner companies, the sale of certain partner company interests in secondary market transactions, or a combination thereof, as well as other opportunities to maximize shareholder value. The Company anticipates distributing to shareholders net proceeds from the sale of partner companies or partner company interests, as applicable, after satisfying its debt obligations and working capital needs. In connection with the Company’s change in strategy, in January 2018, the Company implemented an initiative to reduce the operating costs of the Company. In April 2018, the Company announced additional management changes intended to further streamline the Company’s organizational structure and further reduce its operating costs. In connection with the changes that the Company has implemented, the Company will incur approximately \$3.8 million of severance payments to terminated employees that will be paid over approximately twelve months. The Company anticipates that with these organizational changes and cost reduction initiatives, its ongoing annualized operating expenses excluding interest, depreciation, severance and stock-based compensation, will approximate \$8 million to \$9 million.

In May 2017, the Company entered into a \$75.0 million secured, revolving credit facility (“Credit Facility”) with HPS Investment Partners, LLC (“Lender”). As of March 31, 2018, the Company had \$50.0 million of principal outstanding on the Credit Facility due in May 2020. The Credit Facility requires the Company to maintain (i) a liquidity threshold of at least \$20 million of unrestricted cash; (ii) a tangible net worth, plus unrestricted cash, of at least 1.75x the amount then outstanding under the Credit Facility; (iii) a minimum aggregate appraised value of the Company’s ownership interests in its partner companies, plus unrestricted cash in excess of the liquidity threshold, of at least \$350 million; and (iv) certain diversification requirements and concentration limits with respect to the Company’s capital deployments to its partner companies. As of the date these consolidated financial statements were issued, the Company was in compliance with all of these covenants.

The Company funds its operations with cash and marketable securities on hand as well as proceeds from the sales of its interests in its partner companies. Due to the nature of the mergers and acquisitions market, and the developmental cycle of companies like the Company’s partner companies, the Company’s ability to generate specific amounts of liquidity from sales of its partner company interests in any given period of time cannot be assured. Accordingly, the

forecasts which the Company utilizes for projecting future compliance with covenants related to its Credit Facility include significantly discounted probability-weighted proceeds from the sales of its interests in its partner companies. Based on these forecasts, it is probable that the Company will not be able to remain in compliance with certain of its debt covenants over the next twelve months. Non-compliance with any of the covenants would constitute an event of default under the Credit Facility, and the Lender could choose to accelerate the maturity of the indebtedness. If the Lender chose not to provide a waiver and were to accelerate the maturity of the indebtedness, the Company would not have sufficient liquidity to repay the entire balance of its outstanding borrowings and other obligations under the Credit Facility. The uncertainty associated with the Company's ability to repay its outstanding debt obligations in such a scenario raises substantial doubt about its ability to continue as a going concern for one year after the issuance date of the financial statements.

In order for the Company to maintain compliance with these covenants, the Company's plan includes selling certain of its partner company interests in the ordinary course of its business, limiting capital deployments to existing partner companies, and refinancing all or a portion of its 2018 Debentures that mature on May 15, 2018. Should the Company not be in compliance with any of its debt covenants and be unable to obtain waivers for such events of default, management would pursue one of a number of potential alternatives to satisfy the obligations, including completing an equity offering or obtaining a new debt facility to refinance its existing debt.

Significant Accounting Policies

Restricted Cash Equivalents

Restricted cash equivalents in prior periods represented cash required to be set aside by a contractual agreement with a bank as collateral for a letter of credit. During the first quarter of 2018, the restriction on the cash lapsed in connection with the termination of the related letter of credit and is classified as Cash and cash equivalents on the Consolidated Balance Sheet as of March 31, 2018. The following table provides a reconciliation of cash, cash equivalents and restricted cash equivalents reported within the Consolidated Balance Sheets that sum to the total of the same such amounts shown in the Consolidated Statements of Cash Flows:

	March 31, 2018	December 31, 2017
	(Unaudited - In thousands)	
Cash and cash equivalents	\$31,294	\$ 20,751
Long-term restricted cash equivalents	—	6,336
Total cash, cash equivalents and restricted cash equivalents	\$31,294	\$ 27,087

Recently Adopted Accounting Pronouncements

In January 2016, the FASB issued ASU 2016-01, Recognition and Measurement of Financial Assets and Financial Liabilities. ASU 2016-01 requires that equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) are to be measured at fair value with changes in fair value recognized in net income. However, an entity may choose to measure equity investments that do not have readily determinable fair values at cost minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer. Furthermore, equity investments without readily determinable fair values are to be assessed for impairment using a qualitative approach. The amendments in ASU 2016-01 should be applied by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption, with other amendments related specifically to equity securities without readily determinable fair values applied prospectively. The Company adopted the amendments in ASU 2016-01 when they became effective on January 1, 2018. The adoption of this guidance did not have a material impact upon the Company's financial condition or results of operations.

Recently Issued Accounting Pronouncements Not Yet Adopted

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-09, Revenue from Contracts with Customers (Topic 606) ("ASU 2014-09"). ASU 2014-09 and related subsequent amendments outline a single comprehensive model to use to account for revenue arising from contracts with customers and supersede most current revenue recognition guidance. For public companies, the guidance is effective for annual periods beginning after December 15, 2017 and any interim periods that fall within that reporting period. For nonpublic companies, the guidance is effective for annual periods beginning after December 15, 2018 and interim periods within annual periods beginning after December 15, 2019 with early adoption permitted. As the new standard will supersede most existing revenue guidance, it could impact revenue and cost recognition for partner companies. Any change in revenue or cost recognition for partner companies could affect the Company's recognition of its share of the results of its equity method partner companies. On July 20, 2017, the SEC staff observer at the FASB's Emerging Issues Task Force ("EITF") meeting announced that the SEC staff will not object if a private company equity method investee meeting the definition of a public business entity that otherwise would not meet the definition of a public business entity except for the inclusion of its financial statements or financial information in

another entity's filings with the SEC, uses private company adoption dates for the new revenue standard. As a result, the Company's private, calendar year partner companies will adopt the new revenue standard for the year ending December 31, 2019. The impact of adoption of the new revenue standard will be reflected in the Company's financial results for the interim and annual reporting periods beginning in 2020 on a one quarter-lag basis.

In February 2016, the FASB issued ASU 2016-02, Leases. The guidance in ASU 2016-02 requires that a lessee recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term. For leases with a term of 12 months or less, a lessee is permitted to make an accounting policy election by class of underlying asset not to recognize lease assets and lease liabilities. As with previous

guidance, there continues to be a differentiation between finance leases and operating leases, however this distinction now primarily relates to differences in the manner of expense recognition over time and in the classification of lease payments in the statement of cash flows. Lease assets and liabilities arising from both finance and operating leases will be recognized in the statement of financial position. The transitional guidance for adopting the requirements of ASU 2016-02 calls for a modified retrospective approach that includes a number of optional practical expedients that entities may elect to apply. The guidance in ASU 2016-02 will become effective for the Company on January 1, 2019. The Company anticipates making the accounting policy election not to recognize lease assets and lease liabilities for leases with a term of 12 months or less. As of December 31, 2017, the Company's only material long-term lease was for its corporate headquarters in Radnor, PA under a lease expiring in 2026. The Company also has immaterial office equipment leases expiring at various dates through 2020. The Company is currently evaluating the impact that the adoption of ASU 2016-02 will have on its consolidated financial statements.

2. Ownership Interests in and Advances to Partner Companies

The following summarizes the carrying value of the Company's ownership interests in and advances to partner companies.

	March 31, December 31, 2018 2017 (Unaudited - In thousands)	
Equity Method Companies:		
Partner companies	\$98,911	\$ 107,646
Private equity funds	442	443
	99,353	108,089
Other Companies:		
Partner companies and other holdings	13,856	2,762
Private equity funds	1,334	1,334
	15,190	4,096
Advances to partner companies	17,734	22,506
	\$132,277	\$ 134,691

In February 2018, Nexxt, Inc., formerly Beyond.com, repaid \$10.5 million of principal outstanding on a note received in connection with the Company's sale of its interest back to Nexxt for \$26.0 million in March 2017. In that transaction, the Company received \$15.5 million in cash and a three-year, \$10.5 million note for the balance due, which accrued interest at a rate of 9.5% per annum. Interest was payable annually and interest income was recorded as earned throughout the year. The \$10.5 million note was fully reserved and had a carrying value of zero as of December 31, 2017. The Company waived the interest accrued to date in connection with the early repayment of the principal balance. The receipt of \$10.5 million of cash in February 2018 resulted in a gain of \$9.5 million, net of the interest accrued to date, which is included in Equity income (loss) in the Consolidated Statements of Operations for the three months ended March 31, 2018.

In January 2018, Spongecell, Inc. merged into Flashtalking, a privately-held company. The Company received Flashtalking ordinary shares equal to approximately 10% of Flashtalking's issued share capital at the time of the closing. The Company's final number of Flashtalking shares will be subject to customary indemnification and working capital provisions and agreements. The Company recorded its ownership interest in Flashtalking at \$11.2 million, which reflects its fair value at the time of closing. The Company recognized a gain of \$4.0 million on the transaction, which is included in Equity income (loss) in the Consolidated Statements of Operations for the three months ended March 31, 2018.

In February 2018, the Company sold 414,237 shares of Invitae Corporation ("Invitae") common stock on the open market for proceeds of \$2.6 million after transaction fees. The Company obtained shares of Invitae in August 2017 when Invitae, a public company, acquired former partner company Good Start Genetics, Inc. In that transaction, the Company received 414,237 shares of Invitae common stock, excluding 124,092 shares of Invitae common stock

which will be held in escrow until August 2018. The Invitae shares were classified as Trading securities and recorded at their fair value, which was \$3.8 million at December 31, 2017. During the first quarter of 2018, the Company recorded a \$1.2 million loss due to a decline in the value of the Invitae shares, which is included in Other income (loss) in the Consolidated Statements of Operations for the three months ended March 31, 2018.

In January 2018, the Company received \$0.6 million of proceeds from the sale of the assets of Aventura, Inc., a former partner company that ceased operations and was fully impaired in 2016. The Company recognized a gain of \$0.6 million, which is reflected in Equity income (loss) in the Consolidated Statements of Operations for the three months ended March 31, 2018.

SAFEGUARD SCIENTIFICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company discloses aggregate summarized statements of operations for any partner companies accounted for under the equity method that are deemed significant. The following table provides significant partner company operations information for the three months ended March 31, 2018. The partner company results of operations have been compiled from respective partner company financial statements, reflect certain historical adjustments, and are reported on a one quarter lag basis.

Three
Months Ended
March March
31, 2018 31, 2017
(In thousands)

Results of Operations:

Revenue	\$498	\$6
Gross profit	\$(32)	\$(436)
Net loss	\$(2,974)	\$(4,191)

3. Acquisitions of Ownership Interests in Partner Companies

First quarter of 2018

The Company funded an aggregate of \$1.3 million of convertible loans to NovaSom, Inc. The Company had previously deployed an aggregate of \$24.1 million in NovaSom. NovaSom is a medical device company focused on obstructive sleep apnea, specifically home testing with its FDA-cleared wireless device called AccuSom® home sleep test. The Company accounts for its interest in NovaSom under the equity method.

The Company funded an aggregate of \$0.8 million of convertible bridge loans to InfoBionic, Inc. The Company had previously deployed an aggregate of \$19.7 million in InfoBionic. InfoBionic is an emerging digital health company focused on creating patient monitoring solutions for chronic disease management with an initial market focus on cardiac arrhythmias. The Company accounts for its interest in InfoBionic under the equity method.

The Company funded an aggregate of \$0.5 million of convertible bridge loans to Spongecell, Inc. The Company had previously deployed an aggregate of \$18.6 million in Spongecell. In the first quarter of 2018, Spongecell merged into Flashtalking. The Company previously accounted for its interest in Spongecell under the equity method.

The Company funded an aggregate of \$0.5 million of convertible bridge loans to WebLinc, Inc. The Company had previously deployed an aggregate of \$14.0 million in WebLinc. WebLinc is a commerce platform and services provider for fast growing online retailers. The Company accounts for its interest in WebLinc under the equity method. The Company funded an aggregate of \$0.4 million of convertible bridge loans to Brickwork. The Company had previously deployed an aggregate of \$4.2 million in Brickwork. Brickwork helps retailers inform, target, convert, and prepare for store shoppers online as the first scalable software-as-a-service platform powering a seamless customer path between online and in-store shopping. The Company accounts for its interest in Brickwork under the equity method.

The Company funded an aggregate of \$0.3 million of convertible bridge loans to Cask Data, Inc. The Company had previously deployed an aggregate of \$13.0 million in Cask Data. Cask Data makes building and running big data solutions on-premises or in the cloud easy with Cask Data Application Platform. The Company accounts for its interest in Cask Data under the equity method.

The Company funded an aggregate of \$0.2 million of a convertible bridge loan to Sonobi, Inc. The Company had previously deployed \$9.2 million in Sonobi. Sonobi is an advertising technology developer that designs advertising tools and solutions for the industry's leading media, publishers, brand advertisers, media agencies, DSPs, and media technology providers. The Company accounts for its interest in Sonobi under the equity method.

4. Fair Value Measurements

The Company categorizes its financial instruments into a three-level fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). If the inputs used to measure fair value fall within different levels of the hierarchy, the category level is based on the lowest priority level input that is significant to the fair value measurement of the instrument. Financial instruments recorded at fair value on the Company's Consolidated Balance Sheets are categorized as follows:

Level 1—Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2—Include other inputs that are directly or indirectly observable in the marketplace.

SAFEGUARD SCIENTIFICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Level 3—Unobservable inputs which are supported by little or no market activity.

The fair value hierarchy also requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

The following table provides the carrying value and fair value of certain financial assets and liabilities of the Company measured at fair value on a recurring basis as of March 31, 2018 and December 31, 2017:

	Carrying Value	Fair Value Measurement at March 31, 2018		
		Level 1	Level 2	Level 3
		(Unaudited - In thousands)		
Cash and cash equivalents	\$31,294	\$31,294	\$ —	—
Marketable securities—held-to-maturity:				
Certificates of deposit	\$3,044	\$3,044	\$ —	—
	Carrying Value	Fair Value Measurement at December 31, 2017		
		Level 1	Level 2	Level 3
		(Unaudited - In thousands)		
Cash and cash equivalents	\$20,751	\$20,751	\$ —	—
Long-term restricted cash equivalents	6,336	6,336	—	—
Trading securities	3,761	3,761	—	—
Marketable securities—held-to-maturity:				
Certificates of deposit	\$4,452	\$4,452	\$ —	—

As of March 31, 2018, \$3.0 million of marketable securities had contractual maturities which were less than one year. Certificates of deposit are classified as held-to-maturity securities carried at amortized cost, which, due to the short-term maturity of these instruments, approximates fair value using quoted prices in active markets for identical assets or liabilities defined as Level 1 inputs under the fair value hierarchy. Trading securities at December 31, 2017 consisted of 414,237 shares of Invitae Corporation common shares obtained in connection with the sale of Good Start Genetics. The trading securities were carried at fair value based on the closing stock price on the last trading day of the reporting period. The Company sold all of the Invitae shares during the first quarter of 2018 for \$2.6 million of cash proceeds.

5. Credit Facility and Convertible Debentures

Credit Facility

In May 2017, the Company entered into a \$75.0 million secured, revolving credit facility (“Credit Facility”) with HPS Investment Partners, LLC (“Lender”). At closing, the Company borrowed \$50.0 million, which resulted in net proceeds of \$44.3 million after closing fees to the Lender and other third parties. The Credit Facility has a three-year term with a scheduled maturity of May 11, 2020 and bears interest at a rate of either: (A) LIBOR plus 8.5% (subject to a LIBOR floor of 1%), payable on the last day of the one, two or three month interest period applicable to the LIBOR rate advance, or (B) 7.5% plus the greater of: 2%; the Federal Funds Rate plus 0.5%; LIBOR plus 1%; or the U.S. Prime Rate, payable monthly in arrears. The Credit Facility is not amortized and interest payable under the Credit Facility will reflect at least \$50 million as being drawn and outstanding at all times during the term. The Credit Facility also includes an unused line fee equal to 0.75% per annum of the average unused portion of the Credit Facility and a loan service fee, both paid quarterly. The Credit Facility is secured by all of the Company's assets in accordance with the terms of the Credit Facility.

The Credit Facility requires the Company to maintain (i) a liquidity threshold of at least \$20 million of unrestricted cash; (ii) a tangible net worth, plus unrestricted cash of at least 1.75x the amount then outstanding under the Credit

Facility; (iii) a minimum aggregate appraised value of the Company's ownership interests in its partner companies, plus unrestricted cash in excess of the liquidity threshold of at least \$350 million; and (iv) certain diversification requirements and concentration limits with respect to the Company's capital deployments to its partner companies. Subject to customary exclusions, the Lender has the right to have one observer representative attend meetings of the Company's Board of Directors.

The Credit Facility provides for customary events of default which include (subject in certain cases to customary grace and cure periods), among others, nonpayment of principal or interest; non-compliance with debt covenants; defaults in, or failure to pay, certain other indebtedness; the rendering of judgments to pay certain amounts of money; and certain events of bankruptcy or insolvency. Generally, if an event of default occurs and is not cured within the time periods specified (if any), the Lender may declare the outstanding amount under the Credit Facility to be immediately due and payable.

SAFEGUARD SCIENTIFICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

At March 31, 2018, the principal amount outstanding under the Credit Facility was \$50.0 million, the unamortized discount and debt issuance costs were \$4.3 million and the net carrying value of the credit facility was \$45.7 million. The Company is amortizing the excess of the principal amount of the Credit Facility over its carrying value over the three-year term as additional interest expense using the effective interest method. For the three months ended March 31, 2018, the Company recorded \$1.8 million of interest expense and made cash interest payments of \$1.3 million under the Credit Facility. The effective interest rate on the Credit Facility is 15.0%.

Convertible Debentures

In November 2012, the Company issued \$55.0 million principal amount of its 5.25% convertible senior debentures due on May 15, 2018 (the "2018 Debentures"). Interest on the 2018 Debentures is payable semi-annually. In July and June 2017, the Company repurchased on the open market, and retired, an aggregate of \$14.0 million face value of the 2018 Debentures at a cost of \$14.5 million, including transaction fees. At March 31, 2018, the Company had \$41.0 million of outstanding 2018 Debentures.

The 2018 Debentures may be settled in cash or partially in cash upon conversion. Accordingly, the Company separately accounts for the liability and equity components of the 2018 Debentures. The carrying amount of the liability component was determined at the transaction date by measuring the fair value of a similar liability that does not have an associated equity component. The carrying amount of the equity component represented by the embedded conversion option was determined by deducting the fair value of the liability component from the initial proceeds of the 2018 Debentures as a whole.

At March 31, 2018, the carrying amount of the equity component was \$5.6 million, the principal amount of the liability component was \$41.0 million, the unamortized discount and debt issuance costs were \$0.2 million and the net carrying value of the liability component was \$40.8 million. The Company is amortizing the excess of the face value of the 2018 Debentures over their carrying value over their term as additional interest expense using the effective interest method. The Company recorded interest expense of \$0.9 million and \$1.1 million for the three months ended March 31, 2018 and 2017, respectively. The cash interest paid was zero for the three months ended March 31, 2018 and 2017. The effective interest rate on the 2018 Debentures is 8.7%. At March 31, 2018, the fair value of the \$41.0 million outstanding 2018 Debentures was approximately \$41.3 million, based on the midpoint of the bid and ask prices as of such date. The Company anticipates refinancing the outstanding 2018 Debentures by the maturity date of May 15, 2018.

6. Stock-Based Compensation

Stock-based compensation expense was recognized in the Consolidated Statements of Operations as follows:

	Three months ended March 31, 2018 2017 (Unaudited - In thousands)	
General and administrative expense	\$ 277	\$(105)
	\$ 277	\$(105)

The fair value of the Company's option awards to employees was estimated at the date of grant using the Black-Scholes option-pricing model. The risk-free rate was based on the U.S. Treasury yield curve in effect at the end of the quarter in which the grant occurred. The expected term of stock options granted was estimated using the historical exercise behavior of employees. Expected volatility was based on historical volatility measured using weekly price observations of the Company's common stock for a period equal to the stock option's expected term.

7. Income Taxes

The Company's consolidated income tax benefit (expense) was \$0.0 million for the three months ended March 31, 2018 and 2017. The Company has recorded a valuation allowance to reduce its net deferred tax asset to an amount that

is more likely than not to be realized in future years. Accordingly, the benefit of the net operating loss that would have been recognized in the three months ended March 31, 2018 was offset by changes in the valuation allowance. The tax expense that would have been recognized in the three months ended March 31, 2018 was offset by changes in the valuation allowance. During the three months ended March 31, 2018, the Company had no material changes in uncertain tax positions.

In December 2017, the U.S. government enacted comprehensive tax legislation commonly referred to as the Tax Cuts and Jobs Act (the "Tax Act"). The Tax Act makes broad and complex changes to the U.S. tax code, including, but not limited to: (i) reducing the U.S. federal corporate tax rate from 35 percent to 21 percent; (ii) eliminating the corporate alternative minimum tax (AMT) and changing how existing AMT credits can be realized; (iii) creating a new limitation on deductible interest expense; and (iv) changing rules related to uses and limitations of net operating carryforwards created in tax years beginning after December 31, 2017. The most significant impact on the Company's consolidated financial statements was a

reduction of approximately \$82.5 million in deferred tax assets in 2017 which was offset by changes to the Company's valuation allowance.

8. Net Loss Per Share

The calculations of net loss per share were as follows:

	Three months ended March 31,	
	2018	2017
	(Unaudited -	
	In thousands, except per share data)	
Basic:		
Net loss	\$ (6,170)	\$ (22,097)
Weighted average common shares outstanding	20,506	20,380
Net loss per share	\$ (0.30)	\$ (1.08)
Diluted:		
Net loss	\$ (6,170)	\$ (22,097)
Weighted average common shares outstanding	20,506	20,380
Net loss for dilutive share computation	\$ (0.30)	\$ (1.08)

Basic and diluted average common shares outstanding for purposes of computing net income (loss) per share includes outstanding common shares and vested deferred stock units (DSUs).

If a consolidated or equity method partner company has dilutive stock options, unvested restricted stock, DSUs or warrants, diluted net income (loss) per share is computed by first deducting the income attributable to the potential exercise of the dilutive securities of the partner company from net income (loss). Any impact is shown as an adjustment to net income (loss) for purposes of calculating diluted net income (loss) per share.

Diluted earnings per share for the three months ended March 31, 2018 and 2017 do not reflect the following potential shares of common stock that would have an anti-dilutive effect or have unsatisfied performance or market conditions:

• At March 31, 2018 and 2017, options to purchase 0.6 million and 0.7 million shares of common stock, respectively, at prices ranging from \$9.83 to \$19.95 for both periods, were excluded from the calculations.

• At March 31, 2018 and 2017, unvested restricted stock, performance-based stock units and DSUs convertible into 1.0 million and 0.9 million shares of stock, respectively, were excluded from the calculations.

• At March 31, 2018 and 2017, 2.3 million and 3.0 million shares of common stock representing the effect of the assumed conversion of the 2018 Debentures, were excluded from the calculations.

SAFEGUARD SCIENTIFICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

9. Segment Reporting

The Company operates as one operating segment based upon the similar nature of its technology-driven partner companies, the functional alignment of the organizational structure, and the reports that are regularly reviewed by the chief operating decision maker for the purpose of assessing performance and allocating resources. As of March 31, 2018, the Company held interests in 25 non-consolidated partner companies. The Company's active partner companies were as follows as of March 31, 2018:

Partner Company	Safeguard Primary Ownership as of March 31, 2018	Accounting Method
AdvantEdge Healthcare Solutions, Inc.	40.1%	Equity
Aktana, Inc.	24.6%	Equity
Apprenda, Inc.	29.3%	Equity
Brickwork	20.3%	Equity
Cask Data, Inc.	31.2%	Equity
CloudMine, Inc.	47.3%	Equity
Clutch Holdings, Inc.	41.3%	Equity
Flashtalking *	10.3%	Other
Hoopla Software, Inc.	25.5%	Equity
InfoBionic, Inc.	39.5%	Equity
Lumesis, Inc.	43.8%	Equity
MediaMath, Inc.	20.5%	Equity
meQuilibrium	36.2%	Equity
Moxe Health Corporation	32.4%	Equity
NovaSom, Inc.	31.7%	Equity
Prognos (fka Medivo, Inc.)	28.7%	Equity
Propeller Health, Inc.	24.0%	Equity
QuanticMind, Inc.	24.7%	Equity
Sonobi, Inc.	21.6%	Equity
Syapse, Inc.	20.1%	Equity
T-REX Group, Inc.	21.1%	Equity
Transactis, Inc.	23.8%	Equity
Trice Medical, Inc.	24.8%	Equity
WebLinc, Inc.	38.0%	Equity
Zipnosis, Inc.	25.4%	Equity

* Spongecell, Inc. merged into Flashtalking in January 2018.

As of March 31, 2018 and December 31, 2017, all of the Company's assets were located in the United States.

SAFEGUARD SCIENTIFICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

10. Commitments and Contingencies

The Company and its partner companies are involved in various claims and legal actions arising in the ordinary course of business. In the current opinion of the Company, the ultimate disposition of these matters will not have a material adverse effect on the Company's consolidated financial position or results of operations, however, no assurance can be given as to the outcome of these actions, and one or more adverse rulings could have a material adverse effect on the Company's consolidated financial position and results of operations or that of its partner companies. The Company records costs associated with legal fees as such services are rendered.

The Company had outstanding guarantees of \$3.8 million at March 31, 2018 which related to one of the Company's private equity holdings.

The Company is required to return a portion or all the distributions it received as a general partner of a private equity fund for further distribution to such fund's limited partners ("clawback"). The Company's ownership in the fund is 19%. The clawback liability is joint and several, such that the Company may be required to fund the clawback for other general partners should they default. The Company believes its potential liability due to the possibility of default by other general partners is remote. In 2017, the Company was notified by the fund's manager that the fund was being dissolved and \$1.0 million of the Company's clawback liability was paid. The maximum additional clawback liability is \$0.3 million which was reflected in Other long-term liabilities on the Consolidated Balance Sheet at March 31, 2018.

In October 2001, the Company entered into an agreement with a former Chairman and Chief Executive Officer of the Company, to provide for annual payments of \$0.65 million per year and certain health care and other benefits for life. The related current liability of \$0.8 million was included in Accrued expenses and other current liabilities and the long-term portion of \$1.7 million was included in Other long-term liabilities on the Consolidated Balance Sheet at March 31, 2018.

The Company previously provided a \$6.3 million letter of credit to the landlord of CompuCom Systems, Inc.'s Dallas headquarters as required in connection with the sale of CompuCom Systems in 2004. The letter of credit was secured by cash and was classified as Long-term restricted cash equivalents on the Consolidated Balance Sheet as of December 31, 2017. During the first quarter of 2018, the restriction on the cash lapsed in connection with the termination of the related letter of credit and is classified as Cash and cash equivalents on the Consolidated Balance Sheet as of March 31, 2018.

In January 2018, the Company announced a change in strategy and implemented an initiative to reduce the operating costs of the Company. In April 2018, the Company announced additional management changes intended to further streamline the Company's organizational structure and further reduce its operating costs. In connection with the changes that the Company has implemented, the Company will incur approximately \$3.8 million of severance payments to terminated employees that will be paid over approximately twelve months. The Company has agreements with certain remaining employees that provide for severance payments to the employee in the event the employee is terminated without cause or an employee terminates his employment for "good reason." The Company recognized \$1.1 million of severance expense for the three months ended March 31, 2018 and \$1.0 million was classified as accrued compensation and benefits on the Consolidated Balance Sheet as of March 31, 2018. The maximum aggregate exposure under employment and severance agreements for remaining employees was approximately \$6.7 million at April 15, 2018.

In June 2011, the Company's former partner company, Advanced BioHealing, Inc. ("ABH") was acquired by Shire plc ("Shire"). Prior to the expiration of the escrow period in March 2012, Shire filed a claim against all amounts held in escrow related to the sale based principally upon a United States Department of Justice ("DOJ") false claims act investigation relating to ABH (the "Investigation"). In connection with the Investigation, in July 2015 the Company received a Civil Investigation Demand-Documentary Material ("CID") from the DOJ regarding ABH and Safeguard's relationship with ABH. Pursuant to the CID, the Company provided the requested materials and information. To the Company's knowledge, the CID was related to multiple qui tam ("whistleblower") actions, one of which was filed in

2014 by an ex-employee of ABH that named the Company and one of the Company's employees along with other entities and individuals as defendants. At this time, the DOJ has declined to pursue the qui tam action as it relates to the Company and such Company employee. In addition, in connection with the above matters, the Company and other former equity holders in ABH recently entered into a settlement and release with Shire, which resulted in the release to Shire of all amounts held in escrow related to the sale of ABH.

SAFEGUARD SCIENTIFICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

11. Equity

In July 2015, the Company's Board of Directors authorized the Company, from time to time and depending on market conditions, to repurchase up to \$25.0 million of the Company's outstanding common stock. During 2016, the Company repurchased 0.4 million shares at an aggregate cost of \$5.4 million with \$14.6 million remaining for repurchase under the existing authorization.

In February 2018, the Company's Board of Directors adopted a tax benefits preservation plan (the "Plan") designed to protect and preserve the Company's ability to utilize its net operating loss carryforwards ("NOLs"). The Company intends to submit the Plan for shareholder ratification at its 2018 Annual Meeting of Shareholders. The purpose of the Plan is to preserve the Company's ability to use its NOLs, which would be substantially limited if the Company experienced an "ownership change" as defined under Section 382 of the Internal Revenue Code. In general, an ownership change would be deemed to have occurred if the Company's shareholders who are treated as owning five percent or more of the outstanding shares of Safeguard for purposes of Section 382 ("five-percent shareholders") collectively increase their aggregate ownership in the Company's overall shares outstanding by more than 50 percentage points. Whether this change has occurred would be measured by comparing each five-percent shareholder's current ownership as of the measurement date to such shareholders' lowest ownership percentage during the three-year period preceding the measurement date. To protect the Company's NOLs from being limited or permanently lost under Section 382, the Plan is intended to deter any person or group from acquiring beneficial ownership of 4.99% or more of the Company's outstanding common stock without the approval of the Board, reducing the likelihood of an unintended ownership change. Under the Plan, the Company will issue one preferred stock purchase right (the "Rights") for each share of Safeguard's common stock held by shareholders of record on March 2, 2018. The issuance of the Rights will not be taxable to Safeguard or its shareholders and will not affect Safeguard's reported earnings per share. The Rights will trade with Safeguard's common shares and will expire no later than February 19, 2021. The Rights and the Plan may also expire on an earlier date upon the occurrence of other events, including a determination by the Company's Board that the Plan is no longer necessary or desirable for the preservation of the Company's tax attributes or that no tax attributes may be carried forward (with such expiration occurring as of the beginning of the applicable taxable year). There can be no assurance that the Plan will prevent the Company from experiencing an ownership change.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Cautionary Note Concerning Forward-Looking Statements

This Quarterly Report on Form 10-Q contains forward-looking statements that are based on current expectations, estimates, forecasts and projections about Safeguard Scientifics, Inc. ("Safeguard" or "we"), the industries in which we operate and other matters, as well as management's beliefs and assumptions and other statements regarding matters that are not historical facts. These statements include, in particular, statements about our plans, strategies and prospects. For example, when we use words such as "projects," "expects," "anticipates," "intends," "plans," "believes," "seeks," "estimates," "should," "would," "could," "will," "opportunity," "potential" or "may," variations of such words or other words to convey uncertainty of future events or outcomes, we are making forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Our forward-looking statements are subject to risks and uncertainties. Factors that could cause actual results to differ materially, include, among others, our ability to make good decisions about the deployment of capital, the fact that our partner companies may vary from period to period, our substantial capital requirements and absence of liquidity from our partner company holdings, fluctuations in the market prices of our publicly traded partner company holdings, competition, our inability to obtain maximum value for our partner company holdings, our ability to attract and retain qualified employees, our ability to execute our strategy, market valuations in sectors in which our partner companies operate, our inability to control our partner companies, our need to manage our assets to avoid registration under the Investment Company Act of 1940, and risks associated with our partner companies and their performance, including the fact that most of our partner companies have a limited history and a history of operating losses, face intense competition and may never be profitable, the effect of economic conditions in the business sectors in which Safeguard's partner companies operate, compliance with government regulation and legal liabilities, all of which are discussed in Item 1A. "Risk Factors" in Safeguard's Annual Report on Form 10-K and updated, as applicable, in "Factors that May Affect Future Results" and Item 1A. "Risk Factors" below. Many of these factors are beyond our ability to predict or control. In addition, as a result of these and other factors, our past financial performance should not be relied on as an indication of future performance. All forward-looking statements attributable to us, or to persons acting on our behalf, are expressly qualified in their entirety by this cautionary statement. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, except as required by law. In light of these risks and uncertainties, the forward-looking events and circumstances discussed in this report might not occur.

Business Overview

Over the recent past, Safeguard has provided capital and relevant expertise to fuel the growth of technology-driven businesses in healthcare, financial services and digital media. Throughout this document, we use the term "partner company" to generally refer to those companies in which we have an equity interest and in which we are actively involved, influencing development through board representation and management support, in addition to the influence we exert through our equity ownership. From time to time, in addition to these partner companies, we also hold relatively small equity interests in other enterprises where we do not exert significant influence and do not participate in management activities. In some cases, these interests relate to former partner companies.

In January 2018, Safeguard announced that, from that date forward, we will not deploy any capital into new partner company opportunities and will focus on supporting our existing partner companies and maximizing monetization opportunities for partner company interests to enable distributions of net proceeds to shareholders. In that context, we will consider initiatives including, among others: the sale of individual partner companies, the sale of certain partner company interests in secondary market transactions, or a combination thereof, as well as other opportunities to maximize shareholder value. We anticipate distributing to shareholders net proceeds from the sale of partner companies or partner company interests, as applicable, after satisfying our debt obligations and working capital needs.

Safeguard's existing group of partner companies consist of technology-driven businesses in healthcare, financial services and digital media that are capitalizing on the next wave of enabling technologies with a particular focus on the Internet of Everything, enhanced security and predictive analytics. We strive to create long-term value for our shareholders by helping our partner companies to increase their market penetration, grow revenue and improve cash

flow. Safeguard typically deploys up to \$25 million in a company.

Results of Operations

We operate as one operating segment based upon the similar nature of our technology-driven partner companies, the functional alignment of the organizational structure, and the reports that are regularly reviewed by the chief operating decision maker for the purpose of assessing performance and allocating resources.

There is intense competition in the markets in which our partner companies operate. Additionally, the markets in which these companies operate are characterized by rapidly changing technology, evolving industry standards, frequent introduction of new products and services, shifting distribution channels, evolving government regulation, frequently changing intellectual property landscapes and changing customer demands. Their future success depends on each company's ability to execute its business plan and to adapt to its respective rapidly changing market.

As previously stated, throughout this document, we use the term "partner company" to generally refer to those companies in which we have an economic interest and in which we are actively involved influencing development, usually through board representation in addition to our equity ownership.

The following listing of our partner companies includes only entities which were considered partner companies as of March 31, 2018. Certain entities which may have been partner companies in previous periods are omitted if, as of March 31, 2018, they had been sold or are no longer considered a partner company.

Safeguard Primary Ownership as of March 31,			
Partner Company	2018	2017	Accounting Method
AdvantEdge Healthcare Solutions, Inc.	40.1%	40.1%	Equity
Aktana, Inc.	24.6%	31.2%	Equity
Apprenda, Inc.	29.3%	29.4%	Equity
Brickwork	20.3%	20.3%	Equity
Cask Data, Inc.	31.2%	31.3%	Equity
CloudMine, Inc.	47.3%	47.3%	Equity
Clutch Holdings, Inc.	41.3%	42.8%	Equity
Flashtalking *	10.3%	NA	Other
Hoopla Software, Inc.	25.5%	25.5%	Equity
InfoBionic, Inc.	39.5%	39.7%	Equity
Lumesis, Inc.	43.8%	44.1%	Equity
MediaMath, Inc.	20.5%	20.5%	Equity
meQuilibrium	36.2%	31.5%	Equity
Moxe Health Corporation	32.4%	32.4%	Equity
NovaSom, Inc.	31.7%	31.7%	Equity
Prognos (fka Medivo, Inc.)	28.7%	35.2%	Equity
Propeller Health, Inc.	24.0%	24.0%	Equity
QuanticMind, Inc.	24.7%	23.2%	Equity
Sonobi, Inc.	21.6%	21.6%	Equity
Syapse, Inc.	20.1%	26.2%	Equity
T-REX Group, Inc.	21.1%	23.6%	Equity
Transactis, Inc.	23.8%	24.0%	Equity
Trice Medical, Inc.	24.8%	27.6%	Equity
WebLinc, Inc.	38.0%	38.0%	Equity
Zipnosis, Inc.	25.4%	25.4%	Equity

* Spongecell, Inc. merged into Flashtalking in January 2018.

Three months ended March 31, 2018 versus the three months ended March 31, 2017

	Three months ended March 31,		
	2018	2017	Variance
	(In thousands)		
General and administrative expense	\$(5,589)	\$(4,947)	\$(642)
Other income (loss)	(1,435)	249	(1,684)
Interest income	798	801	(3)
Interest expense	(2,690)	(1,198)	(1,492)
Equity income (loss)	2,746	(17,002)	19,748
	\$(6,170)	\$(22,097)	\$15,927

General and Administrative Expense. General and administrative expense increased \$0.6 million for the three months ended March 31, 2018, compared to the prior year period, primarily due to a \$1.1 million charge for severance that will be paid over approximately the next twelve months to employees who were terminated in January 2018 in connection with our change in strategy. Additionally, professional fees increased \$0.8 million for the three months ended March 31, 2018, compared to the prior year period, primarily due to costs associated with activist shareholder matters. These increases were partially offset by a \$1.3 million decrease in employee compensation and related expenses due to employee terminations and operating cost reduction initiatives implemented in January 2018.

Other Income (Loss). Other income (loss) decreased \$1.7 million for the three months ended March 31, 2018 compared to the prior year period. Other income (loss) for the three months ended March 31, 2018 reflected a \$1.2 million decrease in the fair value of shares of Invitae Corporation common stock obtained in connection with the sale of Good Start Genetics in August 2017. Other income (loss) for the three months ended March 31, 2017 reflected a \$0.4 million gain related to our Penn Mezzanine debt and equity participations, partially offset by an impairment of \$0.2 million related to our interest in a legacy private equity fund.

Interest Income. Interest income remained relatively consistent compared to the prior year period.

Interest Expense. The increase of \$1.5 million for the three months ended March 31, 2018 compared to the prior year period was primarily attributable to \$1.8 million of interest expense related to borrowings under the new credit facility we entered into in May 2017, partially offset by a \$0.3 million decrease in interest expense due to the partial repurchase of \$14.0 million face value of convertible senior debentures in June and July 2017.

Equity Income (Loss). Equity income (loss) increased \$19.8 million for the three months ended March 31, 2018 compared to the prior year period. The components of equity income (loss) for the three months ended March 31, 2018 and 2017 were as follows:

Three months ended March 31, 2018:

Gain on proceeds received from repayment of note from Nexxt (fka Beyond.com)	\$9,511
Gain on Spongecell's merger into Flashtalking	3,966
Gain on proceeds received from escrow related to the sale of Aventura and Pneuron assets	704
Unrealized dilution loss on the decrease of our percentage ownership in partner companies	(434)
Share of loss of our equity method partner companies	(11,001)
	\$2,746

Three months ended March 31, 2017:

Gain on proceeds received from escrow related to sale of Quantia	\$600
Gain on sale of Nexxt	108
Unrealized dilution loss on the decrease of our percentage ownership in partner companies	(83)
Loss on impairment of Aventura	(254)
Loss on impairment of Pneuron	(2,735)
Share of loss of our equity method partner companies	(14,638)
	\$(17,002)

The change in our share of equity loss of our equity method partner companies for the three months ended March 31, 2018 compared to the prior year period was due to a decrease in the number of partner companies and a decrease in losses associated with our partner companies.

Income Tax Benefit (Expense)

Income tax benefit (expense) was \$0.0 million for the three months ended March 31, 2018 and 2017. We have recorded a valuation allowance to reduce our net deferred tax asset to an amount that is more likely than not to be realized in future years. Accordingly, the benefit of the net operating loss that would have been recognized in the three months ended March 31, 2018 and 2017 was offset by changes in the valuation allowance.

Liquidity and Capital Resources

As of March 31, 2018, we had \$31.3 million of cash and cash equivalents and \$3.0 million of marketable securities for a total of \$34.3 million. As of March 31, 2018, the Company had \$41.0 million of principal outstanding on our 2018 Debentures, which the Company anticipates refinancing by the maturity date of May 15, 2018, and \$50.0 million of principal outstanding on its Credit Facility due in May 2020. The Company currently has \$25.0 million of availability under the Credit Facility.

In January 2018, Safeguard announced that, from that date forward, we will not deploy any capital into new partner company opportunities and will focus on supporting our existing partner companies and maximizing monetization opportunities for partner company interests to enable distributions of net proceeds to shareholders. In that context, we will consider initiatives including, among others: the sale of individual partner companies, the sale of certain partner company interests in secondary market transactions, or a combination thereof, as well as other opportunities to maximize shareholder value. We anticipate distributing to shareholders net proceeds from the sale of partner companies or partner company interests, as applicable, after satisfying our debt obligations and working capital needs. In connection with our change in strategy, in January 2018, we implemented an initiative to reduce our operating costs. In April 2018, we announced additional management changes intended to further streamline our organizational structure and further reduce our operating costs. In connection with the changes that the Company has implemented, we will incur approximately \$3.8 million of severance payments to terminated employees that will be paid over approximately twelve months. We anticipate that with these organizational changes and cost reduction initiatives, our ongoing annualized operating expenses excluding interest, depreciation, severance and stock-based compensation, will approximate \$8 million to \$9 million. The maximum aggregate exposure under employment and severance agreements for remaining employees was approximately \$6.7 million at April 15, 2018.

In May 2017, we entered into a \$75.0 million secured, revolving credit facility (“Credit Facility”) with HPS Investment Partners, LLC (“Lender”). As of September 30, 2017, we had \$50.0 million of principal outstanding on the Credit Facility due in May 2020. The Credit Facility requires us to maintain (i) a liquidity threshold of at least \$20 million of unrestricted cash; (ii) a tangible net worth, plus unrestricted cash, of at least 1.75x the amount then outstanding under the Credit Facility; (iii) a minimum aggregate appraised value of our ownership interests in its partner companies, plus unrestricted cash in excess of the liquidity threshold, of at least \$350 million; and (iv) certain diversification requirements and concentration limits with respect to our capital deployments to its partner companies. As of the date these consolidated financial statements were issued, we were in compliance with all of these covenants.

We fund our operations with cash and marketable securities on hand as well as proceeds from the sales of our interests in our partner companies. Due to the nature of the mergers and acquisitions market, and the developmental cycle of companies like our partner companies, our ability to generate specific amounts of liquidity from sales of our partner company interests in any given period of time cannot be assured. Accordingly, the forecasts which we utilize for projecting future compliance with covenants related to our Credit Facility include significantly discounted probability-weighted proceeds from the sales of our interests in our partner companies. Based on these forecasts, it is probable that we will not be able to remain in compliance with certain of our debt covenants over the next twelve months. Non-compliance with any of the covenants would constitute an event of default under the Credit Facility, and the Lender could choose to accelerate the maturity of the indebtedness. If the Lender chose not to provide a waiver and were to accelerate the maturity of the indebtedness, we would not have sufficient liquidity to repay the entire balance of our outstanding borrowings and other obligations under the Credit Facility. The uncertainty associated with our ability to repay our outstanding debt obligations in such a scenario raises substantial doubt about our ability to continue as a going concern for one year after the issuance date of the financial statements.

In order for us to maintain compliance with these covenants, our plan includes selling certain of our partner company interests in the ordinary course of our business, limiting capital deployments to existing partner companies, and refinancing all or a portion of our 2018 Debentures that mature on May 15, 2018. Should we not be in compliance with any of our debt covenants and be unable to obtain waivers for such events of default, management would pursue one of a number of potential alternatives to satisfy the obligations, including completing an equity offering or obtaining a new debt facility to refinance our existing debt.

In November 2012, we issued \$55.0 million in face amount of our 5.25% convertible senior debentures due on May 15, 2018 (the "2018 Debentures"). Interest on the 2018 Debentures is payable semi-annually. At the debentures holders' option, the 2018 Debentures are convertible into our common stock at any time after November 15, 2017. The conversion rate of the 2018 Debentures is 55.17 shares of common stock per \$1,000 principal amount of debentures, equivalent to a conversion price of approximately \$18.13 per share of common stock. The closing price per share of our common stock at March 31, 2018 was \$12.25. The 2018 Debentures holders have the right to require us to repurchase the 2018 Debentures if we undergo a fundamental change as defined in the debenture agreement, including the sale of all or substantially all of our common stock or assets, liquidation, or dissolution; a change in control; the delisting of our common stock from the New York Stock Exchange or the NASDAQ Global Market (or any of their respective successors); or when continuing directors cease to constitute a majority of our board of directors as defined in the agreement. On or after November 15, 2016, we may redeem for cash some or all of the debentures, subject to certain conditions. Upon any such redemption of the 2018 Debentures, we will pay a redemption price of 100% of their principal amount, plus accrued and unpaid interest. Upon the conversion of the 2018 Debentures we have the right to settle the conversion in stock, cash or a combination thereof.

In July and June 2017, we repurchased on the open market, and retired, an aggregate of \$14.0 million face value of 2018 Debentures at a cost of \$14.5 million, including transaction fees. We had \$41.0 million face value of 2018 Debentures outstanding at March 31, 2018 due on May 15, 2018.

We previously provided a \$6.3 million letter of credit to the landlord of CompuCom Systems, Inc.'s Dallas headquarters as required in connection with the sale of CompuCom Systems in 2004. The letter of credit was secured by cash and was classified as Long-term restricted cash equivalents on the Consolidated Balance Sheet as of December 31, 2017. During the first quarter of 2018, the restriction on the cash lapsed in connection with the termination of the related letter of credit and is classified as Cash and cash equivalents on the Consolidated Balance Sheet as of March 31, 2018.

In July 2015, the Company's Board of Directors authorized us, from time to time and depending on market conditions, to repurchase up to \$25.0 million of the Company's outstanding common stock. During the year ended December 31, 2016, we repurchased 0.4 million shares at an aggregate cost of \$5.4 million with \$14.6 million remaining for repurchase under the existing authorization.

We are required to return a portion or all the distributions we received as a general partner of a private equity fund for further distribution to such fund's limited partners ("clawback"). Our ownership in the fund is 19%. The clawback liability is joint and several, such that we may be required to fund the clawback for other general partners should they default. We believe our potential liability due to the possibility of default by other general partners is remote. In 2017, we were notified by the fund's manager that the fund was being dissolved and \$1.0 million of our clawback liability was paid. The maximum additional clawback liability is \$0.3 million which was reflected in Other long-term liabilities on the Consolidated Balance Sheet at March 31, 2018.

Our ability to generate liquidity from sales of partner companies, sales of marketable securities and from equity and debt issuances has been adversely affected from time to time by adverse circumstances in the U.S. capital markets and other factors. The transactions we enter into in pursuit of our strategy could increase or decrease our liquidity at any point in time. As we seek to provide additional funding to existing partner companies or commit capital to other initiatives, we may be required to expend our cash or incur debt, which will decrease our liquidity. Conversely, as we dispose of our interests in partner companies from time to time, we may receive proceeds from such sales, which could increase our liquidity. From time to time, we are engaged in discussions concerning acquisitions and dispositions which, if consummated, could impact our liquidity, perhaps significantly.

Analysis of Consolidated Cash Flows

Cash flow activity was as follows:

	Three months ended March 31,		
	2018	2017	Variance
	(In thousands)		
Net cash used in operating activities	\$(6,774)	\$(6,541)	\$(233)

Net cash provided by investing activities	11,131	15,116	(3,985)
Net cash used in financing activities	(150)	(90)	(60)
	\$4,207	\$8,485	\$(4,278)

Net Cash Used In Operating Activities

Net cash used in operating activities increased by \$0.2 million for the three months ended March 31, 2018 compared to the prior year period. The increase was primarily due to \$1.3 million of cash interest payments related to our credit facility we entered into in May 2017, partially offset by a \$1.1 million decrease in employee compensation and related expenses due to employee terminations and operating cost reduction initiatives implemented in January 2018.

Net Cash Provided by Investing Activities

Net cash provided by investing activities decreased by \$4.0 million for the three months ended March 31, 2018 compared to the prior year period. The decrease primarily related to a \$12.5 million decrease in proceeds from the sales of and distributions from companies and a \$8.9 million decrease in cash proceeds from the net change in marketable securities, partially offset by the repayment of the \$10.5 million principal outstanding on a note from Nexxt, Inc., a \$4.5 million decrease in acquisitions of ownership interests in companies, and a \$2.4 million decrease in advances and loans to companies.

Cash proceeds from the sales of and distributions from companies were \$3.3 million for the three months ended March 31, 2018 which related primarily to:

In February 2018, we sold 414,237 shares of Invitae Corporation ("Invitae") common stock on the open market for proceeds of \$2.6 million after transaction fees. The shares of Invitae were obtained in August 2017 when Invitae, a public company, acquired former partner company Good Start Genetics, Inc.

In January 2018, we received \$0.6 million of proceeds from the sale of the assets of Aventura, Inc., a former partner company that ceased operations and was fully impaired in 2016.

Cash proceeds from the sales of and distributions from partner companies was \$15.8 million for the three months ended March 31, 2017 which related primarily to proceeds from the sale of our interest in partner company Nexxt, Inc., formerly Beyond.com, back to Nexxt, Inc. for \$26.0 million. We received \$15.5 million in cash in March 2017 and a three-year, \$10.5 million note, that was repaid during the three months ended March 31, 2018.

Net Cash Used In Financing Activities

Net cash used in financing activities remained relatively consistent compared to the prior year period.

Contractual Cash Obligations and Other Commercial Commitments

There have been no material changes to the contractual cash obligations and other commercial commitments we previously disclosed under Item 7 of Part II of our Annual Report on Form 10-K for the year ended December 31, 2017, filed with the SEC on March 7, 2018.

Factors That May Affect Future Results

You should carefully consider the information set forth below. The following risk factors describe situations in which our business, financial condition and/or results of operations could be materially harmed, and the value of our securities may be adversely affected. You should also refer to other information included or incorporated by reference in this report.

The intended monetization of our partner company interests and distribution of net proceeds to shareholders are subject to factors beyond our control.

In January 2018, we announced that we will not deploy any capital into new partner companies. We will instead focus on supporting, and maximizing monetization opportunities for our existing partner company interests to enable distributions of net proceeds to shareholders. However, this strategic plan may require providing significant additional capital and operational support to such existing partner companies and we may not be able to sell our partner company interests during any specific time frame or otherwise on desirable terms, if at all, and there can be no assurance as to how long this process will take or the results that this process will yield. There can be no assurance as to whether we will realize the value of escrowed proceeds, holdbacks or other contingent consideration, if any, associated with the sale of partner company interests. Additionally, there can be no assurance that we will be able to satisfy our liabilities during this process. Further, the method, timing and amount of any distributions resulting from the monetization of existing partner companies will be at the discretion of our Board of Directors and will depend on market and business conditions and our overall liabilities, capital structure and liquidity position.

The continuing costs and burdens associated with being a public company will constitute a much larger percentage of our expenses and we may in the future delist our Common Stock with the New York Stock Exchange and seek to deregister our Common Stock with the SEC.

We will remain a public company and will continue to be subject to the listing standards of the New York Stock Exchange and SEC rules and regulations, including the Dodd-Frank Wall Street Reform and Consumer Protection Act and the Sarbanes-Oxley Act of 2002. The costs and burdens of being a public company will be a significant and continually increasing portion of our expenses if we are able to monetize partner company interests. As part of such monetization efforts, we will likely in the future, once the majority of our partner company interests have been monetized and proceeds therefrom distributed, delist our Common Stock from the New York Stock Exchange and seek to deregister our Common Stock with the SEC. However, there can be no assurance as to the timing of such transactions, or whether such transactions will be completed at all, and we will continue to face the costs and burdens of being a public company until such time as our Common Stock is delisted with the New York Stock Exchange and deregistered with the SEC.

Our principal business strategy depends upon our ability to make good decisions regarding the deployment of capital into, and subsequent disposition of, existing partner company interests and, ultimately, the performance of our partner companies, which is uncertain.

If we make poor decisions regarding the deployment of capital into, and subsequent disposition of, existing partner companies, our business strategy will not succeed. If our partner companies do not succeed, the value of our assets could be significantly reduced and require substantial impairments or write-offs and our results of operations and the price of our common stock would be adversely affected. The risks relating to our partner companies include:

- most of our partner companies have a history of operating losses and/or limited operating history;
- the intense competition affecting the products and services our partner companies offer could adversely affect their businesses, financial condition, results of operations and prospects for growth;
- the inability to adapt to changing marketplaces;
- the inability to manage growth;
- the need for additional capital to fund their operations, which we may not be able to fund or which may not be available from third parties on acceptable terms, if at all;
- the inability to protect their proprietary rights and/or infringing on the proprietary rights of others;
- that our partner companies could face legal liabilities from claims made against them based upon their operations, products or work;
- the impact of economic downturns on their operations, results and growth prospects;

- the inability to attract and retain qualified personnel;
- the existence of government regulations and legal uncertainties may place financial burdens on the businesses of our partner companies; and
- the inability to plan for and manage catastrophic events.

These and other risks are discussed in detail under the caption “Risks Related to Our Partner Companies” below.

Our Credit Facility subjects us to interest rate risk.

In May 2017, we entered into a \$75.0 million secured, revolving credit facility (“Credit Facility”) with HPS Investment Partners, LLC (“Lender”). Debt service costs under the Credit Facility are subject to interest rate changes. Interest rates could rise from time to time and significantly increase our cost of borrowing. If that were to occur, replacing the Credit Facility with alternative credit arrangements having a lower cost of borrowing would likely not be possible and no assurance can be given that we would be able to refinance the Credit Facility on attractive terms or at all.

Servicing the indebtedness under the Credit Facility will require a significant amount of cash and our ability to generate cash depends on many factors beyond our control.

Our ability to make payments on the indebtedness under the Credit Facility will depend on our ability to generate cash in the future. We generate cash from proceeds we receive in connection with the sales of our interests in our partner companies. Due to the nature of the mergers and acquisitions market, and the developmental cycle of companies like our partner companies, our ability to generate specific amounts of liquidity from sales of our partner company interests in any given period of time cannot be assured. Our ability to generate cash is also, to a certain extent, subject to general economic, financial, competitive, legislative, regulatory and other factors that are beyond our control. The risk exists that our business will be unable to generate sufficient cash flow to service our indebtedness under the Credit Facility.

Covenants in the agreements governing the Credit Facility could adversely affect our business and/or result in the operation of our business in a way other than as desired by management; our ability to comply with such covenants may be affected by events beyond our control; and a breach of any of these covenants could result in a default under the agreements governing the Credit Facility, which, if not cured or waived, could result in the acceleration of the indebtedness under the Credit Facility.

The Credit Facility contains various covenants that prohibit or limit, subject to certain exceptions, our ability to, among other things:

- Sell, transfer, lease, convey or otherwise dispose of all or any part of our business or property;
- Exceed concentration limits with respect to the amount of capital deployed to any single partner company;
- Exceed concentration limits with respect to the amount of capital deployed to one or more partner companies operating in the same or similar industries;
- Deploy capital to partner companies operating outside of certain specified industries;
- Incur or assume liens or additional debt or provide guarantees in respect of obligations of other persons;
- Pay any dividends or make any distribution (in cash or in kind) or payment in respect of, or redeem, retire or purchase any capital stock;
- Enter into, or permit any of our subsidiaries to enter into, any sale and leaseback transaction;
- Wind-up, liquidate or dissolve, or merge, consolidate or amalgamate with any person, or permit any of our subsidiaries to do (or agree to do) so;
- Enter into certain transactions with affiliates; and
- Amend, modify or otherwise change any of our governing documents.

In addition, the Credit Facility requires us to among other things, maintain (i) a liquidity threshold of at least \$20 million of unrestricted cash; (ii) a tangible net worth, plus unrestricted cash, of at least 1.75x the amount then outstanding under the Credit Facility; and (iii) a minimum aggregate appraised value of the Company’s ownership interests in its partner companies, plus unrestricted cash in excess of the liquidity threshold, of at least \$350 million.

The foregoing covenants could adversely affect our ability to finance our operations, engage in business activities that may be in our interest and plan for or react to market conditions or otherwise execute our business strategies.

Our ability to comply with these covenants may be affected by events beyond our control, including prevailing economic, financial and industry conditions.

Our failure to comply with any of these covenants could result in a default under the Credit Facility. If that were to occur, the Lender could choose to accelerate the maturity of the indebtedness. If the Lender were to accelerate the maturity of the indebtedness, we may not have sufficient liquidity to repay the entire balance of the outstanding borrowings and other obligations under the Credit Facility.

A significant amount of our deployed capital may be concentrated in partner companies operating in the same or similar industries, limiting the diversification of our capital deployments.

Except as may be agreed to with our debt providers, we do not have fixed guidelines for diversification of capital deployments, and our capital deployments could be concentrated in several partner companies that operate in the same or similar industries. This may cause us to be more susceptible to any single economic, regulatory or other occurrence affecting those particular industries than we would otherwise be if our partner companies operated in more diversified industries.

Our business model does not rely upon, or plan for, the receipt of operating cash flows from our partner companies. Our partner companies generally provide us with no cash flow from their operations. We rely on cash on hand, liquidity events and our ability to generate cash from capital raising activities to finance our operations.

We need capital to fund the capital needs of our existing partner companies. We also need cash to service and repay our outstanding debt, finance our corporate overhead and meet our existing funding commitments. As a result, we have substantial cash requirements. Our partner companies generally provide us with no cash flow from their operations. To the extent our partner companies generate any cash from operations, they generally retain the funds to develop their own businesses. As a result, we must rely on cash on hand, partner company liquidity events and new capital raising activities to meet our cash needs. If we are unable to find ways of monetizing our holdings or raising additional capital on attractive terms, we may face liquidity issues that will require us to constrain our ability to execute our business strategy and limit our ability to provide financial support to our existing partner companies. Fluctuations in the price of the common stock of our publicly traded holdings may affect the price of our common stock.

From time to time, we may hold equity interests in companies that are publicly traded. Fluctuations in the market prices of the common stock of publicly traded holdings may affect the price of our common stock. Historically, the market prices of our publicly traded holdings have been highly volatile and subject to fluctuations unrelated or disproportionate to operating performance.

We may be unable to obtain maximum value for our holdings or to sell our holdings on a timely basis.

We hold significant positions in our partner companies. Consequently, if we were to divest all or part of our holdings in a partner company, we may have to sell our interests at a relative discount to a price which may be received by a seller of a smaller portion. For partner companies with publicly traded stock, we may be unable to sell our holdings at then-quoted market prices. The trading volume and public float in the common stock of a publicly traded partner company may be small relative to our holdings. As a result, any significant open-market divestiture by us of our holdings in such a partner company, if possible at all, would likely have a material adverse effect on the market price of its common stock and on our proceeds from such a divestiture. Additionally, we may not be able to take our partner companies public as a means of monetizing our position or creating shareholder value.

Registration and other requirements under applicable securities laws and contractual restrictions also may adversely affect our ability to dispose of our partner company holdings on a timely basis.

Our success is dependent on our senior management.

Our success is dependent on our senior management team's ability to execute our strategy. On April 6, 2018, we publicly announced a series of management changes intended to streamline our organizational structure and reduce our operating costs. These aggressive cost-reduction initiatives are intended to better align our cost structure with the strategy we announced in January 2018 to reduce our operating costs, monetize our Partner Company interests and maximize the net proceeds distributable to our shareholders. These management changes included the departure of three members of our management team, including our current President and Chief Executive Officer, our current Senior Vice President and Chief Financial Officer, and our current Senior Vice President of Investor Relations and Corporate Communications. A loss of one or more of the remaining members of our senior management team without adequate replacement could have a material adverse effect on us.

Our business strategy may not be successful if valuations in the market sectors in which our partner companies participate decline.

Our strategy involves creating value for our shareholders by helping our partner companies build value and, if appropriate, accessing the public and private capital markets. Therefore, our success is dependent on the value of our

partner companies as determined by the public and private capital markets. Many factors, including reduced market interest, may cause

the market value of our partner companies to decline. If valuations in the market sectors in which our partner companies participate decline, their access to the public and private capital markets on terms acceptable to them may be limited.

Our partner companies could make business decisions that are not in our best interests or with which we do not agree, which could impair the value of our holdings.

Although we currently own a significant, influential interest in some of our partner companies, we do not maintain a controlling interest in any of our partner companies. Acquisitions of interests in partner companies in which we share or have no control, and the dilution of our interests in or loss of control of partner companies, will involve additional risks that could cause the performance of our interests and our operating results to suffer, including:

- the management of a partner company having economic or business interests or objectives that are different from ours; and

- the partner companies not taking our advice with respect to the financial or operating issues they may encounter.

Our inability to control our partner companies also could prevent us from assisting them, financially or otherwise, or could prevent us from liquidating our interests in them at a time or at a price that is favorable to us. Additionally, our partner companies may not act in ways that are consistent with our business strategy. These factors could hamper our ability to maximize returns on our interests and cause us to incur losses on our interests in these partner companies.

We may have to buy, sell or retain assets when we would otherwise not wish to do so in order to avoid registration under the Investment Company Act.

The Investment Company Act of 1940 regulates companies which are engaged primarily in the business of investing, reinvesting, owning, holding or trading in securities. Under the Investment Company Act, a company may be deemed to be an investment company if it owns investment securities with a value exceeding 40% of the value of its total assets (excluding government securities and cash items) on an unconsolidated basis, unless an exemption or safe harbor applies. We refer to this test as the “40% Test.” Securities issued by companies other than consolidated partner companies are generally considered “investment securities” for purposes of the Investment Company Act, unless other circumstances exist which actively involve the company holding such interests in the management of the underlying company. We are a company that partners with growth-stage companies to build value; we are not engaged primarily in the business of investing, reinvesting or trading in securities. We are in compliance with the 40% Test.

Consequently, we do not believe that we are an investment company under the Investment Company Act.

We monitor our compliance with the 40% Test and seek to conduct our business activities to comply with this test. It is not feasible for us to be regulated as an investment company because the Investment Company Act rules are inconsistent with our strategy of actively helping our partner companies in their efforts to build value. In order to continue to comply with the 40% Test, we may need to take various actions which we would otherwise not pursue.

For example, we may need to retain a controlling interest in a partner company that we no longer consider strategic, we may not be able to acquire an interest in a company unless we are able to obtain a controlling ownership interest in the company, or we may be limited in the manner or timing in which we sell our interests in a partner company. Our ownership levels also may be affected if our partner companies are acquired by third parties or if our partner companies issue stock which dilutes our ownership interest. The actions we may need to take to address these issues while maintaining compliance with the 40% Test could adversely affect our ability to create and realize value at our partner companies.

Economic disruptions and downturns may have negative repercussions for us.

Events in the United States and international capital markets, debt markets and economies may negatively impact our stock price and our ability to pursue certain tactical and strategic initiatives, such as accessing additional public or private equity or debt financing for us or for our partner companies and selling our interests in partner companies on terms acceptable to us and in time frames consistent with our expectations.

We cannot provide assurance that material weaknesses in our internal control over financial reporting will not be identified in the future.

We cannot assure you that material weaknesses in our internal control over financial reporting will not be identified in the future. Any failure to maintain or implement required new or improved controls, or any difficulties we encounter in their implementation, could result in a material weakness, or could result in material misstatements in our

Consolidated Financial Statements. These misstatements could result in a restatement of our Consolidated Financial Statements, cause us to fail to meet our reporting obligations and/or cause investors to lose confidence in our reported financial information, leading to a decline in our stock price.

Risks Related to Our Partner Companies

Most of our partner companies have a history of operating losses and/or limited operating history and may never be profitable.

Most of our partner companies have a history of operating losses and/or limited operating history, have significant historical losses and may never be profitable. Many have incurred substantial costs to develop and market their products, have incurred net losses and cannot fund their cash needs from operations. We expect that the operating expenses of certain of our partner companies will increase substantially in the foreseeable future as they continue to develop products and services, increase sales and marketing efforts, and expand operations.

Our partner companies face intense competition, which could adversely affect their business, financial condition, results of operations and prospects for growth.

There is intense competition in the technology marketplaces, and we expect competition to intensify in the future. Our business, financial condition, and results of operations will be materially adversely affected if our partner companies are not able to compete successfully. Many of the present and potential competitors may have greater financial, technical, marketing and other resources than those of our partner companies. This may place our partner companies at a disadvantage in responding to the offerings of their competitors, technological changes or changes in client requirements. Also, our partner companies may be at a competitive disadvantage because many of their competitors have greater name recognition, more extensive client bases and a broader range of product offerings. In addition, our partner companies may compete against one another.

The success or failure of many of our partner companies is dependent upon the ultimate effectiveness of newly-created technologies, medical devices, financial services, healthcare diagnostics, etc.

Our partner companies' business strategies are often highly dependent upon the successful launch and commercialization of an innovative technology or device, including, without limitation, technologies or devices used in healthcare, financial services or digital media. Despite all of our efforts to understand the research and development underlying the innovation or creation of such technologies and devices before we deploy capital into a partner company, sometimes the performance of the technology or device does not match our expectations or those of our partner company. In those situations, it is likely that we will incur a partial or total loss of the capital which we deployed in such partner company.

Our partner companies may fail if they do not adapt to changing marketplaces.

If our partner companies fail to adapt to changes in technology and customer and supplier demands, they may not become or remain profitable. There is no assurance that the products and services of our partner companies will achieve or maintain market penetration or commercial success, or that the businesses of our partner companies will be successful.

The technology marketplaces are characterized by:

- rapidly changing technology;
- evolving industry standards;
- frequent introduction of new products and services;
- shifting distribution channels;
- evolving government regulation;
- frequently changing intellectual property landscapes; and
- changing customer demands.

Our future success will depend on our partner companies' ability to adapt to these evolving marketplaces. They may not be able to adequately or economically adapt their products and services, develop new products and services or establish and maintain effective distribution channels for their products and services. If our partner companies are unable to offer competitive products and services or maintain effective distribution channels, they will sell fewer products and services and forego potential revenue, possibly causing them to lose money. In addition, we and our partner companies may not be able to respond to the marketplace changes in an economically efficient manner, and our partner companies may become or remain unprofitable.

Our partner companies may grow rapidly and may be unable to manage their growth.

We expect some of our partner companies to grow rapidly. Rapid growth often places considerable operational, managerial and financial strain on a business. To successfully manage rapid growth, our partner companies must, among other things:

- improve, upgrade and expand their business infrastructures;
- scale up production operations;
- develop appropriate financial reporting controls;

- attract and retain qualified personnel; and
- maintain appropriate levels of liquidity.

If our partner companies are unable to manage their growth successfully, their ability to respond effectively to competition and to achieve or maintain profitability will be adversely affected.

Based on our business model, some or all of our partner companies will need to raise additional capital to fund their operations at any given time. We may not be able to fund some or all of such amounts and such amounts may not be available from third parties on acceptable terms, if at all. Further, if our partner companies do raise additional capital, either debt or equity, such capital may rank senior to our interests in such companies.

We cannot be certain that our partner companies will be able to obtain additional financing on favorable terms when needed, if at all. Because our resources and our ability to raise capital are not unlimited, we may not be able to provide partner companies with sufficient capital resources to enable them to reach a cash-flow positive position or a sale of the company, even if we wish to do so. General economic disruptions and downturns may also negatively affect the ability of some of our partner companies to fund their operations from other stockholders and capital sources. We also may fail to accurately project the capital needs of partner companies. If partner companies need capital but are not able to raise capital from us or other outside sources, then they may need to cease or scale back operations. In such event, our interest in any such partner company will become less valuable. If our partner companies raise additional capital, either debt or equity, that ranks senior to the capital we have deployed, such capital may entitle its holders to receive returns of capital before the dates on which we are entitled to receive any return of our deployed capital. Also, in the event of any insolvency, liquidation, dissolution, reorganization or bankruptcy of a partner company, holders of such partner company's instruments that rank senior to our deployed capital will typically be entitled to receive payment in full before we receive any return of our deployed capital. After returning such senior capital, such partner company may not have any remaining assets to use for returning capital to us, causing us to lose some or all of our deployed capital in such partner company.

Economic disruptions and downturns may negatively affect our partner companies' plans and their results of operations.

Many of our partner companies are largely dependent upon outside sources of capital to fund their operations. Disruptions in the availability of capital from such sources will negatively affect the ability of such partner companies to pursue their business models and will force such companies to revise their growth and development plans accordingly. Any such changes will, in turn, negatively affect our ability to realize the value of our capital deployments in such partner companies.

In addition, downturns in the economy as well as possible governmental responses to such downturns and/or to specific situations in the economy could affect the business prospects of certain of our partner companies, including, but not limited to, in the following ways: weaknesses in the financial services industries; reduced business and/or consumer spending; and/or systemic changes in the ways the healthcare system operates in the United States. Some of our partner companies may be unable to protect their proprietary rights and may infringe on the proprietary rights of others.

Our partner companies assert various forms of intellectual property protection. Intellectual property may constitute an important part of partner company assets and competitive strengths. Federal law, most typically copyright, patent, trademark and trade secret laws, generally protects intellectual property rights. Although we expect that our partner companies will take reasonable efforts to protect the rights to their intellectual property, third parties may develop similar intellectual property independently. Moreover, the complexity of international trade secret, copyright, trademark and patent law, coupled with the limited resources of our partner companies and the demands of quick delivery of products and services to market, create a risk that partner company efforts to prevent misappropriation of their technology will prove inadequate.

Some of our partner companies also license intellectual property from third parties and it is possible that they could become subject to infringement actions based upon their use of the intellectual property licensed from those third parties. Our partner companies generally obtain representations as to the origin and ownership of such licensed intellectual property. However, this may not adequately protect them. Any claims against our partner companies' proprietary rights, with or without merit, could subject the companies to costly litigation and divert their technical and

management personnel from other business concerns. If our partner companies incur costly litigation and their personnel are not effectively deployed, the expenses and losses incurred by our partner companies will increase and their profits, if any, will decrease.

Third parties have and may assert infringement or other intellectual property claims against our partner companies based on their patents or other intellectual property claims. Even though we believe our partner companies' products do not infringe any third party's patents, they may have to pay substantial damages, possibly including treble damages, if it is ultimately determined that they do. They may have to obtain a license to sell their products if it is determined that their products infringe

on another person's intellectual property. Our partner companies might be prohibited from selling their products before they obtain a license, which, if available at all, may require them to pay substantial royalties. Even if infringement claims against our partner companies are without merit, defending these types of lawsuits takes significant time, is expensive and may divert management attention from other business concerns.

Certain of our partner companies could face legal liabilities from claims made against their operations, products or work.

Because manufacture and sale of certain partner company products entail an inherent risk of product liability, certain partner companies maintain product liability insurance. Although none of our current partner companies have experienced any material losses in this regard, there can be no assurance that they will be able to maintain or acquire adequate product liability insurance in the future and any product liability claim could have a material adverse effect on a partner company's financial stability, revenues and results of operations. In addition, many of the engagements of our partner companies involve projects that are critical to the operation of their clients' businesses. If our partner companies fail to meet their contractual obligations, they could be subject to legal liability, which could adversely affect their business, operating results and financial condition. Partner company contracts typically include provisions designed to limit their exposure to legal claims relating to their services and products. However, these provisions may not protect our partner companies or may not be enforceable. Also, some of our partner companies depend on their relationships with their clients and their reputation for high-quality services and integrity to retain and attract clients. As a result, claims made against our partner companies' work may damage their reputation, which in turn could impact their ability to compete for new work and negatively impact their revenue and profitability.

Our partner companies' success depends on their ability to attract and retain qualified personnel.

Our partner companies depend upon their ability to attract and retain senior management and key personnel, including trained technical and marketing personnel. Our partner companies also will need to continue to hire additional personnel as they expand. Although our current partner companies have not been the subject of a work stoppage, any future work stoppage could have a material adverse effect on their respective operations. A shortage in the availability of the requisite qualified personnel or work stoppage would limit the ability of our partner companies to grow, to increase sales of their existing products and services, and to launch new products and services.

Government regulations and legal uncertainties may place financial burdens on the businesses of our partner companies.

Failure to comply with applicable requirements of the FDA or comparable regulation in foreign countries can result in fines, recall or seizure of products, total or partial suspension of production, withdrawal of existing product approvals or clearances, refusal to approve or clear new applications or notices and criminal prosecution. Manufacturers of pharmaceuticals and medical diagnostic devices and operators of laboratory facilities are subject to strict federal and state regulation regarding validation and the quality of manufacturing and laboratory facilities. Failure to comply with these quality regulation systems requirements could result in civil or criminal penalties or enforcement proceedings, including the recall of a product or a "cease distribution" order. The enactment of any additional laws or regulations that affect healthcare insurance policy and reimbursement (including Medicare reimbursement) could negatively affect some of our partner companies. If Medicare or private payers change the rates at which our partner companies or their customers are reimbursed by insurance providers for their products, such changes could adversely impact our partner companies.

Some of our partner companies may be subject to significant environmental, health and safety regulation.

Some of our partner companies may be subject to licensing and regulation under federal, state and local laws and regulations relating to the protection of the environment and human health and safety, including laws and regulations relating to the handling, transportation and disposal of medical specimens, infectious and hazardous waste and radioactive materials, as well as to the safety and health of manufacturing and laboratory employees. In addition, the federal Occupational Safety and Health Administration has established extensive requirements relating to workplace safety. Compliance with such regulations could increase operating costs at certain of our partner companies, and the failure to comply could negatively affect the operations and results of some of our partner companies.

Catastrophic events may disrupt our partner companies' businesses.

Some of our partner companies are highly automated businesses and rely on their network infrastructure, various software applications and many internal technology systems and data networks for their customer support, development, sales and marketing and accounting and finance functions. Further, some of our partner companies provide services to their customers from data center facilities in multiple locations. Some of these data centers are operated by third parties, and the partner companies have limited control over those facilities. A disruption or failure of these systems or data centers in the event of a natural disaster, telecommunications failure, power outage, cyber-attack, war, terrorist attack or other catastrophic event could cause system interruptions, reputational harm, delays in product development, breaches of data security and loss of

critical data. Such an event could also prevent the partner companies from fulfilling customer orders or maintaining certain service level requirements, particularly in respect of their SaaS offerings. While certain of our partner companies have developed certain disaster recovery plans and maintain backup systems to reduce the potentially adverse effect of such events, a catastrophic event that resulted in the destruction or disruption of any of their data centers or their critical business or information technology systems could severely affect their ability to conduct normal business operations and, as a result, their business, operating results and financial condition could be adversely affected.

We cannot provide assurance that our partner companies' disaster recovery plans will address all of the issues they may encounter in the event of a disaster or other unanticipated issue, and their business interruption insurance may not adequately compensate them for losses that may occur from any of the foregoing. In the event that a natural disaster, terrorist attack or other catastrophic event were to destroy any part of their facilities or interrupt their operations for any extended period of time, or if harsh weather or health conditions prevent them from delivering products in a timely manner, their business, financial condition and operating results could be adversely affected.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

There have been no material changes to the information we previously disclosed under Item 7A of Part II of our Annual Report on Form 10-K for the year ended December 31, 2017, filed with the SEC on March 7, 2018.

Item 4. Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures as of March 31, 2018 are functioning effectively to provide reasonable assurance that the information required to be disclosed by us in reports filed under the Securities Exchange Act of 1934 is (i) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and (ii) accumulated and communicated to our management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding disclosure. A controls system cannot provide absolute assurance that the objectives of the controls system are met, and no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected.

(b) Change in Internal Control over Financial Reporting

No change in our internal control over financial reporting occurred during our most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II

OTHER INFORMATION

Item 1. Legal Proceedings

None.

Item 1A. Risk Factors

Except as included under the heading "Factors That May Affect Future Results" above, there have been no material changes in our risk factors from the information set forth in our Annual Report on Form 10-K for the year ended December 31, 2017.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The following table provides information about purchases of equity securities by the Company and affiliated purchasers of the Company, during the quarter ended March 31, 2018, which equity securities are registered pursuant to Section 12 of the Securities Exchange Act of 1934, as amended (the "Exchange Act"):

Period	Total Number of Shares Purchased (a)	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plan (b)	Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plan (b)
January 1, 2018 - January 31, 2018	500	\$11.1000	—	\$ 14,636,135
February 1, 2018 - February 28, 2018	—	\$—	—	\$ 14,636,135
March 1, 2018 - March 31, 2018	11,596	\$12.4415	—	\$ 14,636,135
Total	12,096	\$12.3861	—	

(a) During the first quarter of 2018, the Company repurchased an aggregate of 12 thousand shares of its common stock initially issued as restricted stock awards to employees and subsequently withheld from employees to satisfy the statutory withholding tax liability upon the vesting of such restricted stock awards.

(b) In July 2015, our Board of Directors authorized the Company to repurchase shares of its outstanding common stock with an aggregate value of up to \$25.0 million. These repurchases may be made in open market or privately negotiated transactions, including under plans complying with Rule 10b5-1 of the Exchange Act, based on market conditions, stock price, and other factors. The share repurchase program does not obligate the Company to acquire any specific number of shares.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

Item 6. Exhibits

(a) Exhibits.

The following is a list of exhibits required by Item 601 of Regulation S-K to be filed as part of this Report. For exhibits that previously have been filed, the Registrant incorporates those exhibits herein by reference. Documents which are incorporated by reference to filings by parties other than the Registrant are identified in a footnote to this table.

Exhibit Number	Description
31.1 †	<u>Certification of Stephen T. Zarrilli pursuant to Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934.</u>
31.2 †	<u>Certification of Jeffrey B. McGroarty pursuant to Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934.</u>
32.1 ‡	<u>Certification of Stephen T. Zarrilli pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</u>
32.2 ‡	<u>Certification of Jeffrey B. McGroarty pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</u>
101	The following materials from Safeguard Scientifics, Inc. Quarterly Report on Form 10-Q for the quarter ended March 31, 2018, formatted in XBRL (eXtensible Business Reporting Language); (i) Consolidated Balance Sheets (unaudited); (ii) Consolidated Statements of Operations (unaudited); (iii) Consolidated Statements of Comprehensive Income (Loss) (unaudited); (iv) Condensed Consolidated Statements of Cash Flows (unaudited); (v) Consolidated Statement of Changes in Equity (unaudited); and (vi) Notes to Consolidated Financial Statements (unaudited).

† Filed herewith

‡ Furnished herewith

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.

SAFEGUARD SCIENTIFICS, INC.

Date: April 26, 2018 /s/ Stephen T. Zarrilli

Stephen T. Zarrilli

President and Chief Executive Officer

Date: April 26, 2018 /s/ Jeffrey B. McGroarty

Jeffrey B. McGroarty

Senior Vice President and Chief Financial Officer