EMAGIN CORP
Form 10-Q
November 08, 2012

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

Form 10-Q

(Mark One)
R QUARTERLY REPORT UNDER SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2012
or

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

For the transition period from to

Commission file number 001-15751

eMAGIN CORPORATION
(Exact name of registrant as specified in its charter)

Delaware	56-1764501
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

3006 Northup Way, Suite 103, Bellevue, Washington 98004
(Address of principal executive offices)

(425) 284-5200
(Registrant's telephone number, including area code)

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 Per Share

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 R No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T

(§232.405 of this chapter) during the preceding 12 months). Yes R No ¨

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

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

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

The number of shares of common stock outstanding as of October 31, 2012 was 23,674,541.

Table Of Contents

eMagin Corporation

Form 10-Q
For the Quarter ended September 30, 2012

Table of Contents

		Page
PART I FINANCIAL INFORMATION		
Item 1	Condensed Consolidated Financial Statements	3
	Condensed Consolidated Balance Sheets as of September 30, 2012 (unaudited) and December 31, 2011	3
	Condensed Consolidated Statements of Operations for the Three and Nine Months ended September 30, 2012 and 2011 (unaudited)	4
	Condensed Consolidated Statements of Cash Flows for the Nine Months ended September 30, 2012 and 2011 (unaudited)	5
	Notes to Condensed Consolidated Financial Statements (unaudited)	6
Item 2	Management's Discussion and Analysis of Financial Condition and Results of Operations	14
Item 3	Quantitative and Qualitative Disclosures About Market Risk	18
Item 4	Controls and Procedures	19
PART II OTHER INFORMATION		
Item 1	Legal Proceedings	20
Item 1A	Risk Factors	20
Item 2	Unregistered Sales of Equity Securities and Use of Proceeds	20
Item 3	Defaults Upon Senior Securities	20
Item 4	Mine Safety Disclosures	20
Item 5	Other Information	20
Item 6	Exhibits	20
SIGNATURES		21

CERTIFICATIONS

Table Of Contents

ITEM 1. Condensed Consolidated Financial Statements

eMAGIN CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except share data)

	September 30, 2012 (unaudited)	December 31, 2011
ASSETS		
Current assets:		
Cash and cash equivalents	$ 7,567	$ 7,571
Investments	8,267	5,745
Accounts receivable, net	4,977	5,576
Inventories, net	2,814	2,760
Prepaid expenses and other current assets	931	1,008
Total current assets	24,556	22,660
Long-term investments	761	1,000
Equipment, furniture and leasehold improvements, net	6,904	5,980
Other assets	125	127
Deferred tax asset	8,165	8,165
Total assets	$ 40,511	$ 37,932
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 888	$ 961
Accrued expenses	2,462	2,246
Other current liabilities	739	614
Total current liabilities	4,089	3,821
Commitments and contingencies (Note 8)		
Shareholders' equity:		
Preferred stock, $.001 par value: authorized 10,000,000 shares:		
Series B Convertible Preferred stock, (liquidation preference of $5,659,000) stated value $1,000 per share, $.001 par value: 10,000 shares designated and 5,659 issued and outstanding as of September 30, 2012 and December 31, 2011	—	—
Common stock, $.001 par value: authorized 200,000,000 shares, issued and outstanding, 23,674,541 shares as of September 30, 2012 and 23,513,978 as of December 31, 2011	24	24
Additional paid-in capital	223,052	220,838
Accumulated deficit	(186,191)	(186,656)
Treasury stock, 150,000 shares as of September 30, 2012 and 25,000 shares as of December 31, 2011	(463)	(95)
Total shareholders' equity	36,422	34,111

Total liabilities and shareholders' equity	$	40,511	$	37,932

See notes to Condensed Consolidated Financial Statements.

Table Of Contents

eMAGIN CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except share and per share data)
(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Revenue:				
Product	$ 6,309	$ 6,306	$ 19,263	$ 16,564
Contract	1,201	1,957	2,971	4,589
Total revenue, net	7,510	8,263	22,234	21,153
Cost of goods sold:				
Product	3,132	2,902	9,914	8,554
Contract	729	1,002	1,477	2,368
Total cost of goods sold	3,861	3,904	11,391	10,922
Gross profit	3,649	4,359	10,843	10,231
Operating expenses:				
Research and development	1,173	765	3,571	2,071
Selling, general and administrative	1,918	1,992	6,525	6,361
Total operating expenses	3,091	2,757	10,096	8,432
Income from operations	558	1,602	747	1,799
Other income (expense):				
Interest expense, net	(10)	(26)	(18)	(85)
Other income, net	13	3	32	32
Change in fair value of warrant liability	—	3,028	—	2,548
Total other income (expense), net	3	3,005	14	2,495
Income before provision for income taxes	561	4,607	761	4,294
Provision for income taxes	221	488	295	542
Net income	$ 340	$ 4,119	$ 466	$ 3,752
Less net income allocated to participating securities	83	1,015	113	954
Net income allocated to common shares	$ 257	$ 3,104	$ 353	$ 2,798
Income per share, basic	$ 0.01	$ 0.13	$ 0.02	$ 0.13
Income per share, diluted	$ 0.01	$ 0.03	$ 0.01	$ 0.02
Weighted average number of shares outstanding:				
Basic	23,444,361	23,084,229	23,473,770	22,153,525
Diluted	25,393,035	25,322,920	25,360,864	25,642,105

See notes to Condensed Consolidated Financial Statements.

Table Of Contents

eMAGIN CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Nine Months Ended September 30,	
	2012	2011
	(unaudited)	
Cash flows from operating activities:		
Net income	$466	$3,752
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	168	118
Reduction of provision for sales returns and doubtful accounts	—	(98)
Stock-based compensation	1,959	1,777
Change in the fair value of warrant liability	—	(2,548)
Changes in operating assets and liabilities:		
Accounts receivable	599	(645)
Inventory	(54)	(214)
Prepaid expenses and other current assets	77	(80)
Accounts payable, accrued expenses, and other current liabilities	267	(453)
Net cash provided by operating activities	3,482	1,609
Cash flows from investing activities:		
Purchase of equipment	(1,090)	(1,350)
Purchase of investments, net	(2,283)	(2,645)
Net cash used in investing activities	(3,373)	(3,995)
Cash flows from financing activities:		
Proceeds from exercise of stock options	255	526
Proceeds from exercise of stock warrants	—	562
Purchase of treasury stock for retirement	(368)	—
Net cash (used in) provided by financing activities	(113)	1,088
Net decrease in cash and cash equivalents	(4)	(1,298)
Cash and cash equivalents, beginning of period	7,571	7,796
Cash and cash equivalents, end of period	$7,567	$6,498
Cash paid for interest, net of amount capitalized of $13 thousand in 2012	$—	$42
Cash paid for taxes	$—	$15
Non-cash financing activities:		
Issuance of 476,663 shares of common stock for cashless exercise of 581,895 warrants in 2011.	$—	$—
Conversion of 20 shares of Series B Convertible Preferred Stock for 26,666 shares of common stock in 2011.	$—	$—
Issuance of 49,685 shares of common stock for cashless exercise of 60,000 stock options in 2011.	$—	$—

See notes to Condensed Consolidated Financial Statements.

Table Of Contents

eMAGIN CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 1: Summary of Significant Accounting Policies

The Business

eMagin Corporation (the "Company") designs, develops, manufactures, and markets OLED (organic light emitting diode) on silicon microdisplays and virtual imaging products which utilize OLED microdisplays. The Company's products are sold mainly in North America, Asia, and Europe.

Basis of Presentation

In the opinion of management, the accompanying unaudited condensed consolidated financial statements of eMagin Corporation and its subsidiary reflect all adjustments, including normal recurring accruals, necessary for a fair presentation. All significant intercompany balances and transactions have been eliminated in consolidation. Certain information and footnote disclosure normally included in annual financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to instructions, rules and regulations prescribed by the Securities and Exchange Commission. The Company believes that the disclosures provided herein are adequate to make the information presented not misleading when these unaudited condensed consolidated financial statements are read in conjunction with the audited consolidated financial statements contained in the Company's Annual Report on Form 10-K for the year ended December 31, 2011. The results of operations for the period ended September 30, 2012 are not necessarily indicative of the results to be expected for the full year. The consolidated condensed financial statements of December 31, 2011 are derived from audited financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2011.

In accordance with accounting principles generally accepted in the United States of America, management utilizes certain estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. On an on-going basis, management evaluates its estimates and judgments related to, among others, allowance for doubtful accounts, warranty reserves, inventory reserves, stock-based compensation expense, deferred tax asset valuation allowances, litigation and other loss contingencies. Management bases its estimates and judgments on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results could differ from those estimates.

Revenue and Cost Recognition

Revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred, selling price is fixed or determinable and collection is reasonably assured. Product revenue is generally recognized when products are shipped to customers. The Company defers revenue recognition on products sold directly to the consumer with a maximum thirty day right of return. Revenue is recognized upon the expiration of the right of return.

The Company also earns revenues from certain research and development ("R&D") activities (contract revenues) under both firm fixed-price contracts and cost-type contracts. Revenues relating to firm fixed-price contracts and cost-type contracts are generally recognized on the percentage-of-completion method of accounting as costs are incurred (cost-to-cost basis). Progress is generally based on a cost-to-cost approach however an alternative method may be used such as physical progress, labor hours or others depending on the type of contract. Physical progress is

determined as a combination of input and output measures as deemed appropriate by the circumstances. Contract costs include all direct material and labor costs and an allocation of allowable indirect costs as defined by each contract, as periodically adjusted to reflect revised agreed upon rates. These rates are subject to audit by the other party.

Recently Issued Accounting Pronouncements

There are no recently issued accounting pronouncements that are expected to have a material impact on the Company's consolidated results of operations, financial position and cash flows.

Table Of Contents

Investments

Investments consist of debt securities including corporate obligations and FDIC-insured certificates of deposit with maturities up to eighteen months. The Company classifies these securities as held-to-maturity since it has the positive intent and ability to hold them until maturity. These securities are carried at amortized cost.

The held-to-maturity investments consist of the following as of September 30, 2012 and December 31, 2011(in thousands):

	September 30, 2012				December 31, 2011			
	Amortized Cost	Gross Unrecognized Gains	Gross Unrecognized Losses	Aggregate Fair Value	Amortized Cost	Gross Unrecognized Gains	Gross Unrecognized Losses	Aggregate Fair Value
Current investments:								
Corporate debt securities	$1,267	$ —	$ —	$1,267	$—	$ —	$ —	$—
Long-term investments:								
Corporate debt securities	$261	$ —	$ —	$261	$—	$ —	$ —	$—

The current investments mature within one year and the long-term investments mature between one and two years.

Net Income per Common Share

Basic income per share is computed using the weighted average number of common shares outstanding during the period, and excludes any dilutive effects of common stock equivalent shares, such as stock options, warrants, and convertible preferred stock. Diluted income per share is computed using the weighted average number of common shares outstanding and potentially dilutive common stock equivalent shares outstanding during the period. Common stock equivalent shares are excluded from the computation if their effect is anti-dilutive.

The Company’s Series B Convertible Preferred stock (“Preferred Stock – Series B”) is considered a participating security as the preferred stock participates in dividends with the common stock, which requires the use of the two-class method when computing basic and diluted earnings per share. The Preferred Stock – Series B is not required to absorb any net loss. The Company does not intend to pay dividends on its common or preferred stock.

Table Of Contents

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

	Three Months Ended September 30, 2012 (unaudited)			Three Months Ended September 30, 2011 (unaudited)		
	Income	Shares	Per Share Amount	Income	Shares	Per Share Amount
Basic EPS						
Net Income	$340			$4,119		
Income allocated to participating securities	$83			$1,015		
Income allocated to common shares	$257	23,444,361	$0.01	$3,104	23,084,229	$0.13
Diluted EPS						
Less: Change in fair value of warrant liability allocated to common shares	—			2,268		
Diluted potential common shares (1)		1,948,674			2,238,691	
Income allocated to common shares	$257	25,393,035	$0.01	$836	25,322,920	$0.03

	Nine Months Ended September 30, 2012 (unaudited)			Nine Months Ended September 30, 2011 (unaudited)		
	Income	Shares	Per Share Amount	Income	Shares	Per Share Amount
Basic EPS						
Net Income	$466			$3,752		
Income allocated to participating securities	$113			$954		
Income allocated to common shares	$353	23,473,770	$0.02	$2,798	22,153,525	$0. 13
Diluted EPS						
Less: Change in fair value of warrant liability allocated to common shares	—			2,247		
Diluted potential common shares (1)		1,887,094			3,488,580	
Income allocated to common shares	$353	25,360,864	$0.01	$551	25,642,105	$0.02

(1) Dilutive potential common shares consist of stock options and warrants.

For the three and nine months ended September 30, 2012, there were stock options and warrants to acquire 2,657,398 and 3,024,398 shares, respectively, of the Company’s common stock which were excluded from the computation of its diluted earnings per share as their effect would be antidilutive.

8

Table Of Contents

For the three and nine months ended September 30, 2011, there were stock options outstanding to acquire 1,545,086 and 1,463,086 shares of the Company's common stock which were excluded from the computation of its diluted earnings per share as their effect would be antidilutive.

Note 2: Accounts Receivable, net

The majority of the Company's commercial accounts receivable are due from Original Equipment Manufacturers ("OEM's"). Credit is extended based on an evaluation of a customer's financial condition and, generally, collateral is not required.

Accounts receivable consisted of the following (in thousands):

	September 30, 2012 (unaudited)	December 31, 2011
Accounts receivable	$ 5,244	$ 5,844
Less allowance for doubtful accounts	(267)	(268)
Net receivable	$ 4,977	$ 5,576

Note 3: Inventories, net

The components of inventories are as follows (in thousands):

	September 30, 2012 (unaudited)	December 31, 2011
Raw materials	$ 1,415	$ 1,092
Work in process	811	985
Finished goods	597	689
	2,823	2,766
Less inventory reserve	(9)	(6)
Total inventories, net	$ 2,814	$ 2,760

Note 4: Line of Credit

At September 30, 2012, the Company renewed its line of credit with Access Business Finance, LLC ("Access") under which the Company may borrow up to a maximum of $3 million based on a borrowing base equivalent of 75% of eligible accounts receivable. There were no changes in the terms of the line of credit. The terms are: the minimum monthly interest payment is $1,000; the interest rate is Prime plus 5% but not less than 8.25%; and the early termination fee is $6,000. The renewal date of the line of credit is September 1, 2013. The Company's obligations under the agreement are secured by its assets. The Company accrued $30,000 in loan fees which were charged to prepaid expense and will be amortized over the renewal period of twelve months. For the three and nine months ended September 30, 2012, the Company had not borrowed on its line of credit.

Table Of Contents

Note 5: Stock-based Compensation

The Company uses the fair value method of accounting for share-based compensation arrangements. The fair value of stock options is estimated at the date of grant using the Black-Scholes option valuation model. Stock-based compensation expense is reduced for estimated forfeitures and is amortized over the vesting period using the straight-line method.

The following table summarizes the allocation of non-cash stock-based compensation to our expense categories for the three and nine month periods ended September 30, 2012 and 2011 (in thousands):

	Three Months Ended September 30, (unaudited)		Nine Months Ended September 30, (unaudited)	
	2012	2011	2012	2011
Cost of revenue	$ 70	$ 62	$ 206	$ 148
Research and development	147	130	434	279
Selling, general and administrative	342	224	1,319	1,350
Total stock compensation expense	$ 559	$ 416	$ 1,959	$ 1,777

At September 30, 2012, total unrecognized compensation costs related to stock options was approximately $3.2 million, net of estimated forfeitures. Total unrecognized compensation cost will be adjusted for future changes in estimated forfeitures and is expected to be recognized over a weighted average period of approximately 1.9 years.

The following key assumptions were used in the Black-Scholes option pricing model to determine the fair value of stock options granted:

	For the Nine Months Ended September 30,	
	2012	2011
Dividend yield	0 %	0 %
Risk free interest rates	0.36 – 0.87%	1.04 - 2.37 %
Expected volatility	71.8 to 81.2 %	67.1 to 85.7 %
Expected term (in years)	3.0 to 5.5	3.5 to 5.5

The Company has not declared or paid any dividends and does not currently expect to do so in the near future. The risk-free interest rate used in the Black-Scholes option pricing model is based on the implied yield currently available on U.S. Treasury securities with an equivalent term. Expected volatility is based on the weighted average historical volatility of the Company's common stock for the equivalent term. The expected term of options represents the period that our stock-based awards are expected to be outstanding and was determined based on historical experience and vesting schedules of similar awards.

Table Of Contents

A summary of the Company's stock option activity for the nine months ended September 30, 2012 is presented in the following tables:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (In Years)	Aggregate Intrinsic Value
Outstanding at December 31, 2011	4,242,251	$3.93		
Options granted	687,531	3.47		
Options exercised	(160,563)	1.59		
Options forfeited or expired	(18,152)	8.83		
Options cancelled	—	—		
Outstanding at September 30, 2012	4,751,067	$3.93	5.53	$5,725,866
Vested or expected to vest at September 30, 2012 (1)	4,674,855	$3.90	5.55	$5,700,655
Exercisable at September 30, 2012	3,226,827	$3.14	5.92	$5,221,647

(1) The expected to vest options are the result of applying the pre-vesting forfeiture rate assumptions to total unvested options.

The aggregate intrinsic value in the table above represents the difference between the exercise price of the underlying options and the quoted price of the Company's common stock. During the three and nine months ended September 30, 2012, the aggregate intrinsic value of options exercised was $357 thousand and $421 thousand, respectively. The Company issues new shares of common stock upon exercise of stock options.

Note 6: Shareholders' Equity

Preferred Stock - Series B Convertible Preferred Stock ("the Preferred Stock – Series B")

As of September 30, 2012 and December 31, 2011, there were 5,659 shares of Preferred Stock – Series B issued and outstanding.

Common Stock

The Company received approximately $213 thousand and $255 thousand for the exercise of 131,688 and 160,563 stock options in the three and nine months ended September 30, 2012, respectively. The Company received approximately $12 thousand and $526 thousand for the exercise of 10,000 and 458,011 stock options in the three and nine months ended September 30, 2011, respectively. For the nine months ended September 30, 2011, there were 60,000 options exercised on a cashless basis resulting in 49,685 shares of common stock issued.

For the three and nine months ended September 30, 2012, there were no warrant exercises. There were 186,666 and 581,995 warrants exercised on a cashless basis resulting in 154,728 and 476,663 shares of common stock issued in the three and nine months ended September 30, 2011, respectively. For the three and nine months ended September 30, 2011, the Company received proceeds of approximately $480 thousand and $562 thousand from the exercise of warrants and issued 1,000,000 and 1,072,116 shares of common stock, respectively.

On August 24, 2011, the Company's Board of Directors approved a stock repurchase plan authorizing the Company to repurchase up to $2.5 million of its common stock. During the nine months ended September 30, 2012, the Company

purchased 125,000 shares of its common stock. These shares were purchased at an average cost of $2.95 per share, for a total of approximately $368 thousand. As of September 30, 2012, there was approximately $2.0 million remaining under the stock repurchase plan.

Table Of Contents

Note 7: Income Taxes

The Company's effective tax rate for the nine months ended September 30, 2012 and 2011 was 38.8% and 32.8%, respectively. The differences between the effective tax rate of 38.8% and the U.S. federal statutory rate of 34% for the nine months ended September 30, 2012 were primarily due to the impact of state income taxes and alternative minimum tax. For the nine months ended September 30, 2011, the difference between the effective tax rate of 32.8% and the U.S. federal statutory rate of 34% was primarily due to the impact of alternative minimum tax and state income taxes.

Due to the Company's operating loss carryforwards, all tax years remain open to examination by the major taxing jurisdictions to which the Company is subject. In the event that the Company is assessed interest or penalties at some point in the future, it will be classified in the financial statements as tax expense.

The Company's deferred tax assets and their potential realizability are evaluated each quarter to determine if any changes should be made to the valuation allowance. As of September 30, 2012, the Company has determined based on the weight of the available evidence, both positive and negative, it is more likely than not that $8.1 million of its deferred tax asset will be realized and no additional valuation allowance was released. In the fourth quarter of 2012, the Company expects to have additional information regarding a future, large government program and future sales of its new XGA display for electronic viewfinders which may have an impact on the Company's judgment about the realizability of its deferred tax assets, and the Company may adjust a portion of the valuation allowance as applicable.

Note 8: Commitments and Contingencies

Royalty Payments

The Company signed a license agreement on March 29, 1999 with Eastman Kodak ("Kodak'), under which it is obligated to make royalty payments. Under this agreement, the Company must pay to Kodak a minimum royalty plus a certain percentage of net sales with respect to certain products, which percentages are defined in the agreement. The percentages are on a sliding scale depending on the amount of sales generated. Any minimum royalties paid will be credited against the amounts due based on the percentage of sales. The royalty agreement terminates upon the expiration of the issued patent which is the last to expire. The Company was notified that Kodak sold substantially all rights and obligations under the Company's license agreement to Global OLED Technology ("GOT") as of December 30, 2009.

In late 2008, the Company began evaluating the status of its manufacturing process and the use of the intellectual property ("IP") associated with its license agreement. After this analysis and after making a few changes to its manufacturing process, by the end of 2008 the Company had stopped using the IP covered under the license agreement. The last royalty payment under the license agreement was made in November 2009. The Company determined that it is no longer required to pay the minimum royalty payment and as such has not paid or accrued this amount.

In April 2011, the Company received a request for royalty payments from a representative of GOT. The Company responded stating that the licenses were no longer in force and that the request for royalties was untimely. Although GOT does not agree, both parties have expressed an interest in resolving the disagreement amicably. Communications to date have been preliminary regarding its resolution. The Company estimates that the range of loss contingency is between $0 and $250 thousand.

Table Of Contents

Operating Leases

The Company leases office facilities and office, lab and factory equipment under operating leases. Certain leases provide for payments of monthly operating expenses. The Company currently has lease commitments for space in Hopewell Junction, New York, Bellevue, Washington, and Santa Clara, California.

The Company's manufacturing facilities are leased from IBM in Hopewell Junction, New York. eMagin leases approximately 37,000 square feet to house its equipment for OLED microdisplay fabrication and for research and development, an assembly area and administrative offices. The lease expires May 31, 2014 with the option of extending the lease for five years. The corporate headquarters are located in Bellevue, Washington where eMagin leases approximately 6,300 square feet. The lease expires on August 31, 2014. In addition, the Company leases approximately 2,400 square feet of office space for design and product development in Santa Clara, California and the lease has been extended to October 31, 2015.

Rent expense was approximately $302 thousand and $905 thousand, respectively, for the three and nine months ended September 30, 2012 and approximately $302 thousand and $889 thousand, respectively, for the three and nine months ended September 30, 2011.

Equipment Purchase Commitments

The Company has committed to equipment purchases of $1.7 million at September 30, 2012.

Note 9: Concentrations

For the three and nine months ended September 30, 2012, approximately 68% and 65%, respectively, of the Company's net revenues were derived from customers in the United States and approximately 32% and 35%, respectively, of the Company's net revenues were derived from international customers. For the three and nine months ended September 30, 2011, approximately 59% and 62%, respectively, of the Company's net revenues were derived from customers in the United States and approximately 41% and 38%, respectively, of the Company's net revenues were derived from international customers. For the three months ended September 30, 2012, two customers accounted for 38% of its revenues and for the nine months ended September 30, 2012, one customer accounted for 16% of its revenues. For the three months ended September 30, 2011, two customers accounted for 20% of its revenue and for the nine months ended September 30, 2011, there was no customer that accounted for more than 10% of its revenue.

The following is a schedule of revenue by geographic location (in thousands):

	Three Months Ended September 30, (unaudited)		Nine Months Ended September 30, (unaudited)	
	2012	2011	2012	2011
North and South America	$ 5,442	$ 5,029	$ 15,053	$ 13,562
Europe, Middle East, and Africa	1,349	1,978	5,180	5,505
Asia Pacific	719	1,256	2,001	2,086
Total	$ 7,510	$ 8,263	$ 22,234	$ 21,153

The Company purchases principally all of its silicon wafers from a single supplier located in Taiwan.

13

Table Of Contents

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

Statement of Forward-Looking Information

In this quarterly report, references to "eMagin Corporation," "eMagin," "Virtual Vision," "the Company," "we," "us," and "our" refer to eMagin Corporation and its wholly owned subsidiary, Virtual Vision, Inc.

Except for the historical information contained herein, some of the statements in this Report contain forward-looking statements that involve risks and uncertainties. These statements are found in the sections entitled "Management's Discussion and Analysis of Financial Condition and Results of Operation" and "Risk Factors." They include statements concerning: our business strategy; expectations of market and customer response; liquidity and capital expenditures; future sources of revenues; expansion of our proposed product line; and trends in industry activity generally. In some cases, you can identify forward-looking statements by words such as "may," "will," "should," "expect," "plan," "could," "anticipate," "intend," "believe," "estimate," "predict," "potential," "goal," or "continue" or similar terminology. These statements are only predictions and involve known and unknown risks, uncertainties and other factors, including, but not limited to, the risks outlined under "Risk Factors," that may cause our actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by such forward-looking statements. For example, assumptions that could cause actual results to vary materially from future results include, but are not limited to: our ability to successfully develop and market our products to customers; our ability to generate customer demand for our products in our target markets; the development of our target markets and market opportunities; our ability to manufacture suitable products at competitive cost; our ability to successfully launch new equipment on our manufacturing line; market pricing for our products and for competing products; the extent of increasing competition; technological developments in our target markets and the development of alternate, competing technologies in them; and sales of shares by existing shareholders. Although we believe that the expectations reflected in the forward looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. Unless we are required to do so under federal securities laws or other applicable laws, we do not intend to update or revise any forward-looking statements.

Overview

We design and manufacture miniature displays, which we refer to as OLED-on-silicon-microdisplays, and microdisplay modules for virtual imaging, primarily for incorporation into the products of other manufacturers. Microdisplays are typically smaller than many postage stamps, but when viewed through a magnifier they can contain all of the information appearing on a high-resolution personal computer screen. Our microdisplays use organic light emitting diodes, or OLEDs, which emit light themselves when a current is passed through the device. Our technology permits OLEDs to be coated onto silicon chips to produce high resolution OLED-on-silicon microdisplays.

We believe that our OLED-on-silicon microdisplays offer a number of advantages in near to the eye applications over other current microdisplay technologies, including lower power requirements, less weight, fast video speed without flicker, and wider viewing angles. In addition, many computer and video electronic system functions can be built directly into the OLED-on-silicon microdisplay, resulting in compact systems with lower expected overall system costs relative to alternate microdisplay technologies.

We have developed a strong intellectual property portfolio that includes patents, manufacturing know-how and unique proprietary technologies to create high performance OLED-on-silicon microdisplays and related optical systems. We believe our technology, intellectual property portfolio and position in the marketplace, gives us a leadership position in OLED and OLED-on-silicon microdisplay technology. We are one of only a few companies in the world to market and produce significant quantities of high resolution full-color small molecule OLED-on-silicon microdisplays.

At September 30, 2012, we had a total of 95 full-time and part-time employees as compared to 92 employees at December 31, 2011.

In the third quarter of 2012, we continued work on bringing up our new OLED deposition machine and qualifying the process for production. Our work to fully automate the tool was completed and we began manufacturing displays using this machine. Since there are numerous products and each requires a separate qualification process to be completed, we plan to continue to run some production on the Satella (our other OLED deposition machine) as necessary to meet customer demand.

Also in the third quarter 2012, we completed our initial version of our new XGA display and sent samples to a prospective customer. This display is intended to be used in electronic viewfinders of cameras. This development extends our product line further, enabling us to more favorably address more applications and opportunities for OLED microdisplays.

A detailed discussion of our business may be found in Part I, “Business,” of our 2011 Annual Report on Form 10-K for the year ended December 31, 2011 as filed with the Securities and Exchange Commission on March 10, 2012.

Table Of Contents

CRITICAL ACCOUNTING POLICIES

Revenue and Cost Recognition

Revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred, selling price is fixed or determinable and collection is reasonably assured. Product revenue is generally recognized when products are shipped to customers. We defer revenue recognition on products sold directly to the consumer with a maximum thirty day right of return. Revenue is recognized upon the expiration of the right of return.

We also earn revenues from certain R&D activities (contract revenues) under both firm fixed-price contracts and cost-type contracts. Revenues relating to firm fixed-price contracts and cost-type contracts are generally recognized on the percentage-of-completion method of accounting as costs are incurred (cost-to-cost basis). Progress is generally based on a cost-to-cost approach however an alternative method may be used such as physical progress, labor hours or others depending on the type of contract. Physical progress is determined as a combination of input and output measures as deemed appropriate by the circumstances. Contract costs include all direct material and labor costs and an allocation of allowable indirect costs as defined by each contract, as periodically adjusted to reflect revised agreed upon rates. These rates are subject to audit by the other party.

Income Taxes

Our deferred tax assets and their potential realizability are evaluated each quarter to determine if any changes should be made to the valuation allowance. As of September 30, 2012, we have determined based on the weight of the available evidence, both positive and negative, it is more likely than not that $8.1 million of our deferred tax asset will be realized and no additional valuation allowance was released. In the fourth quarter of 2012, we expect to have additional information regarding a future, large government program and future sales of our new XGA display for electronic viewfinders which may have an impact on our judgment about the realizability of our deferred tax assets and we may adjust a portion of the valuation allowance as applicable.

Other critical accounting policies, as described in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011, relate to product warranty, use of estimates, fair value of financial instruments and stock-based compensation, and additional information on accounting for income taxes.

NEW ACCOUNTING PRONOUNCEMENTS

See Note 1 of the Condensed Consolidated Financial Statements in Item 1 for a description of recent account pronouncements, including the expected dates of adoption and estimated effects on results of operations and financial condition.

RESULTS OF OPERATIONS

THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2012 COMPARED TO THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2011

Revenues

Revenues for the three and nine months ended September 30, 2012 were approximately $7.5 million and $22.2 million, respectively, as compared to approximately $8.3 million and $21.2 million, respectively, for the three and nine months ended September 30, 2011, a decrease of approximately $0.8 million or 9% for the three month period

and an increase of approximately $1.0 million or 5% for the nine month period.

Product revenue is comprised of sales of displays, Z800 systems, and other hardware. For the three months ended September 30, 2012, product revenue increased approximately $3 thousand as compared to the three months ended September 30, 2011. For the nine months ended September 30, 2012, product revenue increased approximately $2.7 million or 16% as compared to the nine months ended September 30, 2011. The increase in product revenue for the nine month periods was driven primarily by an increase in sales volume as the average sales price per display decreased 1% which is due to the mix of displays sold. For the three and nine months ended September 30, 2012, we shipped 5% and 18%, respectively, more displays as compared to the three and nine months ended September 30, 2011.

Contract revenue is comprised of revenue from research and development or non-recurring engineering ("NRE") contracts. For the three and nine months ended September 30, 2012, contract revenue decreased approximately $0.8 million or 39% and $1.6 million or 35%, respectively, as compared to the three and nine months ended September 30, 2011. The decrease in contract revenue for the three and nine month period in 2012 was a result of fewer and smaller active contracts as compared to 2011. Historically, many of these contracts are with U.S. government agencies. Although eMagin has been and expects to continue to be successful on winning new R&D contracts, including the contracts won this year such as USSOCOM and U.S. Navy, it is likely that the current U.S. government budget issues have impacted the number and amount of contracts available.

Table Of Contents

Cost of Goods Sold

Cost of goods sold is comprised of costs of product and contract revenues. Cost of product revenue includes materials, labor and manufacturing overhead related to our products. Cost of contract revenue includes direct and allocated indirect costs associated with performance of contracts. Cost of goods sold was approximately $3.9 million for the three month periods ended September 30, 2012 and 2011. Cost of goods sold for the nine months ended September 30, 2012 was approximately $11.4 million as compared to approximately $10.9 million for the nine months ended September 30, 2011, an increase of approximately $0.5 million. Cost of goods sold as a percentage of revenues was 51% for both the three and nine months ended September 30, 2012 as compared to 47% and 52% for the three and nine months ended September 30, 2011, respectively.

The following table outlines product, contract and total gross profit and related gross margins for the three and nine months ended September 30, 2012 and 2011 (dollars in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2012	2011	2012	2011
	(unaudited)		(unaudited)	
Product revenue gross profit	$3,177	$3,404	$9,349	$8,010
Product revenue gross margin	50 %	54 %	49 %	48 %
Contract revenue gross profit	$472	$955	$1,494	$2,221
Contract revenue gross margin	39 %	49 %	50 %	48 %
Total gross profit	$3,649	$4,359	$10,843	$10,231
Total gross margin	49 %	53 %	49 %	48 %

The gross profit for the three and nine months ended September 30, 2012 was approximately $3.6 million and $10.8 million, respectively, as compared to approximately $4.4 million and $10.2 million, respectively, for the three and nine months ended September 30, 2011, a decrease of approximately $0.8 million for the three month period and an increase of approximately $0.6 million for the nine month period. Gross margin was 49% for both the three and nine months ended September 30, 2012 and 53% and 48%, respectively, for the three and nine months ended September 30, 2011.

The product gross profit for the three and nine months ended September 30, 2012 was approximately $3.2 million and $9.3 million, respectively, as compared to approximately $3.4 million and $8.0 million, respectively, for the three and nine months ended September 30, 2011, a decrease of $0.2 million for the three month period and an increase of $1.3 million for the nine month period. Product gross margin was 50% and 49%, respectively, for the three and nine months ended September 30, 2012 down from 54% for the three month period and up from 48% for the nine month period. For the three month period of 2012, our gross margin decreased as compared to the three month period of 2011 as the cost per display produced in Q3 2012 was slightly higher than displays produced in Q3 2011 and we had a decrease in the average selling price. For the nine month period of 2012, our gross margin was favorably impacted as fixed production costs are spread over a higher revenue base. For the nine month period of 2012, the cost per display produced was lower than for displays produced in the nine month period in 2011 which was offset by a small decrease in the average selling price.

The contract gross profit for the three and nine months ended September 30, 2012 was approximately $0.5 million and $1.5 million, respectively, as compared to approximately $1.0 million and $2.2 million, respectively, for the three and nine months ended September 30, 2011, a decrease of approximately $0.5 million and $0.7 million, respectively. Contract gross margin was 39% and 50%, respectively, for the three and nine months ended September 30, 2012, a decrease from 49% for the three month period and an increase from 48% for the nine month period. The

contract gross margin is dependent upon the nature of the contract, the amount of costs actually incurred and mix of costs, internal versus external third party costs. External third party costs lower gross margins and reduce the contract gross profit.

Table Of Contents

Operating Expenses

Research and Development. Research and development ("R&D") expenses are company-funded and include salaries and related benefits, development materials and other costs specifically allocated to the development of new microdisplay products, OLED materials and subsystems. R&D related costs associated with fulfilling contracts are categorized as contract cost of goods sold. R&D expenses for the three and nine months ended September 30, 2012 were approximately $1.2 million and $3.6 million, respectively, as compared to approximately $0.8 million and $2.1 million, respectively, for the three and nine months ended September 30, 2011. The increase of approximately $0.4 million and $1.5 million, respectively, is related to an increase in personnel costs and related expenses to support R&D activities.

Selling, General and Administrative. Selling, general and administrative expenses consist principally of salaries and related benefits, professional services fees and marketing, general corporate, and administrative expenses. Selling, general and administrative expenses for the three and nine months ended September 30, 2012 were approximately $1.9 million and $6.5 million, respectively, as compared to approximately $2.0 million and $6.4 million, respectively, for the three and nine months ended September 30, 2011. The decrease in selling, general and administrative expenses for the three month period is attributable to a reduction of personnel and recruiting expenses. Year to date, selling, general and administrative costs have increased slightly, 2.6%.

Other Income (Expense), net. Other income (expense), net consists primarily of interest income earned on investments, interest expense, and income (expense) applicable to the change in the fair value of the warrant liability. For the three and nine months ended September 30, 2012, interest expense was approximately $10 thousand and $18 thousand, respectively, offset by the capitalization of interest $13 thousand for the nine month period as compared to approximately $26 thousand and $85 thousand, respectively, for the three and nine months ended September 30, 2011. We have no debt upon which we are incurring interest expense however we pay fees to keep our line of credit available. Other income, primarily interest income, for the three and nine months ended September 30, 2012 was approximately $13 thousand and $32 thousand, respectively, as compared to approximately $3 thousand and $32 thousand, respectively, for the three and nine months ended September 30, 2011.

Change in Fair Value of Warrant Liability. For the three and nine months ended September 30, 2012, the change in fair value of the warrant liability was $0 as the Company had no warrants that are accounted for as a liability. For the three and nine months ended September 30, 2011, the change in fair value of the warrant liability was income of $3.0 and $2.5 million, respectfully. The change in the fair value of the warrant liability was primarily due to the change in the common stock price of eMagin period over period. The change in fair value of the warrant liability had no impact on our cash balances, operations, or operating income. The warrant was modified to remove the anti-dilution provision therefore there will be no change in the fair value of the existing warrant going forward.

Liquidity and Capital Resources

As of September 30, 2012, we had approximately $16.6 million of cash, cash equivalents, and investments as compared to $14.3 million at December 31, 2011. Of the $16.6 million in cash, approximately $9.0 million was invested in certificates of deposits ("CDs") and corporate bonds.

Cash flow provided by operating activities during the nine months ended September 30, 2012 was approximately $3.5 million, attributable to our net income of approximately $0.5 million, net non-cash expenses of $2.1 million and the change in operating assets and liabilities of $0.9 million. Cash flow provided by operating activities during the nine months ended September 30, 2011 was approximately $1.6 million, attributable to our net income of approximately $3.8 million offset by net non-cash expenses of $0.8 million and the change in operating assets and liabilities of $1.4 million.

Cash used in investing activities during the nine months ended September 30, 2012 was approximately $3.4 million of which $2.3 million purchased investments in CDs and corporate bonds and approximately $1.1 million purchased equipment primarily for upgrading our production line. Cash used in investing activities during the nine months ended September 30, 2011 was approximately $4.0 million of which $2.6 million purchased CDs and approximately $1.4 million purchased equipment primarily for upgrading our production line. Presently we have committed approximately $1.7 million for capital expenditures for the balance of 2012.

Cash used by financing activities during the nine months ended September 30, 2012 was approximately $0.1 million of which approximately $0.4 million was used to purchase treasury stock offset by proceeds from the exercise of stock options of $0.3 million. Cash provided by financing activities during the nine months ended September 30, 2011 was approximately $1.1 million, representing proceeds from the exercise of stock options and warrants.

Table Of Contents

Credit Facility

At September 30, 2012, we had a credit facility with Access Business Finance, LLC ("Access") that provides for up to a maximum amount of $3 million based on a borrowing base equivalent of 75% of eligible accounts receivable. The interest on the credit facility is equal to the Prime Rate plus 5% but may not be less than 8.25% with a minimum monthly interest payment of $1 thousand. On September 1, 2012, we renewed our credit facility for a year. The credit facility will automatically renew on September 1, 2013 for a one year term unless written notice is provided. We did not draw on our credit facility during the quarter ended September 30, 2012, or at any time since its inception in September 2010 and there is no outstanding balance.

The credit facility contains the customary representations and warranties as well as affirmative and negative covenants. We were in compliance with all debt covenants as of September 30, 2012.

We expect our business to experience revenue growth which may result in higher accounts receivable levels and may require increased production and/or higher inventory levels. We anticipate that our cash needs to fund these requirements as well as other operating or investing cash requirements over the next twelve months will be less than our current cash on hand, investments and the cash we anticipate generating from operations. We anticipate that we will not require additional funds over the next twelve months other than perhaps for discretionary capital spending. If unanticipated events arise during the next twelve months, we believe we can raise sufficient funds. However, if we are unable to obtain sufficient funds, we may have to reduce the size of our organization and/or be forced to reduce and/or curtail our production and operations, all of which could have a material adverse impact on our business prospects.

Off-Balance Sheet Arrangements

We do not have any off balance sheet arrangements that are reasonably likely to have a current or future effect on our financial condition, revenues, results of operations, liquidity or capital expenditures.

ITEM 3. Quantitative and Qualitative Disclosures About Market Risk

Market rate risk

We are exposed to market risk related to changes in interest rates.

Interest rate risk

We hold our cash in cash and cash equivalents, certificates of deposits, and corporate bonds. We do not hold derivative financial instruments or equity securities. At September 30, 2012, we have not drawn on our revolving line of credit and therefore do not have any related interest rate risk. A change in interest rates would not have had a material effect on our consolidated financial position, results of operations, or cash flows in the three and nine months ended September 30, 2012.

Table Of Contents

Foreign currency exchange rate risk

We do not have any material foreign currency exchange rate risk.

ITEM 4. Controls and Procedures

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 defined in Rule 13a-15 under the Securities Exchange Act of 1934 (the "Exchange Act")) as of the end of the period covered by this Quarterly Report on Form 10-Q. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. In addition, the design of disclosure controls and procedures must reflect the fact that there are resource constraints and that management is required to apply its judgment in evaluating the benefits of possible controls and procedures relative to their costs.

Based on our evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by this report, our disclosure controls and procedures are designed at a reasonable assurance level and are effective to provide reasonable assurance that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

Limitations on the Effectiveness of Internal Controls.

Our disclosure controls and procedures are designed to provide reasonable, not absolute, assurance that the objectives of our disclosure control system are met. Because of inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues, if any, within a company have been detected. Our Chief Executive Officer and Chief Financial Officer have concluded, based on their evaluation as of the end of the period covered by this report, that our disclosure controls and procedures were sufficiently effective to provide reasonable assurance that the objectives of our disclosure control system were met.

Changes in Internal Controls.

There were no changes in our internal controls over financial reporting during the fiscal quarter ended September 30, 2012 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table Of Contents

PART II - OTHER INFORMATION

ITEM 1. Legal Proceedings

None.

ITEM 1A. Risk Factors

In addition to other information set forth in this Report, you should carefully consider the risk factors previously disclosed in “Item 1A to Part 1” of our Annual Report on Form 10-K for the year ended December 31, 2011. There were no material changes from the risk factors during the nine months ended September 30, 2012.

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

Unregistered Sales of Equity Securities

None.

Issuer Repurchases of Equity Securities

None.

ITEM 3. Defaults Upon Senior Securities

None.

ITEM 4. Mine Safety Disclosures

None.

ITEM 5. Other Information

None.

ITEM 6. Exhibits

31.1	Certification by Chief Executive Officer pursuant to Sarbanes Oxley Section 302 (1)
31.2	Certification by Chief Financial Officer pursuant to Sarbanes Oxley Section 302 (1)
32.1	Certification by Chief Executive Officer pursuant to 18 U.S.C. Section 1350 (1)
32.2	Certification by Chief Financial Officer pursuant to 18 U.S.C. Section 1350 (1)
101.INS	.XBRL Instance Document (2)
101.SCH	XBRL Taxonomy Extension Schema Document (2)
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document (2)

101.DEF	XBRL Taxonomy Extension Definition Linkbase Document (2)
101.LAB	XBRL Taxonomy Extension Label Linkbase Document (2)
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document (2)

(1) Filed herewith.

Table Of Contents

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 on this 8th day of November 2012.

eMAGIN CORPORATION

By: /s/ Andrew G. Sculley
Andrew G. Sculley
Chief Executive Officer
Principal Executive Officer

By: /s/ Paul Campbell
Paul Campbell
Chief Financial Officer
Principal Accounting and Financial Officer