GANNETT CO INC /DE/
Form 10-Q
November 06, 2013

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

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FORM 10-Q

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ý QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 29, 2013
OR
¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
Commission file number 1-6961

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GANNETT CO., INC.
(Exact name of registrant as specified in its charter)

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|---|---|
| Delaware | 16-0442930 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| 7950 Jones Branch Drive, McLean, Virginia | 22107-0910 |
| (Address of principal executive offices) | (Zip Code) |

Registrant’s telephone number, including area code: (703) 854-6000.
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 ý No ¨
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ý No ¨
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):

| | | | |
|---|---|---|---|
| Large Accelerated Filer | ý | Accelerated Filer | ¨ |
| Non-Accelerated Filer | ¨ | Smaller Reporting Company | ¨ |

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act): Yes ¨ No ý
The total number of shares of the registrant’s Common Stock, $1 par value outstanding as of September 29, 2013 was 227,893,735.

PART I. FINANCIAL INFORMATION

Items 1 and 2. Financial Statements and Management's Discussion and Analysis of Financial Condition and Results of Operations

MANAGEMENT'S DISCUSSION AND ANALYSIS OF OPERATIONS

Overview

Gannett Co., Inc. (the Company or Gannett) is a leading international media and marketing solutions company, informing and engaging more than 100 million people on multiple platforms every month through its network of publishing, broadcasting, and digital properties. Its publishing operations include 82 daily newspapers and about 480 magazines and other non-dailies in the U.S., as well as 17 daily paid-for titles, and more than 200 weekly print products, magazines and trade publications in the U.K. Its broadcasting operations consist of 23 television stations in 19 U.S. markets (including 12 television stations in the top 25 markets), reaching 18% of U.S. television households. The Company's Digital Segment consists of stand-alone digital subsidiaries, including CareerBuilder, the global leader in human capital solutions, helping companies target, attract and retain talent. Its online job site, CareerBuilder.com, is the single largest job site within North America, based on listings, traffic and ad revenue. In addition, the Company provides digital applications to consumers and commercial customers across all of its segments, ranging from online news and entertainment to digital marketing solutions.

Recent Developments

On June 12, 2013, Gannett entered into a merger agreement for the acquisition of Belo Corp. (Belo) for cash consideration of approximately $1.5 billion, in addition to the assumption of $715 million of existing Belo debt (the Merger). Belo is the owner of 20 television stations (nine in the top 25 U.S. markets) that reach more than 14% of U.S. television households, including ABC, CBS, NBC, FOX, CW and MyNetwork TV (MNTV) affiliates and their associated websites. Belo also has three local and two regional news channels. Upon completion of the merger, Gannett will operate the fourth-largest English-language television station group in the United States, reaching nearly one-third of all U.S. households.

The Merger will nearly double Gannett's broadcast portfolio from 23 to 43 stations, including stations Gannett expects to service through shared services or similar arrangements. Upon completion of the Merger, Gannett will achieve greater geographic diversity, operating or servicing 21 stations in the top 25 U.S. markets. Gannett's broadcast group will become the #1 CBS affiliate group, the #4 ABC affiliate group and will expand its already #1 NBC affiliate group position. In connection with the Merger, Gannett and Belo have planned, simultaneously with the consummation of the Merger, for a restructuring of certain of Belo's media holdings in which their stations located in the Louisville, Kentucky; Phoenix, Arizona; Portland, Oregon; St. Louis, Missouri; and Tucson, Arizona television markets (the Assigned Stations) will be conveyed to third parties (the Restructuring and, together with the Merger, the Transaction). Gannett will enter into shared services and similar support arrangements with the third party owners of these stations.

On August 22, 2013, the Company and Belo each received a request for additional information and documents (Second Requests) from the U.S. Department of Justice (DOJ) pursuant to the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended (HSR Act), in connection with the Merger. The Company and Belo are responding promptly to the Second Requests and continue working cooperatively with the DOJ as it conducts its review of the Merger.

On September 25, 2013, the Belo shareholders approved the Merger agreement by more than 72% of the voting power of all outstanding shares entitled to vote. Closing of the Transaction will occur once all closing conditions have been satisfied, including the expiration or termination of any waiting period under the HSR Act and the grant by the Federal Communications Commission of its consent to the consummation of the Transaction (each of which has been impacted by the shutdown of the federal government in October 2013), the receipt of specified third party consents, and other customary closing conditions.

On July 29, 2013, the Company completed the private placement of $600 million in aggregate principal amount of its 5.125% senior unsecured notes due 2020 (the 2020 Notes). The 2020 Notes were priced at 98.566% of face value, resulting in a yield to maturity of 5.375%. Subject to certain exceptions, the 2020 Notes may not be redeemed by the Company prior to July 15, 2016. The 2020 Notes were issued in a private offering that is exempt from the registration

requirements of the Securities Act of 1933. The 2020 Notes are guaranteed on a senior basis by the subsidiaries of the Company that guarantee its revolving credit facility, term loan and its notes maturing in 2014 and thereafter. The Company used the net proceeds to repay the outstanding indebtedness under its revolving credit facilities. Remaining proceeds will be used to repay the Company's outstanding unsecured notes, and/or for general corporate purposes.
On October 3, 2013, the Company completed the private placement of $600 million in aggregate principal amount of its 5.125% senior unsecured notes due 2019 (the 2019 Notes) and $650 million in aggregate principal amount of its 6.375% senior unsecured notes due 2023 (the 2023 Notes, and collectively with the 2019 Notes, the Merger Financing Notes).  The 2019

Notes were priced at 98.724% of face value, resulting in a yield to maturity of 5.375%. Subject to certain exceptions, the 2019 Notes may not be redeemed by the Company prior to October 15, 2016. The 2023 Notes were priced at 99.086% of face value, resulting in a yield to maturity of 6.500%. Subject to certain exceptions, the 2023 Notes may not be redeemed by the Company prior to October 15, 2018. The Merger Financing Notes were issued in a private offering that is exempt from the registration requirements of the Securities Act of 1933. The Merger Financing Notes are guaranteed on a senior basis by the subsidiaries of the Company that guarantee its revolving credit facility, term loan and its notes maturing in 2014 and thereafter. The net proceeds from the offering of the Merger Financing Notes were deposited into an escrow account and are held by a bank escrow agent, where such proceeds will remain until the satisfaction of certain conditions, including the consummation of the proposed acquisition of Belo. Upon the closing of the Merger, the net proceeds from the sale of the Merger Financing Notes plus available cash will be used to finance the acquisition. Any remaining proceeds may be used for general corporate purposes.

On August 5, 2013, the Company also entered into its Amended and Restated Credit Agreement, which is described below under "Liquidity, Capital Resources and Cash Flows."

Results from Operations

The Company generates revenue within its Publishing Segment primarily through advertising and subscriptions to Gannett's print and digital publications. Its advertising departments sell retail, classified and national advertising across multiple platforms including print, web sites, mobile, tablet and other specialty publications. The principal sources of revenues within the Company's Broadcasting Segment are advertising, fees paid for retransmission of the Company's television signals on satellite and cable networks, and payments for other services, such as the production of advertising content. Advertising includes local advertising focused on the immediate geographic area of the stations, national advertising, and advertising on the stations' web, tablet and mobile products. The largest subsidiary within Gannett's Digital Segment is CareerBuilder, which generates revenues both through its own sales force by providing talent and compensation intelligence, human resource related consulting services and recruitment solutions and through sales of employment advertising placed with its affiliated media organizations.

The Company's operating expenses consist primarily of payroll and benefits. Other significant operating expenses include production (raw materials) and distribution costs within its Publishing Segment, the costs of locally produced and purchased syndicated programming in the Broadcasting Segment and sales and marketing costs within the Digital Segment.

Consolidated Summary

A consolidated summary of the Company's results is presented below:

| In thousands of dollars, except earnings per share amounts | Third Quarter | | | | Year-to-Date | | | |
|---|---|---|---|---|---|---|---|---|
| | 2013 | 2012 | Change | | 2013 | 2012 | Change | |
| Operating revenues | $1,252,890 | $1,309,261 | (4 | %) | $3,793,324 | $3,834,888 | (1 | %) |
| Operating expenses | 1,081,192 | 1,092,062 | (1 | %) | 3,267,687 | 3,265,513 | — | % |
| Operating income | $171,698 | $217,199 | (21 | %) | $525,637 | $569,375 | (8 | %) |
| Non-operating expense | $47,497 | $29,891 | 59 | % | $113,232 | $92,874 | 22 | % |
| Provision for income taxes | $26,700 | $38,700 | (31 | %) | $71,700 | $116,500 | (38 | %) |
| Net income attributable to Gannett Co., Inc. | $79,748 | $133,083 | (40 | %) | $297,933 | $321,195 | (7 | %) |
| Per share – basic | $0.35 | $0.58 | (40 | %) | $1.30 | $1.38 | (6 | %) |
| Per share – diluted | $0.34 | $0.56 | (39 | %) | $1.27 | $1.35 | (6 | %) |

The cyclical nature of revenues within the Company's Broadcast Segment impacts year-over-year comparisons, due to the significant Summer Olympic and political spending that takes place during the third quarter every four years. The Company's operating revenues, which declined 4% on a GAAP (generally accepted accounting principles) basis in the third quarter of 2013, would have been flat if adjusted to remove the estimated impact of the incremental Olympic and record political advertising revenue reported in the third quarter of 2012. The Company's 2013 results, in comparison to 2012, were also impacted by the significant ramp-up of its All-Access Content Subscription Model, which

generated increases in circulation revenue as sites were launched throughout 2012; these benefits have narrowed throughout 2013 due to the lapping of the launch of the majority of sites.
Operating income for the third quarter of 2013 decreased 21% compared to the third quarter last year, reflecting higher Digital Segment operating income, offset by lower Publishing and Broadcasting Segment operating income.
Digital Segment

operating income increased 5% to $42.1 million, driven by solid revenue growth at CareerBuilder partially offset by higher sales-related expenses. Broadcasting Segment operating income decreased 29% to $83.8 million for the quarter due primarily to the loss of revenue associated with the Summer Olympics and record political advertising, which totaled $75 million, in the third quarter last year. Publishing Segment operating income was $62.7 million for the quarter, down 15% from last year due to advertising softness and investments in strategic initiatives.
For the year-to-date period, operating income decreased 8% compared to last year. Broadcasting Segment results for the year-to-date period were down 7% reflecting substantially lower political revenues and the absence of Olympic advertising revenues. Digital results were up 9% principally reflecting higher revenues at CareerBuilder. Publishing Segment results were down 13% due to slow economic growth and secular challenges that tempered advertising demand.
Net income attributable to Gannett for the third quarter of 2013 was $79.7 million, compared to $133.1 million in the third quarter of 2012, a decrease of 40%. Net income attributable to Gannett represents net income reduced by net income attributable to noncontrolling interests. Noncontrolling interests consist of the minority owners of CareerBuilder. Net income attributable to noncontrolling interests was $17.8 million in the third quarter of 2013 compared to $15.5 million in the same period in 2012. Earnings per diluted share were $0.34 for the third quarter.
For the year-to-date period, net income attributable to Gannett was $297.9 million, compared to $321.2 million last year, a decrease of 7%. Earnings per diluted share were $1.27 for the year-to-date period compared to $1.35 last year.
The weighted average number of diluted shares outstanding for the third quarter of 2013 totaled 234,438,000 compared to 235,550,000 for the third quarter of 2012. For the first nine months of 2013 and 2012, the weighted average number of diluted shares outstanding totaled 234,724,000 and 237,699,000 respectively. The decrease is primarily due to shares repurchased since the third quarter of 2012, partially offset by equity awards issued in connection with the Company's share-based compensation programs. See Part II, Item 2 for information on share repurchases.
Results for the third quarter of 2013 include $9.2 million in costs associated with workforce restructuring ($5.6 million after-tax or $0.02 per share), transformation costs of $10.3 million ($6.2 million after-tax or $0.03 per share) and other non-operating non-cash charges of $16.6 million ($8.2 million after-tax or $0.04 per share) that together total $36.2 million ($20.1 million after-tax or $0.09 per share). Results for the third quarter of 2012 include $8.0 million in costs due to workforce restructuring ($5.0 million after-tax or $0.02 per share), transformation costs of $7.5 million ($4.5 million after-tax or $0.02 per share), and pension settlement charges of $2.5 million ($1.5 million after-tax or $0.01 per share) which totaled $17.9 million ($10.9 million after-tax or $0.05 per share). These special items were offset by a benefit of $13.1 million ($0.06 per share) in the third quarter of 2012 due to a multi-year federal exam resolution that resulted in the reduction of prior year uncertain tax benefits and a significant tax benefit resulting from state tax settlements.
Year-to-date 2013 results include $36.3 million in costs associated with workforce restructuring ($22.0 million after-tax or $0.09 per share), transformation costs of $30.0 million ($18.1 million after-tax or $0.08 per share), and other non-operating non-cash charges of $19.4 million ($10.7 million after-tax or $0.05 per share) that totaled $85.7 million ($50.8 million after-tax or $0.22 per share). These special items for the first nine months of 2013 were offset by a tax benefit of $27.8 million ($0.12 per share) primarily due to a multi-year federal audit settlement. Results for the first nine months of 2012 include $34.0 million in costs due to workforce restructuring ($20.5 million after-tax or $0.09 per share), transformation costs of $17.3 million ($10.4 million after-tax or $0.04 per share) and pension settlement charges totaling $7.9 million ($4.7 million after-tax or $0.02 per share) offset by special tax benefits of $13.1 million ($0.06 per share) due to a multi-year federal exam resolution that resulted in the reduction of prior year uncertain tax benefits and a significant tax benefit resulting from state tax settlements. Excluding the special tax benefit, these 2012 year-to-date costs totaled $59.3 million ($35.7 million after-tax or $0.15 per share).
A separate discussion of results excluding the effect of these special items (non-GAAP basis) appears on page 10.
Operating Revenues
Operating revenues decreased 4% to $1.25 billion in the third quarter of 2013 from $1.31 billion in the third quarter of 2012. The cyclical nature of revenues within the Company's Broadcast Segment impacts year-over-year comparisons, due to the significant Summer Olympic and political spending that takes place during the third quarter every four

years. The Company’s operating revenues in the third quarter of 2013 would have been flat compared to third quarter last year, when adjusted to remove the estimated incremental Olympic and record political advertising revenue in the third quarter of 2012. For the first nine months of 2013 operating revenues decreased 1% to $3.79 billion from $3.83 billion in 2012. Publishing Segment revenues were down 4% for the quarter and declined 2% for the year-to-date period, reflecting softer advertising revenues which continued to face headwinds from a tepid economic recovery and secular industry declines. In addition, year-over-year revenue growth comparisons were impacted by the lapping of the roll-out of the All-Access Content Subscription Model last year. Broadcasting Segment revenues decreased 14% for the quarter, reflecting the incremental revenue associated with the 2012 Summer Olympics and substantially higher political revenue in the third quarter last year. Adjusted for these seasonal

impacts, Broadcasting Segment revenues increased 14% in the third quarter of 2013 compared to the same quarter last year. On a year-to-date basis, Broadcasting Segment revenues decreased 2%, as a significant increase in retransmission and digital revenues were offset by the loss of Olympic and incremental political revenue generated last year. Digital Segment revenues were 5% higher for the quarter and 4% higher for the year-to-date period, reflecting solid revenue growth at CareerBuilder.

Third quarter 2013 company-wide digital revenues, which include Digital Segment specific revenues as well as digital product and service revenues generated by the other business segments, were $376.1 million, 12% higher compared to the third quarter of 2012 and were 30% of the Company's total operating revenues. Year-to-date company-wide digital revenues were $1.10 billion, 20% higher compared to the same period in 2012. Comparisons for both the quarter and year-to-date periods reflect revenue increases driven by the roll-out of the All-Access Content Subscription Model last year as well as higher digital advertising and marketing solutions sales across all segments. Through the end of the third quarter of 2012, 69 local publishing markets had launched the All-Access Content Subscription Model, with all 78 markets completed by the end of 2012.

Operating Expenses

Operating expenses decreased 1% for the quarter and were relatively unchanged for the year-to-date period in 2013 compared to the same periods last year. The expense comparisons were impacted by cost management, transformation efforts and reduction of direct costs in light of secular headwinds in the Publishing Segment, partially offset by higher Digital Segment sales costs related to increased revenue at CareerBuilder as well as investments in strategic initiatives. Operating expenses were also impacted by special items in both years that consist of workforce restructuring and transformation costs as well as pension settlement charges in 2012. A separate discussion of operating expenses excluding special items (non-GAAP basis) begins on page 10.

Non-Operating Income and Expense

The Company's net equity income in unconsolidated investees for the third quarter of 2013 was $11.7 million compared to $3.0 million in the third quarter last year. Net equity income in unconsolidated investees totaled $28.9 million for the first nine months of 2013 compared to $16.0 million last year. The increases primarily reflect better results at Classified Ventures and the Company's newspaper partnerships.

The Company's interest expense for the third quarter of 2013 was $41.6 million, up 16% from the same quarter last year reflecting a $5.6 million interest expense impact from the $600 million senior note issuance in July 2013. Total average outstanding debt was $1.81 billion for the third quarter of 2013 compared to $1.68 billion last year. The weighted average interest rate on total outstanding debt was 7.92% for the third quarter of 2013 compared to 7.57% last year. Interest expense for the first nine months of 2013 was $113.2 million, up 1% from last year. Total average outstanding debt was $1.66 billion for the first nine months of 2013 compared to $1.73 billion last year. The weighted average interest rate for total outstanding debt was 8.02% for the first nine months of 2013 compared to 7.67% last year.

Other non-operating expense was $17.6 million for the third quarter of 2013 compared to non-operating income of $2.9 million for the same period last year. Other non-operating expense totaled $29.0 million for the first nine months of 2013 compared to non-operating income of $2.7 million for the same period last year. The decreases for both the quarter and year-to-date periods were primarily due to a $16.6 million non-cash charge associated with the change in control and sale of interests related to Captivate in the third quarter of 2013. In addition, costs related to the pending Belo acquisition totaled $4.4 million in the third quarter of 2013 and $13.9 million on a year-to-date basis.

Provision for Income Taxes

The Company's effective income tax rate was 25.1% for the third quarter of 2013, compared to 22.5% for the third quarter of 2012. The tax rate for the third quarter in 2013 was higher than the comparable rate in 2012 due to special items consisting primarily of a multi-year federal audit settlement which contributed a net tax benefit to 2012's results of $13.1 million. The Company's effective income tax rate was 19.4% for the first nine months of 2013, compared to 26.6% for the same period last year. The rate for the first nine months of 2013 was lower than the comparable rate in 2012 due to special items contributing a net tax benefit of $27.8 million in 2013 that related primarily to a multi-year federal audit settlement. A separate discussion of effective income tax rates excluding special items (non-GAAP basis) appears on page 15.

Segment Results

The following is a discussion of the Company's reported operating segment results for the third quarter and first nine months of 2013. Unless otherwise noted, all comparisons are to the comparable prior year period.

Publishing Segment Results

Publishing Segment revenues were generated principally from advertising and circulation sales, which accounted for 61% and 32%, respectively, of total Publishing Segment revenues for the third quarter and year-to-date periods. Advertising revenues include amounts generated from print advertising as well as digital advertising on publishing-related Internet websites, mobile and tablet applications. "All Other" Publishing Segment revenues are mainly from commercial printing operations. The table below presents the main components of Publishing Segment revenues:

| Publishing Segment Revenues (in thousands of dollars) | Third Quarter | | | Year-to-Date | | |
|---|---|---|---|---|---|---|
| | 2013 | 2012 | Change | 2013 | 2012 | Change |
| Advertising | $520,189 | $552,676 | (6 %) | $1,609,164 | $1,698,376 | (5 %) |
| Circulation | 274,999 | 276,655 | (1 %) | 840,626 | 803,929 | 5 % |
| All other | 62,891 | 60,869 | 3 % | 183,753 | 182,290 | 1 % |
| Total Publishing Segment revenues | $858,079 | $890,200 | (4 %) | $2,633,543 | $2,684,595 | (2 %) |

Publishing Segment revenues were down 4% in the third quarter of 2013 and 2% for the year-to-date period due primarily to lower advertising revenues. On a year-to-date basis, the decline was mitigated by an increase in circulation revenues. On a constant currency basis, Publishing Segment revenues decreased 3% from the third quarter of 2012 and just under 2% for the year-to-date period.

The table below presents the principal categories of advertising revenues for the Publishing Segment:

| Publishing Segment Advertising Revenues (in thousands of dollars) | Third Quarter | | | Year-to-Date | | |
|---|---|---|---|---|---|---|
| | 2013 | 2012 | Change | 2013 | 2012 | Change |
| Retail | $269,516 | $281,673 | (4 %) | $831,553 | $871,151 | (5 %) |
| National | 81,489 | 90,582 | (10 %) | 261,315 | 276,226 | (5 %) |
| Classified | 169,184 | 180,421 | (6 %) | 516,296 | 550,999 | (6 %) |
| Total Publishing Segment advertising revenues | $520,189 | $552,676 | (6 %) | $1,609,164 | $1,698,376 | (5 %) |

Publishing Segment advertising revenues decreased 6% in the third quarter of 2013 to $520.2 million and decreased 5% for the year-to-date period to $1.61 billion. Advertising continues to be impacted by the lagging economies in the U.S. and U.K., as well as secular industry challenges. In the U.S., advertising revenues decreased 6% for the quarter and 5% year-to-date. On a constant currency basis, advertising revenues in the U.K. declined 5% for the third quarter and 7% for the year-to-date period. The average exchange rate used to translate U.K. publishing results from the British pound to U.S. dollars decreased 2% for the quarter and year-to-date periods.

The percentage changes within the advertising revenue categories for U.S. Publishing, Newsquest, total Publishing Segment, including on a constant currency basis, are as follows:

| Publishing Segment Advertising Revenue Categories | Third Quarter | | | |
|---|---|---|---|---|
| | U.S. Publishing | Newsquest (in pounds) | Total Publishing Constant Currency | Total Publishing Segment |
| Retail | (5 %) | 1 % | (4 %) | (4 %) |
| National | (10 %) | (12 %) | (10 %) | (10 %) |
| Classified | (5 %) | (8 %) | (6 %) | (6 %) |
| Total Publishing Segment advertising revenues | (6 %) | (5 %) | (6 %) | (6 %) |

| | Year-to-Date | | | |
|---|---|---|---|---|
| | U.S. Publishing | Newsquest (in pounds) | Total Publishing Constant Currency | Total Publishing Segment |
| Retail | (5 %) | (3 %) | (4 %) | (5 %) |
| National | (4 %) | (17 %) | (5 %) | (5 %) |
| Classified | (5 %) | (8 %) | (6 %) | (6 %) |
| Total Publishing Segment advertising revenues | (5 %) | (7 %) | (5 %) | (5 %) |

Across the Publishing Segment in the third quarter, all categories of year-over-year advertising revenue comparisons were lower as tepid economic growth in the U.S. and U.K. impacted advertising demand. However, retail advertising saw a sequential improvement over the second quarter comparisons by 150 basis points.

National advertising was 10% lower in the third quarter due in part to the absence of advertising at USA TODAY related to the Olympics that benefited the third quarter results last year. For the first nine months, national advertising was 5% lower compared to the same period last year.

Classified advertising revenue at the Company’s domestic publishing operations declined 5% for the third quarter of 2013 but most categories had better third quarter year-over-year comparisons than the second quarter comparisons. For the first nine months of 2013, domestic publishing classified advertising revenue declined 5% compared to the prior year. Third quarter classified advertising revenues in the U.K. were 8% lower, in pounds, compared to last year.

Overall percentage changes within the classified revenue categories for U.S. Publishing, Newsquest, total Publishing Segment, including on a constant currency basis, are as follows:

| Publishing Segment Classified Advertising Revenue Categories | Third Quarter | | | |
|---|---|---|---|---|
| | U.S. Publishing | Newsquest (in pounds) | Total Publishing Constant Currency | Total Publishing Segment |
| Automotive | — % | (7 %) | (1 %) | (1 %) |
| Employment | (9 %) | (7 %) | (8 %) | (9 %) |
| Real Estate | (3 %) | (9 %) | (6 %) | (6 %) |
| Legal | (11 %) | — % | (11 %) | (11 %) |
| Other | (7 %) | (9 %) | (8 %) | (8 %) |
| Total Publishing Segment classified revenue | (5 %) | (8 %) | (6 %) | (6 %) |

| | Year-to-Date | | | |
|---|---|---|---|---|
| | U.S. Publishing | Newsquest (in pounds) | Total Publishing Constant Currency | Total Publishing Segment |
| Automotive | (1 %) | (10 %) | (2 %) | (3 %) |
| Employment | (9 %) | (5 %) | (7 %) | (8 %) |
| Real Estate | (4 %) | (9 %) | (6 %) | (6 %) |
| Legal | (9 %) | — % | (9 %) | (9 %) |
| Other | (6 %) | (9 %) | (7 %) | (7 %) |
| Total Publishing Segment classified revenue | (5 %) | (8 %) | (6 %) | (6 %) |

Total circulation revenues decreased 1% for the third quarter of 2013 to $275.0 million from $276.7 million last year but increased 5% to $840.6 million for the first nine months of 2013. Circulation revenue for the Company’s local domestic publishing business was 1% higher in the third quarter of 2013, the sixth consecutive quarter of circulation revenue growth. On a year-to-date basis, circulation revenue for the Company’s local domestic publishing business increased 9% reflecting the roll-out of the All-Access Content Subscription Model. Revenue growth comparisons narrowed over the course of 2013 due to the lapping of the roll-out last year. Circulation revenues in the U.K., in local currency, were 10% higher in the third quarter and 3% higher for the first nine months of 2013 reflecting cover price increases. Circulation revenue at USA TODAY decreased 12% in the third quarter and 11% for the first nine months of 2013 as a result of planned travel partner program changes as well as declines in single copy sales.

Other revenue was up 3% for the quarter and 1% for the year-to-date period as an increase in domestic commercial printing revenues was offset by a decrease in U.K. commercial printing revenues.

Digital revenues associated with the Publishing Segment increased 21% for the third quarter and 45% for the year-to-date period. Digital revenues for the Company’s local domestic publishing business increased 22% for the third quarter and 53% for the year-to-date period. These increases reflect the impact of the All-Access Content Subscription Model as well as the Company’s strategic successes in providing digital advertising and marketing solutions. Digital revenues at USA TODAY and its associated businesses were up 13% for the third quarter and 15% for the first nine months of 2013. Digital revenues in the U.K. were 13% higher for both the quarter and the year-to-date periods in local currency.

Publishing Segment operating expenses decreased 3% in the quarter to $795.3 million compared to $816.5 million in the third quarter a year ago. This decrease was due to cost control and efficiency efforts, partially offset by $8.1 million in strategic initiative investments. Newsprint expense was 9% lower in the quarter and 12% lower year-to-date

due primarily to declines in consumption. Operating expenses for the first nine months of 2013 totaled $2.43 billion, down 1% compared to the same period last year, as strong cost control and efficiency efforts were partially offset by $28.4 million in strategic initiative investments in 2013.

Publishing Segment operating income was $62.7 million in the quarter compared to $73.7 million last year, a decrease of 15%. Operating income for the year-to-date period was $208.1 million, a decrease of 13% compared to last year.

Broadcasting Segment Results

The Broadcasting Segment includes results from the Company's 23 television stations and affiliated digital platforms (including Captivate through September 25, 2013). As discussed further in Note 5 to the Condensed Consolidated Financial Statements, on September 25, 2013 the Company contributed the assets of Captivate to a new company that is jointly owned by Gannett and Generation Partners. As a result, the Company ceased consolidating the results of Captivate as of that date. Broadcasting Segment revenues in the third quarter of 2013 decreased 14% to $203.4 million. Revenues for the year-to-date period of 2013 were $606.9 million, a decrease of 2%.

Television revenues for the third quarter of 2013 were down 15% to $198.5 million. Comparisons were impacted by $42 million in politically-related advertising and approximately $37 million in ad spending related to the Summer Olympics in last year's third quarter. Approximately $4 million of political spending that aired during the Olympics is included in both the political and Olympic categories. Excluding the incremental Olympic and political advertising revenues in last year's results, television revenues increased 14% in the third quarter of 2013. Retransmission revenues increased 63% to $36.2 million for the quarter and television station digital revenues increased 21% compared to the third quarter of 2012.

Television revenues for the year-to-date period were down 2% to $588.8 million. The decrease reflects the absence of the Olympic and political advertising revenues generated in the first nine months of 2012, partially offset by an increase in retransmission fees and television digital revenue. Excluding the incremental impact of Olympic and political advertising spending in 2012, television revenues increased 11% in the first nine months of 2013. Retransmission revenues increased 61% to $109.2 million and television station digital revenues increased 14% for the first nine months of 2013.

Based on current trends and reflecting a record level of political advertising revenues achieved in the fourth quarter in 2012, the percentage decrease in total television revenues for the fourth quarter of 2013 is expected to be in the high teens compared to the fourth quarter of 2012 (excluding the extra week in the period). Excluding the incremental impact of political spending, total television revenues in the fourth quarter this year compared to the fourth quarter last year are expected to be up in the range of 10 to 12 percent.

Broadcasting Segment operating expenses for the third quarter of 2013 increased 1% to $119.6 million and 3% to $341.3 million in the first nine months of 2013. The increases reflect higher costs associated with strategic initiatives partially offset by lower revenue related expenses corresponding with lower political and Olympic revenues.

Operating income in the third quarter of 2013 decreased 29% to $83.8 million from $118.7 million in the third quarter of 2012. Operating income for the first nine months of 2013 was down 7% to $265.6 million.

Digital Segment Results

The Digital Segment includes results for stand-alone digital subsidiaries including CareerBuilder, PointRoll, ShopLocal, and Reviewed.com. Many of the Company's other digital offerings are tightly integrated within its existing publishing or broadcasting offerings, and therefore the results of these integrated digital offerings are reported within the operating results of its Publishing and Broadcasting Segments.

Digital Segment operating revenues increased 5% to $191.4 million in the third quarter of 2013 compared to $182.0 million in 2012. Year-to-date operating revenues for the segment were $552.9 million compared to $531.7 million, an increase of 4%. The increases reflect strong revenue growth at CareerBuilder as it continues to build market share in the U.S. and its international operations.

Digital Segment operating expenses increased 5% to $149.4 million in the third quarter of 2013 compared to $142.1 million in 2012, driven by higher sales costs associated with revenue growth at CareerBuilder. Year-to-date operating expenses were $451.9 million compared to $439.0 million in 2012, an increase of 3%. As a result, Digital Segment operating income for the quarter was $42.1 million, an increase of 5% compared to last year. For the year-to-date period, Digital Segment operating income was $100.9 million, up 9% from the same period in 2012.

Corporate Expense

Corporate expense in the third quarter of 2013 increased 12% to $16.9 million. The increase was due to higher stock-based compensation and the absence of an asset sale gain recognized in the third quarter of 2012. For the year-to-date period of 2013, corporate expense was flat compared to last year and totaled $48.9 million.

Results from Operations - Non-GAAP Information

The Company uses non-GAAP financial performance and liquidity measures to supplement the financial information presented on a GAAP basis. These non-GAAP financial measures should not be considered in isolation from or as a substitute for the related GAAP measures, and should be read in conjunction with financial information presented on a GAAP basis.

The Company discusses in this report non-GAAP financial performance measures that exclude from its reported GAAP results the impact of special items consisting of workforce restructuring charges, transformation costs, pension settlement charges, a non-cash charge related to a change in control and sale of interests in a business, non-cash charges related to certain investments accounted for under the equity method, non-cash impairment charges, a currency-related loss recognized in other non-operating items and certain credits to its income tax provision. The Company believes that such expenses, charges and credits are not indicative of normal, ongoing operations and their inclusion in results makes for more difficult comparisons between periods and with peer group companies.

Workforce restructuring expenses primarily related to incremental expenses the Company has incurred to consolidate or outsource production processes and centralize other functions. These expenses include payroll and related benefit costs. Transformation costs include incremental expenses incurred by the Company to execute on its transformation and growth plan, including those related to the Company's pending Belo acquisition and incremental expenses associated with optimizing the Company's real estate portfolio. The pension settlement charges result from the acceleration of expense related to the timing of certain pension payments. Other non-operating charges include: a non-cash charge related to the change in control and sale of interests in the Company's Captivate business; non-cash charges that were recorded to reduce the book value of certain investments accounted for under the equity method; and a currency loss in the first quarter of 2013 related to the weakening of the British pound associated with the downgrade of the U.K. sovereign credit rating. The year-to-date period for 2013 included credits to the income tax provision related to reserve releases as a result of a federal exam resolution and lapse of a statute of limitation. Third quarter and year-to-date periods for 2012 included a credit related primarily to tax settlements covering multiple years.

Management uses non-GAAP financial performance measures for purposes of evaluating business unit and consolidated company performance. The Company therefore believes that each of the non-GAAP measures provides useful information to investors by allowing them to view the Company's businesses through the eyes of management and the Board of Directors, facilitating comparison of results across historical periods, and providing a focus on the underlying ongoing operating performance of its businesses. In addition, many of the Company's peer group companies present similar non-GAAP measures to better facilitate industry comparisons.

Consolidated Summary - Non-GAAP

The following is a discussion of the Company's as adjusted non-GAAP financial results. All as adjusted (non-GAAP basis) measures are labeled as such or "adjusted."

Adjusted operating results were as follows:

7. Stock Options and Restricted Stock Awards

On November 12, 2014, the Company's stockholders approved the 2014 Equity Incentive Plan (the "2014 Plan"), under which restricted stock awards have been granted to employees, directors and consultants. Previously, options to purchase common stock and restricted stock awards were granted under the 2007 Equity Incentive Plan (the "2007 Plan") and the 2003 Stock Option Plan (the "2003 Plan"). The 2014 Plan, the 2007 Plan and the 2003 Plan are collectively referred to as the "Plans."

Stock Options

All options granted under the Plans become exercisable over periods established at the date of grant. The option exercise price is generally not less than the estimated fair market value of the Company's common stock at the date of grant, as determined by the Company's management and Board of Directors. In addition, the Company has granted nonqualified stock options to a director outside of the Plans. An employee's vested options must be exercised at or

within 90 days of termination to avoid forfeiture. As of December 31, 2014, all outstanding options were fully vested.

Stock option activity for the six months ended December 31, 2014 is as follows:

| | Number of Options[a] | Weighted Average Exercise Price |
|---|---|---|
| Options outstanding at June 30, 2014 | 922,809 | $10.16 |
| Options exercised | (87,575) | $9.07 |
| Options outstanding at December 31, 2014 | 835,234 | $10.28 |

(a) Includes the effect of options granted, exercised, forfeited or expired from the 2003 Plan and 2007 Plan, and options granted outside such plans.

Restricted Stock

The fair value of each restricted stock award is equal to the fair market value of the Company's common stock at the date of grant. Vesting of restricted stock awards generally ranges from one to three years. The estimated fair value of restricted stock awards, including the effect of estimated forfeitures, is recognized on a straight-line basis over the restricted stock's vesting period.

On August 11, 2014, the Company granted performance based restricted stock awards to certain executives. The performance based awards included grants of a maximum aggregate of 76,112 shares that vest based upon achievement of certain thresholds measuring total shareholder return during periods within fiscal 2015 compared to a pre-determined peer group of companies, and grants of a maximum aggregate of 76,112 shares that vest based upon achievement of certain thresholds measuring annual revenue growth during fiscal 2015 compared to a pre-determined peer group of companies. Management adjusts expense as required based on expected revenue growth performance for those awards.

Table of Contents

Restricted stock award activity for the six months ended December 31, 2014 is as follows:

| | Number of Shares | Weighted Average Fair Value |
|---|---|---|
| Restricted stock awards outstanding at June 30, 2014 | 1,276,403 | $17.37 |
| Restricted stock awards granted [1] | 425,644 | $29.15 |
| Restricted stock awards forfeited | (78,747) | $19.84 |
| Restricted stock awards vested | (483,941) | $17.00 |
| Restricted stock awards outstanding at December 31, 2014 | 1,139,359 | $19.89 |

(1) Includes both time-based and performance-based restricted stock awards.

8. Commitment and Contingencies

Operating Leases

The Company leases manufacturing and office space and equipment under various lease agreements that expire at various dates through March 2020. Rental expenses were $797 and $720 for the six months ended December 31, 2014 and 2013, respectively.

Future minimum lease payments under the agreements as of December 31, 2014 are as follows:

| | |
|---|---|
| Six months ended June 30, 2015 | $563 |
| Fiscal 2016 | 763 |
| Fiscal 2017 | 469 |
| Fiscal 2018 | 462 |
| Fiscal 2019 | 462 |
| Thereafter | 346 |
| | $3,065 |

Amounts payable under the Company's Texas production facility lease are included in the amounts above. A portion of those rent payments may reduce the deferred grant incentive liability rather than being recorded as expense. See Note 9 for additional information.

Construction of New Headquarters

On June 11, 2014, the Company entered into a Redevelopment Agreement, a Design-Build Contract, and a Development Services Agreement, as well as various ancillary agreements related to the acquisition of real property located in New Brighton, Minnesota and the development of such property into the Company's new corporate headquarters. Pursuant to the Contract for Private Redevelopment by and among the City of New Brighton (the "City"), Ryan Companies US, Inc. ("Ryan"), and the Company, dated June 11, 2014 (the "Redevelopment Agreement"), the Company purchased approximately ten acres of real property from the City for a purchase price of $500. The City also granted the Company the option to purchase an additional 3.6 acres prior to May 31, 2021.

Pursuant to the Design-Build Cost Plus Construction Contract by and between Ryan and the Company, dated June 11, 2014, the Company has contracted with Ryan to furnish all services, labor, materials, equipment, procurement services, project management and other duties and services necessary for construction of the Company's new headquarters on the land purchased from the City. The Company and Ryan expect to have construction substantially completed by March 1, 2015, and, pursuant to the Redevelopment Agreement discussed above, Ryan and the Company have agreed to complete construction by December 31, 2015. The Company will pay Ryan a fee of 3.85%

of the cost of the work.

The Company also entered into a Development Services Agreement with Ryan, dated June 11, 2014, pursuant to which Ryan will perform certain development services to facilitate development of the project, including coordination with the City and overall coordination of development strategy. The Company will pay Ryan a fee for the development services, which includes a sum equal to 3.25% of the adjusted total project costs, payable at certain points in the construction process, and a sum equal to 5% of the adjusted total project costs, payable upon substantial completion of the project, as well as reimbursement of certain expenses incurred by Ryan.

Table of Contents

In connection with the agreements above, the Company is required to hold approximately $9,128 in an escrow account that will be used to fund the final construction payments. The escrow is classified as construction in progress in property and equipment, net, on the consolidated balance sheet.

9. Texas Production Facility

Effective on September 9, 2009, the Company entered into an agreement with the Pearland Economic Development Corporation (the "PEDC") for the construction and lease of an approximately 46,000 square foot production facility located in Pearland, Texas. The facility primarily serves as an additional manufacturing location for the Company.

The Company and the PEDC entered into a Corporate Job Creation Agreement dated June 17, 2009, which was subsequently amended July 2, 2012. The Job Creation Agreement, as amended, provided the Company with $2,975 in net cash incentive funds. The Company believes it will be able to comply with the conditions specified in the amended agreement. The PEDC will provide the Company with an additional $425 of net cash incentive funds if: (1) the Company hires 125 full-time employees at the facility before June 30, 2015 and (2) maintains 125 employees at the facility through June 30, 2016. The Company had the opportunity to receive an additional $425 of net cash incentive funds upon hiring the 75th employee on or before March 31, 2014; however, the Company did not achieve this incentive.

In order to retain all of the cash incentives, the Company must maintain no fewer than 25 jobs at the Texas facility through June 30, 2015. Failure to meet this requirement will result in an obligation to make reimbursement payments to the PEDC as outlined in the amended agreement. The Company will not have any reimbursement requirements after June 30, 2015. As of December 31, 2014, the Company was in compliance with all minimum requirements under the amended agreement. The Company believes it will be able to comply with the conditions specified in the amended agreement.

The Job Creation Agreement, as amended, also provided the Company with a net $1,020 award, of which $510 was received from the PEDC and the remainder is funded through the Texas Enterprise Fund program associated with the State of Texas. As of December 31, 2014, $340 has been received and the remaining $170 will be provided upon the hiring of the 75th full-time employee at the facility. The grant from the State of Texas is subject to reimbursement if the Company fails to meet certain job creation targets through 2014 and maintain these positions through 2020. The Company reimbursed the State of Texas $46 during fiscal 2014 as it did not meet the target of hiring 75 employees at the facility by December 31, 2013.

The Company has presented the net cash incentive funds as a current and long-term liability on the balance sheet. The liabilities are reduced through the term of the agreement and recorded as an offset to expenditures incurred using a systematic methodology. As of December 31, 2014, the deferred grant incentive liabilities have been reduced by $41 in cumulative expenses, resulting in a remaining current liability of $18.

10. Earnings Per Share

The following table presents a reconciliation of the numerators and denominators used in the basic and diluted earnings per common share computations (in thousands except share and per share amounts):

| | Three Months Ended December 31, | | Six Months Ended December 31, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Numerator | | | | |
| Net loss | $(5,273) | $(8,658) | $(13,497) | $(15,950) |
| Denominator | | | | |

| | | | | |
|---|---|---|---|---|
| Weighted average common shares – basic | 31,487,358 | 27,177,952 | 31,399,234 | 25,964,660 |
| Effect of dilutive stock options and warrants(a)(b) | — | — | — | — |
| Weighted average common shares outstanding – diluted | 31,487,358 | 27,177,952 | 31,399,234 | 25,964,660 |
| Net loss per common share — basic and diluted | $(0.17) | $(0.32) | $(0.43) | $(0.61) |

(a) At December 31, 2014 and 2013, 0 and 984,991 warrants, respectively, were outstanding. The effect of the shares that would be issued upon exercise of these warrants has been excluded from the calculation of diluted loss per share because those shares are anti-dilutive.

(b) At December 31, 2014 and 2013, 835,234 and 1,080,456 stock options, respectively, were outstanding. The effect of the shares that would be issued upon exercise of these options has been excluded from the calculation of diluted loss per share because those shares are anti-dilutive.

Table of Contents

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

You should read the following discussion and analysis of our financial condition and results of operations together with our financial statements and the related notes appearing under Item 1 of Part I. Some of the information contained in this discussion and analysis or set forth elsewhere in this quarterly report, including information with respect to our plans and strategy for our business and expected financial results, includes forward-looking statements that involve risks and uncertainties. You should review the "Risk Factors" discussed in our Form 10-K for the year ended June 30, 2014 for a discussion of important factors that could cause actual results to differ materially from the results described in or implied by the forward-looking statements contained in the following discussion and analysis.

OVERVIEW

We are a medical device company focused on developing and commercializing innovative solutions for vascular and coronary disease. Our peripheral arterial disease ("PAD") products, the Stealth 360°® PAD System (the "Stealth 360"), the Diamondback 360® PAD System (the "Diamondback 360 Peripheral"), and the Diamondback Predator 360°® (the "Predator 360") are catheter-based platforms capable of treating a broad range of plaque types in leg arteries both above and below the knee and address many of the limitations associated with existing surgical, catheter and pharmacological treatment alternatives. In March 2014, we received approval for the Diamondback 360® 60cm Peripheral Orbital Atherectomy System ("OAS") access device, which allows physicians to treat PAD patients in the small and tortuous vessels located below the knee through alternative access sites in the ankle or foot. We refer to the Stealth 360, Diamondback 360 Peripheral, Predator 360, and the Diamondback 360 60cm Peripheral OAS collectively in this report as the "PAD Systems." We have also obtained approval to market our Diamondback 360® Coronary OAS ("CAD System") as a treatment for severely calcified coronary arteries.

Since 1997, we have devoted substantially all of our resources to the development of the PAD Systems and, since 2007, to the approval of our CAD System. From 2003 to 2005, we conducted numerous bench and animal tests in preparation for application submissions to the Food and Drug Administration ("FDA"). We initially focused our testing on providing a solution for coronary in-stent restenosis, but later changed the focus to PAD. In 2006, we obtained an investigational device exemption from the FDA to conduct our pivotal OASIS clinical trial, which was completed in January 2007. The OASIS clinical trial was a prospective 20-center study that involved 124 patients with 201 lesions.

In August 2007, the FDA granted us 510(k) clearance for the use of the Diamondback 360 Peripheral as a therapy in patients with PAD. We commenced commercial introduction of the Diamondback 360 Peripheral in the United States in September 2007. We were granted 510(k) clearance of the Predator 360 in March 2009 and Stealth 360 in March 2011. We received 510(k) clearance of the Diamondback 360 60cm Peripheral OAS in March 2014. We market the PAD Systems in the United States through a direct sales force and expend significant capital on our sales and marketing efforts to expand our customer base and utilization per customer. At our facilities, we assemble the saline infusion pump and the single-use catheter used in the PAD Systems with components purchased from third-party suppliers, as well as with components manufactured in-house. We purchase supplemental products from third-party suppliers.

In November 2014, we received CE Mark for our Stealth 360 and are currently evaluating the timing and structure of our plans to commercialize our products in Europe.

We have developed a modified version of our orbital technology to treat coronary arteries. A coronary application required us to conduct a clinical trial and file a premarket approval ("PMA") application and obtain approval from the FDA. In March 2013, we completed submission of our PMA application to the FDA for our OAS to treat calcified coronary arteries. In October 2013, we received PMA from the FDA to market the CAD System as a treatment for

severely calcified coronary arteries. We commenced a controlled commercial launch of the CAD System following the receipt of PMA approval.

As of December 31, 2014, we had an accumulated deficit of $252.1 million. We expect our losses to continue as we invest in sales, marketing, medical education, clinical studies and product research and development for our next phase of growth in the peripheral market and broaden the commercial launch of our CAD System. To date, we have financed our operations primarily from the issuance of stock, convertible promissory notes, and debt.

Table of Contents

## CRITICAL ACCOUNTING POLICIES AND SIGNIFICANT JUDGMENTS AND ESTIMATES

Our management’s discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of our consolidated financial statements requires us to make estimates, assumptions and judgments that affect amounts reported in those statements. Our estimates, assumptions and judgments, including those related to revenue recognition, allowance for doubtful accounts, excess and obsolete inventory, and stock-based compensation, are updated as appropriate at least quarterly. We use authoritative pronouncements, our technical accounting knowledge, cumulative business experience, judgment and other factors in the selection and application of our accounting policies. While we believe that the estimates, assumptions and judgments that we use in preparing our consolidated financial statements are appropriate, these estimates, assumptions and judgments are subject to factors and uncertainties regarding their outcome. Therefore, actual results may materially differ from these estimates.

Some of our significant accounting policies require us to make subjective or complex judgments or estimates. An accounting estimate is considered to be critical if it meets both of the following criteria: (1) the estimate requires assumptions about matters that are highly uncertain at the time the accounting estimate is made, and (2) different estimates that reasonably could have been used, or changes in the estimate that are reasonably likely to occur from period to period, would have a material impact on the presentation of our financial condition, results of operations, or cash flows.

Our critical accounting policies are identified in our Annual Report on Form 10-K for the fiscal year ended June 30, 2014 in Management's Discussion and Analysis of Financial Condition and Results of Operations under the heading "Critical Accounting Policies and Significant Judgments and Estimates." There were no significant changes to our critical accounting policies during the six months ended December 31, 2014.

## RESULTS OF OPERATIONS

The following table sets forth our results of operations expressed as dollar amounts (in thousands) and the changes between the specified periods expressed as percent increases or decreases:

| | Three Months Ended December 31, | | | Six Months Ended December 31, | | |
|---|---|---|---|---|---|---|
| | 2014 | 2013 | Percent Change | 2014 | 2013 | Percent Change |
| Revenues | $44,732 | $32,337 | 38.3 % | $86,086 | $62,103 | 38.6 % |
| Cost of goods sold | 9,346 | 7,313 | 27.8 | 18,231 | 14,177 | 28.6 |
| Gross profit | 35,386 | 25,024 | 41.4 | 67,855 | 47,926 | 41.6 |
| Expenses: | | | | | | |
| Selling, general and administrative | 32,553 | 27,468 | 18.5 | 66,060 | 52,839 | 25.0 |
| Research and development | 8,085 | 5,051 | 60.1 | 15,237 | 9,429 | 61.6 |
| Total expenses | 40,638 | 32,519 | 25.0 | 81,297 | 62,268 | 30.6 |
| Loss from operations | (5,252) | (7,495) | (29.9) | (13,442) | (14,342) | (6.3) |
| Interest and other, net | (21) | (1,163) | (98.2) | (55) | (1,608) | (96.6) |
| Net loss | $(5,273) | $(8,658) | (39.1) | $(13,497) | $(15,950) | (15.4) |

Comparison of Three Months Ended December 31, 2014 with Three Months Ended December 31, 2013

Revenues. Revenues increased by $12.4 million, or 38.3%, from $32.3 million for the three months ended December 31, 2013 to $44.7 million for the three months ended December 31, 2014. This increase was primarily attributable to a $5.9 million, or 21.0%, increase in sales of our PAD Systems, which reflects a 21.1% increase in number of devices sold. Additionally, sales of the CAD System increased approximately $5.6 million, due to expanded sales of the CAD System compared to the initial controlled commercial launch in the three months ended December 31, 2013 following our PMA approval in October 2013.

Other product revenue also increased $871,000, or 22.4%, during the three months ended December 31, 2014 as compared to the three months ended December 31, 2013, primarily driven by increased sales of PAD and CAD Systems, which the other products support.

Table of Contents

Currently, all of our revenues are in the United States; however, we intend to sell internationally in the future and have commenced the process of seeking approval to do so in both Europe and Japan. In November 2014, we received CE Mark for the Stealth 360 and are currently evaluating the timing and structure of our plans to commercialize products in Europe. We expect our revenue to increase as we continue to increase the number of physicians using the devices, increase the usage per physician, introduce new and improved products, generate additional clinical data, continue the controlled commercial launch of our CAD System, and expand into new geographies.

Cost of Goods Sold. Cost of goods sold increased by $2.0 million, or 27.8%, from $7.3 million for the three months ended December 31, 2013 to $9.3 million for the three months ended December 31, 2014. Cost of goods sold represents the cost of materials, labor and overhead for single-use catheters, guidewires, saline pumps, and other ancillary products. The increase was due to an increase in the quantities of products sold, partially offset by lower indirect costs per unit from higher production volumes and manufacturing efficiencies. Cost of goods sold for the three months ended December 31, 2014 and 2013 includes $241,000 and $169,000, respectively, for stock-based compensation. Gross margin increased from 77.4% during the three months ended December 31, 2013 to 79.1% for the three months ended December 31, 2014, which was primarily due to the increase in sales of our CAD System which have higher average selling prices than PAD Systems, and to lower indirect costs per unit. We expect that gross margin in the remainder of fiscal 2015 will be similar to the three months ended December 31, 2014. Quarterly margin fluctuations could occur based on production volumes, timing of new product introductions, sales mix, pricing changes, or other unanticipated circumstances.

Selling, General and Administrative Expenses. Our selling, general and administrative expenses increased by $5.1 million, or 18.5%, from $27.5 million for the three months ended December 31, 2013 to $32.6 million for the three months ended December 31, 2014. The increase was due primarily to higher coronary expenses from commercial launch, the expansion of our sales and marketing organization and medical and other programs and higher incentive compensation. Selling, general and administrative expenses for the three months ended December 31, 2014 and 2013 include $2.9 million and $2.1 million, respectively, for stock-based compensation. We expect our selling, general and administrative expenses to increase in the future as a result of the costs associated with expanding our sales and marketing organization and medical education and other programs to further commercialize our PAD Systems and expand the commercial launch of our CAD System.

Research and Development Expenses. Research and development expenses increased by $3.0 million, or 60.1%, from $5.1 million for the three months ended December 31, 2013 to $8.1 million for the three months ended December 31, 2014. Research and development expenses relate to specific projects to develop new products or expand into new markets, such as the development of new versions of the PAD and CAD Systems, shaft designs, crown designs, and PAD and CAD clinical trials. The increase related mainly to additional product development projects and clinical studies, and the related increase in headcount. Research and development expenses for the three months ended December 31, 2014 and 2013 include $368,000 and $304,000, respectively, for stock-based compensation. As we continue to expand our product portfolio and clinical studies within the PAD and CAD markets, we generally expect to incur quarterly research and development expenses at or above amounts incurred for the three months ended December 31, 2014. Fluctuations could occur based on the number of projects and studies and the timing of expenditures.

Interest and Other, Net. Interest and other expense, net, was $(21,000) for the three months ended December 31, 2014 compared to $(1.2) million for the three months ended December 31, 2013. The decrease was primarily driven by lower interest expense related to lower outstanding debt balances, as well as the elimination of charges from debt conversions and changes in fair value of the debt conversion option that were associated with the previously outstanding convertible debt.

Comparison of Six Months Ended December 31, 2014 with Six Months Ended December 31, 2013

Revenues. Revenues increased by $24.0 million, or 38.6%, from $62.1 million for the six months ended December 31, 2013 to $86.1 million for the six months ended December 31, 2014. This increase was primarily attributable to a $11.5 million, or 21.2%, increase in sales of our PAD Systems, which reflects a 20.6% increase in number of devices sold. Additionally, sales of the CAD System contributed approximately $10.7 million in revenues in the six months ended December 31, 2014, compared to $388,000 in the six months ended December 31, 2013 following our PMA approval in October 2013. Other product revenue also increased $2.2 million, or 28.9%, during the six months ended December 31, 2014 as compared to the six months ended December 31, 2013, primarily driven by increased sales of PAD and CAD Systems, which the other products support.

Table of Contents

Cost of Goods Sold. Cost of goods sold increased by $4.0 million, or 28.6%, from $14.2 million for the six months ended December 31, 2013 to $18.2 million for the six months ended December 31, 2014. Cost of goods sold represents the cost of materials, labor and overhead for single-use catheters, guidewires, saline pumps, and other ancillary products. The increase was due to an increase in the quantities of products sold, partially offset by lower indirect costs per unit from higher production volumes and manufacturing efficiencies. Cost of goods sold for the six months ended December 31, 2014 and 2013 includes $463,000 and $311,000, respectively, for stock-based compensation. Gross margin increased from 77.2% during the six months ended December 31, 2013 to 78.8% for the six months ended December 31, 2014, which was primarily due to the increase in sales of our CAD System which have higher average selling prices than PAD Systems, and to lower indirect costs per unit.

Selling, General and Administrative Expenses. Our selling, general and administrative expenses increased by $13.3 million, or 25.0%, from $52.8 million for the six months ended December 31, 2013 to $66.1 million for the six months ended December 31, 2014. The increase was due primarily to higher coronary expenses from commercial launch, the expansion of our sales and marketing organization and medical and other programs and higher incentive compensation. Selling, general and administrative expenses for the six months ended December 31, 2014 and 2013 include $5.9 million and $4.0 million, respectively, for stock-based compensation.

Research and Development Expenses. Research and development expenses increased by $5.8 million, or 61.6%, from $9.4 million for the six months ended December 31, 2013 to $15.2 million for the six months ended December 31, 2014. Research and development expenses relate to specific projects to develop new products or expand into new markets, such as the development of new versions of the PAD and CAD Systems, shaft designs, crown designs, and PAD and CAD clinical trials. The increase related mainly to additional product development projects and clinical studies, and the related increase in headcount. Research and development expenses for the six months ended December 31, 2014 and 2013 include $688,000 and $521,000, respectively, for stock-based compensation.

Interest and Other, Net. Interest and other expense, net, was $(55,000) for the six months ended December 31, 2014 compared to $(1.6) million for the six months ended December 31, 2013. The decrease was primarily driven by lower interest expense related to lower outstanding debt balances, as well as the elimination of charges from debt conversions and changes in fair value of the debt conversion option that were associated with the previously outstanding convertible debt.

LIQUIDITY AND CAPITAL RESOURCES

We had cash and cash equivalents of $101.3 million and $126.6 million at December 31, 2014 and June 30, 2014, respectively. During the six months ended December 31, 2014, net cash used in operations amounted to $11.1 million. As of December 31, 2014, we had an accumulated deficit of $252.1 million. We have historically funded our operating losses primarily from the issuance of stock, convertible promissory notes, and debt.

Loan and Security Agreement with Partners for Growth

On April 14, 2010, we entered into a loan and security agreement with Partners for Growth III, L.P. (“PFG”), as amended on August 23, 2011, December 27, 2011, June 30, 2012, and May 10, 2013. The amended agreement provides that PFG will make loans to us up to $5.0 million. The agreement has a maturity date of April 14, 2015. The loans bear interest at a floating per annum rate equal to 2.75% above Silicon Valley Bank’s prime rate, and such interest is payable monthly. The principal balance of and any accrued and unpaid interest on any notes are due on the maturity date and may not be prepaid by us at any time in whole or in part. As of December 31, 2014 and June 30, 2014, there were no loans outstanding.

At any time prior to the maturity date, PFG may, at its option, convert any outstanding loan into shares of our common stock at the applicable conversion price, which in each case equals the ten-day volume weighted average price per share of our common stock prior to the issuance date of each note. We may also effect at any time a mandatory conversion of amounts, subject to certain terms, conditions and limitations provided in the agreement, including a requirement that the ten-day volume weighted average price of our common stock prior to the date of conversion is at least 15% greater than the conversion price. We may reduce the conversion price to a price that represents a 15% discount to the ten-day volume weighted average price of our common stock to satisfy this condition and effect a mandatory conversion. We recorded an expense of $0 and $61,000 for the six months ended December 31, 2014 and 2013, respectively, related to the change in fair value of the conversion options on all outstanding loans. This amount is a component of interest and other, net on the accompanying statement of operations.

Table of Contents

Any loans are secured by certain of our assets, and the agreement contains customary covenants limiting our ability to, among other things, incur debt or liens, make certain investments and loans, effect certain redemptions of and declare and pay certain dividends on our stock, permit or suffer certain change of control transactions, dispose of collateral, or change the nature of our business. In addition, the PFG loan and security agreement contains financial covenants requiring us to maintain certain liquidity and fixed charge coverage ratios. We were in compliance with all financial covenants at December 31, 2014. If we do not comply with the various covenants, PFG may, subject to various customary cure rights, decline to provide additional loans, require amortization of any future loan over its remaining term, or require the immediate payment of all amounts outstanding under any future loan and foreclose on any or all collateral, depending on which financial covenants are not maintained.

Changes in Liquidity

Cash and Cash Equivalents. Cash and cash equivalents were $101.3 million at December 31, 2014 and $126.6 million at June 30, 2014. The decrease is primarily attributable to net cash used in operations and investing activities during the six months ended December 31, 2014.

Operating Activities. Net cash used in operations was $11.1 million and $12.5 million for the six months ended December 31, 2014 and 2013, respectively. For the six months ended December 31, 2014 and 2013, we had a net loss of $13.5 million and $16.0 million, respectively. Significant changes in working capital during these periods included:

- Cash used in accounts receivable of $5.5 million and $1.4 million during the six months ended December 31, 2014 and 2013, respectively, was primarily due to the amount and timing of revenue during the six months ended December 31, 2014 and 2013.
- Cash used in inventories was $1.1 million and $4.0 million during the six months ended December 31, 2014 and 2013, respectively. For the six months ended December 31, 2014, the amount of cash used in inventories was primarily due to higher levels of raw materials for the manufacture of products, including the CAD System commercial launch, and finished goods for future sales. For the six months ended December 31, 2013, cash used in inventories was primarily due to higher levels of finished goods for future sales and timing of inventory purchases and sales.
- Cash provided by (used in) prepaid expenses and other current assets was $287,000 and $(194,000) during the six months ended December 31, 2014 and 2013, respectively, primarily due to payment timing of vendor deposits and other expenditures.
- Cash provided by accounts payable of $0.5 million and $1.4 million during the six months ended December 31, 2014 and 2013, respectively, was due to the amount and timing of purchases and vendor payments and overall increased levels of spending.
- Cash (used in) provided by accrued expenses and other liabilities of $(0.5) million and $1.1 million during the six months ended December 31, 2014 and 2013, respectively, was primarily due to the amount and timing of compensation payments.

Investing Activities. Net cash used in investing activities was $13.9 million and $1.1 million for the six months ended December 31, 2014 and 2013, respectively, related to the purchase of property and equipment and patents. In addition, we purchased available-for-sale marketable securities for the deferred compensation plans during the six months ended December 31, 2014 and paid $8.9 million towards the construction of our new corporate headquarters, which is discussed further below.

Financing Activities. Net cash (used in) provided by financing activities was $(246,000) and $92.4 million for the six months ended December 31, 2014 and 2013, respectively. For the six months ended December 31, 2014, cash used in financing activities was due to payments on debt of $2.4 million, partially offset by proceeds from employee stock purchases of $1.4 million and proceeds from the exercise of stock options of $794,000. For the six months ended

December 31, 2013, cash provided by financing activities included proceeds from the issuance of common stock, net of issuance costs, of $84.4 million, proceeds from exercise of stock options and warrants of $9.1 million, and proceeds from employee stock purchases of $1.3 million, partially offset by payments on debt of $2.4 million.

Our future liquidity and capital requirements will be influenced by numerous factors, including the extent and duration of future operating losses, the level and timing of future sales and expenditures, the results and scope of ongoing research and product development programs, working capital required to support our sales growth, the receipt of and time required to obtain regulatory clearances and approvals, our sales and marketing programs, the continuing acceptance of our products in the marketplace, competing technologies, market and regulatory developments and ongoing facility requirements. As of December 31, 2014, we believe our current cash and cash equivalents will be sufficient to fund working capital requirements,

Table of Contents

capital expenditures (including the new corporate headquarters discussed below) and operations for the foreseeable future, including at least the next twelve months. We intend to retain any future earnings to support operations and to finance the growth and development of our business, and we do not anticipate paying any dividends in the foreseeable future. We may raise additional capital in the future, to fund acceleration of our current growth initiatives or additional growth opportunities, if we believe it will significantly enhance our value.

New Corporate Headquarters. On June 11, 2014, we entered into a Redevelopment Agreement, a Design-Build Contract, and a Development Services Agreement, as well as various ancillary agreements, related to the acquisition of real property located in New Brighton, Minnesota and the development of such property into our new corporate headquarters. Pursuant to the Contract for Private Redevelopment by and among the City of New Brighton (the "City"), Ryan Companies US, Inc. ("Ryan"), and us, dated June 11, 2014 (the "Redevelopment Agreement"), we purchased approximately ten acres of real property from the City for a purchase price of $500,000. The City also granted us the option to purchase an additional 3.6 acres prior to May 31, 2021.

Pursuant to the Design-Build Cost Plus Construction Contract by and between Ryan and us, dated June 11, 2014, we have contracted with Ryan to furnish all services, labor, materials, equipment, procurement services, project management and other duties and services necessary for construction of our new headquarters on the land purchased from the City. We expect to have construction substantially completed by March 1, 2015, and, pursuant to the Redevelopment Agreement discussed above, we and Ryan have agreed to complete construction by December 31, 2015.

We anticipate that the total cost for the construction of the headquarters will be approximately $23.0 million, subject to certain increases or decreases if work is completed prior to or after March 1, 2015 or if changes are made to the project plans during construction. We will pay Ryan a fee of 3.85% of the cost of the work. We also anticipate that the additional cost to furnish, equip and open the headquarters will be approximately $7.0 million.

We also entered into a Development Services Agreement with Ryan, dated June 11, 2014, pursuant to which Ryan will perform certain development services to facilitate development of the project, including coordination with the City and overall coordinate of development strategy. We will pay Ryan a fee for the development services, which includes a sum equal to 3.25% of the adjusted total project costs, payable at certain points in the construction process and a sum equal to 5% of the adjusted total project costs, payable upon substantial completion of the project, as well as reimbursement of certain expenses incurred by Ryan.

In connection with the agreements above, we are required to hold approximately $9.1 million in an escrow account that will be used to fund the final construction payments. The escrow is classified as construction in progress in property and equipment, net, on the consolidated balance sheet.

NON-GAAP FINANCIAL INFORMATION

To supplement our consolidated financial statements prepared in accordance with GAAP, our management uses a non-GAAP financial measure referred to as "Adjusted EBITDA." The following table sets forth, for the periods indicated, a reconciliation of Adjusted EBITDA to the most comparable U.S. GAAP measure expressed as dollar amounts (in thousands):

| | Six Months Ended December 31, | |
|---|---|---|
| | 2014 | 2013 |
| Loss from operations | $(13,442) | $(14,342) |
| Add: Stock-based compensation | 7,083 | 4,855 |
| Add: Depreciation and amortization | 833 | 629 |

| | | |
|---|---|---|
| Adjusted EBITDA | $(5,526) | $(8,858) |

Adjusted EBITDA improved as compared to the prior year period due to increased stock-based compensation and the decrease in loss from operations. The loss from operations was impacted by increases in revenues and gross profit, partially offset by increased operating expenses. Stock-based compensation increased $2.2 million, or 45.9%, as a result of increased employee stock awards granted due to our expanded hiring and higher grant date fair values.

Table of Contents

Use and Economic Substance of Non-GAAP Financial Measures Used and Usefulness of Such Non-GAAP Financial Measures to Investors

We use Adjusted EBITDA as a supplemental measure of performance and believe this measure facilitates operating performance comparisons from period to period and company to company by factoring out potential differences caused by depreciation and amortization expense and non-cash charges such as stock-based compensation. Our management uses Adjusted EBITDA to analyze the underlying trends in our business, assess the performance of our core operations, establish operational goals and forecasts that are used to allocate resources and evaluate our performance period over period and in relation to our competitors' operating results. Additionally, our management is partially evaluated on the basis of Adjusted EBITDA when determining achievement of their incentive compensation performance targets.

We believe that presenting Adjusted EBITDA provides investors greater transparency to the information used by our management for its financial and operational decision-making and allows investors to see our results "through the eyes" of management. We also believe that providing this information better enables our investors to understand our operating performance and evaluate the methodology used by our management to evaluate and measure such performance.
The following is an explanation of each of the items that management excluded from Adjusted EBITDA and the reasons for excluding each of these individual items:

- Stock-based compensation. We exclude stock-based compensation expense from our non-GAAP financial measures primarily because such expense, while constituting an ongoing and recurring expense, is not an expense that requires cash settlement. Our management also believes that excluding this item from our non-GAAP results is useful to investors to understand the application of stock-based compensation guidance and its impact on our operational performance, liquidity and ability to make additional investments in the Company, and it allows for greater transparency to certain line items in our financial statements.
- Depreciation and amortization expense. We exclude depreciation and amortization expense from our non-GAAP financial measures primarily because such expenses, while constituting ongoing and recurring expenses, are not expenses that require cash settlement and are not used by our management to assess the core profitability of our business operations. Our management also believes that excluding these items from our non-GAAP results is useful to investors to understand our operational performance, liquidity and ability to make additional investments in the company.

Material Limitations Associated with the Use of Non-GAAP Financial Measures and Manner in Which We Compensate for these Limitations

Non-GAAP financial measures have limitations as analytical tools and should not be considered in isolation or as a substitute for our financial results prepared in accordance with GAAP. Some of the limitations associated with our use of these non-GAAP financial measures are:

- Items such as stock-based compensation do not directly affect our cash flow position; however, such items reflect economic costs to us and are not reflected in our Adjusted EBITDA, and therefore these non-GAAP measures do not reflect the full economic effect of these items.
- Non-GAAP financial measures are not based on any comprehensive set of accounting rules or principles and therefore other companies may calculate similarly titled non-GAAP financial measures differently than we do, limiting the usefulness of those measures for comparative purposes.
- Our management exercises judgment in determining which types of charges or other items should be excluded from the non-GAAP financial measures we use.

We compensate for these limitations by relying primarily upon our GAAP results and using non-GAAP financial measures only supplementally.

INFLATION

We do not believe that inflation had a material impact on our business and operating results during the periods presented.



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Table of Contents

## OFF-BALANCE SHEET ARRANGEMENTS

Since inception, we have not engaged in any off-balance sheet activities as defined in Item 303(a)(4) of Regulation S-K.

## RECENT ACCOUNTING PRONOUNCEMENTS

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2014-09, “Revenue From Contracts with Customers.” The guidance requires an entity to recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which an entity expects to be entitled in exchange for those goods or services. The guidance also requires expanded disclosures relating to the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. Additionally, qualitative and quantitative disclosures are required about customer contracts, significant judgments and changes in judgments, and assets recognized from the costs to obtain or fulfill a contract. ASU 2014-09 is effective for annual periods beginning after December 15, 2016, including interim periods within that reporting period, using one of two prescribed retrospective methods. Early adoption is not permitted. We are evaluating the impact of the amended revenue recognition guidance on our consolidated financial statements.

In August 2014, the FASB issued ASU No. 2014-15, “Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern.” The guidance requires management to perform interim and annual assessments of an entity's ability to continue as a going concern within one year of the date of issuance of the entity's financial statements. The entity must also provide certain disclosures if there is substantial doubt about the entity's ability to continue as a going concern. ASU 2014-15 is effective for annual periods ending after December 15, 2016, and interim periods thereafter. Early adoption is permitted. We do not anticipate a material impact on our financial statements upon adoption.

## PRIVATE SECURITIES LITIGATION REFORM ACT

The Private Securities Litigation Reform Act of 1995 provides a “safe harbor” for forward-looking statements. Such “forward-looking” information is included in this Form 10-Q, including Item 2 of Part I, and in other materials filed or to be filed by the Company with the Securities and Exchange Commission (as well as information included in oral statements or other written statements made or to be made by the Company). Forward-looking statements include all statements based on future expectations. This Form 10-Q contains forward-looking statements that involve risks and uncertainties, including (i) expected compliance with the conditions specified in our Job Creation Agreement; (ii) our expectation that our losses will continue; (iii) the broadening of the commercial launch of the CAD System; (iv) the expectation of selling our products internationally in the future and the timing and structure of our plans to do so; (v) our expectation of increased revenue and increased selling, general and administrative expenses; (vi) our plans to continue to expand our sales and marketing efforts as well as our product portfolio and clinical studies; (vii) our expectation that gross margin in the remainder of fiscal 2015 will be similar to the three months ended December 31, 2014; (viii) our expectation that we will incur research and development expenses in future quarters at amounts at or above the amounts incurred for the three months ended December 31, 2014; (ix) our belief that our current cash and cash equivalents will be sufficient to fund working capital requirements, capital expenditures and operations for the foreseeable future; (x) our intention to retain any future earnings to support operations and to finance the growth and development of our business; (xi) our dividend expectations; (xii) the potential to raise additional capital in the future; and (xiii) our plans regarding construction of a new headquarters, including the expected completion date and costs of construction and furnishing, equipping and opening the headquarters.

In some cases, you can identify forward-looking statements by the following words: “anticipate,” “believe,” “continue,” “could,” “estimate,” “expect,” “intend,” “may,” “ongoing,” “plan,” “potential,” “predict,” “project,” “should,” “will,” “would,” these terms or other comparable terminology, although not all forward-looking statements contain these words.

Forward-looking statements are only predictions and are not guarantees of performance. These statements are based on our management's beliefs and assumptions, which in turn are based on their interpretation of currently available information.

These statements involve known and unknown risks, uncertainties and other factors that may cause our results or our industry's actual results, levels of activity, performance or achievements to be materially different from the information expressed or implied by these forward-looking statements. These factors include regulatory developments in the U.S. and foreign countries; FDA and similar foreign clearances and approvals; approval of our products for distribution in foreign countries; approval of products for reimbursement and the level of reimbursement; dependence on market growth; agreements with third parties to sell their products; the experience of physicians regarding the effectiveness and reliability of the PAD and CAD Systems; the reluctance of physicians, hospitals and other organizations to accept new products; the potential for unanticipated delays in enrolling medical centers and patients for clinical trials; actual clinical trial and study results; the impact of competitive products and pricing; unanticipated developments affecting our estimates regarding expenses, future revenues and capital requirements; unanticipated delays or costs related to the construction and furnishing of our new headquarters; the difficulty of

Table of Contents

successfully managing operating costs; our inability to expand our sales and marketing organization; our actual research and development efforts and needs; our ability to obtain and maintain intellectual property protection for product candidates; our actual financial resources and our ability to obtain additional financing; fluctuations in results and expenses based on new product introductions, sales mix, unanticipated warranty claims, and the timing of project expenditures; and general economic conditions. These and additional risks and uncertainties are described more fully in our Form 10-K filed with the SEC on August 28, 2014. Copies of filings made with the SEC are available through the SEC's electronic data gathering analysis and retrieval system (EDGAR) at www.sec.gov.

You should read these risk factors and the other cautionary statements made in this Form 10-Q as being applicable to all related forward-looking statements wherever they appear in this Form 10-Q. We cannot assure you that the forward-looking statements in this Form 10-Q will prove to be accurate. Furthermore, if our forward-looking statements prove to be inaccurate, the inaccuracy may be material. You should read this Form 10-Q completely. Other than as required by law, we undertake no obligation to update these forward-looking statements, even though our situation may change in the future.

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

The primary objective of our investment activities is to preserve our capital for the purpose of funding operations, while at the same time maximizing the income we receive from our investments without significantly increasing risk or decreasing availability. To achieve these objectives, our investment policy allows us to maintain a portfolio of cash equivalents and investments in a variety of marketable securities, including money market funds, U.S. government securities, and certain bank obligations. Our cash and cash equivalents as of December 31, 2014 include liquid money market accounts. Due to the short-term nature of these investments, we believe that there is no material exposure to interest rate risk.

## ITEM 4. CONTROLS AND PROCEDURES

### Evaluation of Disclosure Controls and Procedures

Our Chief Executive Officer and Chief Financial Officer, referred to collectively herein as the Certifying Officers, are responsible for establishing and maintaining our disclosure controls and procedures. The Certifying Officers have reviewed and evaluated the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934 (the "Exchange Act")) as of December 31, 2014. Based on that review and evaluation, which included inquiries made to certain other employees of the Company, the Certifying Officers have concluded that, as of the end of the period covered by this Report, the Company's disclosure controls and procedures, as designed and implemented, are effective.

### Changes in Internal Control Over Financial Reporting

There were no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the three months ended December 31, 2014 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II. — OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

None.

### ITEM 1A. RISK FACTORS

In addition to the other information set forth in this report, including the important information in the section entitled "Private Securities Litigation Reform Act," you should carefully consider the "Risk Factors" discussed in our Form 10-K for the year ended June 30, 2014 filed with the SEC on August 28, 2014 for a discussion of important factors that could cause actual results to differ materially from the results described in or implied by the forward-looking statements contained in this report, and materially adversely affect our financial condition or future results. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial might materially adversely affect our actual business, financial condition and/or operating results.

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

None.

### ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

### ITEM 4. MINE SAFETY DISCLOSURES

None.

### ITEM 5. OTHER INFORMATION

Effective February 4, 2015, Kevin J. Kenny, the Company's Executive Vice President of Sales and Marketing, has been appointed as the Company's Chief Operating Officer.

Mr. Kenny, 50, joined the Company in May 2011 as Executive Vice President of Sales and Marketing. From 2002 to 2011, Mr. Kenny served in various positions with Medtronic Inc.'s U.S. Spine and Biologics division, including Vice President of Sales. Previously, Mr. Kenny served as Vice President of U.S. sales for Bausch and Lomb and held various sales and marketing leadership roles with B. Braun/McGaw and Smithkline Beecham.

In connection with Mr. Kenny's appointment as Chief Operating Officer, his annual base salary has been increased to $430,000, retroactive to January 1, 2015, and his target bonus level for cash incentive compensation has been increased to 75% of base salary, effective for the second half of fiscal 2015. Mr. Kenny will no longer be eligible to receive additional incentive compensation based on sales commissions and achievement of sales-related "management by objective" targets. In addition, the period of base salary continuation in connection with a termination of Mr. Kenny without "cause" or for "good reason" (each as defined in his Employment Agreement with the Company) has been increased to 18 months, and Mr. Kenny will receive severance equal to 1.5 times his base salary and target bonus in the year of termination if he is terminated without "cause" or for "good reason" within two years of a change of control.

In connection with this new position, Mr. Kenny is expected to receive a grant of restricted stock under the Company's 2014 Equity Incentive Plan worth approximately $142,000, which would vest over a three-year period, to be granted

at a future meeting of the Human Resources and Compensation Committee of the Company's Board of Directors.

In connection with Mr. Kenny's appointment, the Company and Mr. Kenny entered into Amendment No. 2 to his Employment Agreement with the Company, dated February 4, 2015, reflecting his new title, base salary and severance benefits, as well as the elimination of the sales-related incentive compensation for which he is no longer eligible.

The foregoing description of the material terms of Amendment No. 2 does not purport to be a complete description of the rights and obligations of the parties thereunder and is qualified in its entirety by reference to the full text of Amendment No. 2, which will be filed as an exhibit to the Quarterly Report on Form 10-Q for the quarter ending March 31, 2015.

Table of Contents

ITEM 6. EXHIBITS

(a)Exhibits — See Exhibit Index on page following signatures

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.

| Dated: February 6, 2015 | | CARDIOVASCULAR SYSTEMS, INC. |
|---|---|---|
| | By | /s/ David L. Martin<br>David L. Martin<br>President and Chief Executive Officer<br>(Principal Executive Officer) |
| | By | /s/ Laurence L. Betterley<br>Laurence L. Betterley<br>Chief Financial Officer<br>(Principal Financial and Accounting Officer) |

Table of Contents

EXHIBIT INDEX
CARDIOVASCULAR SYSTEMS, INC.
FORM 10-Q

| Exhibit No. | Description |
| --- | --- |
| 10.1 | Cardiovascular Systems, Inc. 2014 Equity Incentive Plan (previously filed with the SEC as Exhibit 10.1 to and incorporated herein by reference from the Company's Current Report on Form 8-K filed on November 14, 2014). |
| 10.2* | Form of Restricted Stock Agreement for Time-Based Awards under the 2014 Equity Incentive Plan. |
| 10.3* | Form of Restricted Stock Agreement for Performance-Based Awards under the 2014 Equity Incentive Plan. |
| 31.1* | Certification of President and Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2* | Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1** | Certification of President and Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2** | Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 101 | Financial statements from the quarterly report on Form 10-Q of the Company for the quarter ended December 31, 2014, formatted in XBRL: (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Operations, (iii) the Consolidated Statements of Cash Flows, and (iv) the Notes to Financial Statements. |

* Filed herewith.
** Furnished herewith.