

LUNA INNOVATIONS INC
Form 10-Q
August 08, 2013
[Table of Contents](#)

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

**x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE
ACT OF 1934**

For the quarterly period ended June 30, 2013

OR

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

For the transition period from _____ to _____

COMMISSION FILE NUMBER 000-52008

LUNA INNOVATIONS INCORPORATED

(Exact name of registrant as specified in its charter)

Edgar Filing: LUNA INNOVATIONS INC - Form 10-Q

Delaware
(State or Other Jurisdiction of
Incorporation or Organization)

54-1560050
(I.R.S. Employer
Identification Number)

One Riverside Circle, Suite 400

Roanoke, VA 24016

(Address of Principal Executive Offices)

(540) 769-8400

(Registrant's Telephone Number, Including Area Code)

(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. ☒ Yes ☐ No

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

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

Large accelerated filer ☐

Accelerated filer ☐

Non-accelerated filer ☐ (Do not check if a smaller reporting company)

Smaller reporting company ☒

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

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. ☒ Yes ☐ No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: As of July 31, 2013, there were 14,424,663 shares of the registrant's common stock outstanding.

Table of Contents

CAUTIONARY NOTE REGARDING FORWARD LOOKING STATEMENTS

This Quarterly Report on Form 10-Q, including the sections entitled Management's Discussion and Analysis of Financial Condition and Results of Operations and Quantitative and Qualitative Disclosure About Market Risk under Items 2 and 3, respectively, of Part I of this report, and the section entitled Risk Factors under Item 1A of Part II of this report, may contain forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, and Section 27A of the Securities Act of 1933, as amended. All statements other than statements of historical fact are forward-looking statements for purposes of these statutes, including those relating to future events or our future financial performance. In some cases, you can identify these forward looking statements by words such as intends, will, plans, anticipates, expects, may, might, estimates, believes, should, projects, predicts, potential or continue, or the negative of those words and other comparable words, and other words or terms of similar meaning in connection with any discussion of future operating or financial performance. Similarly, statements that describe our management transition, business strategy, goals, prospects, opportunities, outlook, objectives, plans or intentions are also forward-looking statements. These statements are only predictions and may relate to, but are not limited to, expectations of future operating results or financial performance, capital expenditures, introduction of new products, regulatory compliance and plans for growth and future operations, as well as assumptions relating to the foregoing.

These statements are based on current expectations and assumptions regarding future events and business performance and involve known and unknown risks, uncertainties and other factors that may cause actual events or results to be materially different from any future events or results expressed or implied by these statements. These factors include those set forth in the following discussion and within Item 1A Risk Factors of this Quarterly Report on Form 10-Q and elsewhere within this report.

You should not place undue reliance on these forward-looking statements, which apply only as of the date of this Quarterly Report on Form 10-Q. You should carefully review the risk factors described in other documents that we file from time to time with the U.S. Securities and Exchange Commission, or SEC. Except as required by applicable law, including the rules and regulations of the SEC, we do not plan to publicly update or revise any forward-looking statements, whether as a result of any new information, future events or otherwise, other than through the filing of periodic reports in accordance with the Securities Exchange Act of 1934, as amended.

Table of Contents

LUNA INNOVATIONS INCORPORATED
QUARTERLY REPORT ON FORM 10-Q
FOR THE QUARTER ENDED JUNE 30, 2013
TABLE OF CONTENTS

<u>PART I. FINANCIAL INFORMATION</u>	4
ITEM 1. <u>FINANCIAL STATEMENTS</u>	4
ITEM 2. <u>MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS</u>	14
ITEM 3. <u>QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK</u>	22
ITEM 4. <u>CONTROLS AND PROCEDURES</u>	22
<u>PART II. OTHER INFORMATION</u>	23
ITEM 1. <u>LEGAL PROCEEDINGS</u>	23
ITEM 1A. <u>RISK FACTORS</u>	23
ITEM 2. <u>UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS</u>	38
ITEM 3. <u>DEFAULTS UPON SENIOR SECURITIES</u>	38
ITEM 4. <u>MINE SAFETY DISCLOSURES</u>	38
ITEM 5. <u>OTHER INFORMATION</u>	38
ITEM 6. <u>EXHIBITS</u>	38
<u>SIGNATURES</u>	39
<u>EXHIBIT INDEX</u>	40

Table of Contents**PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****Luna Innovations Incorporated****Condensed Consolidated Balance Sheets**

	June 30, 2013 (unaudited)	December 31, 2012
Assets		
Current assets:		
Cash and cash equivalents	\$ 8,742,869	\$ 6,340,461
Accounts receivable, net	6,702,987	7,059,635
Inventory, net	3,646,133	3,336,916
Prepaid expenses	560,275	667,773
Other current assets	70,207	35,629
Total current assets	19,722,471	17,440,414
Property and equipment, net	2,141,390	2,426,638
Intangible assets, net	377,638	437,839
Other assets	80,293	152,877
Total assets	\$ 22,321,792	\$ 20,457,768
Liabilities and stockholders equity		
Liabilities:		
Current Liabilities		
Current portion of long term debt obligation	\$ 1,625,000	\$ 1,500,000
Current portion of capital lease obligation	55,734	54,091
Accounts payable	2,238,501	1,797,571
Accrued liabilities	2,531,515	2,747,175
Deferred credits	611,269	832,822
Total current liabilities	7,062,019	6,931,659
Long-term debt obligation	1,375,000	2,125,000
Long-term lease obligation	100,633	128,917
Total liabilities	8,537,652	9,185,576
Commitments and contingencies		
Stockholders equity:		
Preferred stock, par value \$ 0.001, 1,321,514 shares authorized, issued and outstanding at June 30, 2013 and December 31, 2012	1,322	1,322
Common stock, par value \$ 0.001, 100,000,000 shares authorized, 14,413,385 and 14,009,280 shares issued and outstanding at June 30, 2013 and December 31, 2012, respectively	14,688	14,245
Additional paid-in capital	62,089,490	61,361,505

Edgar Filing: LUNA INNOVATIONS INC - Form 10-Q

Accumulated deficit	(48,321,360)	(50,104,880)
Total stockholders' equity	13,784,140	11,272,192
Total liabilities and stockholders' equity	\$ 22,321,792	\$ 20,457,768

The accompanying notes are an integral part of these condensed consolidated financial statements.

Table of Contents**Luna Innovations Incorporated****Condensed Consolidated Statements of Operations**

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
	(unaudited)		(unaudited)	
Revenues:				
Technology development revenues	\$ 2,807,296	\$ 3,894,846	\$ 5,434,537	\$ 7,837,546
Products and licensing revenues	3,165,764	2,845,864	5,035,439	5,559,677
Total revenues	5,973,060	6,740,710	10,469,976	13,397,223
Cost of revenues:				
Technology development costs	2,209,158	2,729,108	4,381,135	5,428,304
Products and licensing costs	1,355,643	1,267,201	2,288,062	2,514,696
Total cost of revenues	3,564,801	3,996,309	6,669,197	7,943,000
Gross Profit	2,408,259	2,744,401	3,800,779	5,454,223
Operating expense:				
Selling, general and administrative	2,658,605	2,526,638	5,167,251	5,183,614
Research, development, and engineering	666,632	608,459	1,507,124	1,293,240
Total operating expense	3,325,237	3,135,097	6,674,375	6,476,854
Operating loss	(916,978)	(390,696)	(2,873,596)	(1,022,631)
Other income/(expense):				
Other income, net	15,307	23,265	86,540	46,533
Interest expense	(49,781)	(74,357)	(107,960)	(154,015)
Total other expense	(34,474)	(51,092)	(21,420)	(107,482)
Loss from continuing operations before income taxes	(951,452)	(441,788)	(2,895,016)	(1,130,113)
Income tax (benefit)/expense	(160,855)		(956,055)	5,799
Loss from continuing operations	(790,597)	(441,788)	(1,938,961)	(1,135,912)
(Loss)/income from discontinued operations, net of income taxes	(161,485)	199,268	3,772,476	558,644
Net (loss)/income	(952,082)	(242,520)	1,833,515	(577,268)
Preferred stock dividend	26,366	26,784	49,995	60,880
Net (loss)/income attributable to common stockholders	\$ (978,448)	\$ (269,304)	\$ 1,783,520	\$ (638,148)
Net loss per share from continuing operations:				
Basic	\$ (0.06)	\$ (0.03)	\$ (0.14)	\$ (0.08)

Edgar Filing: LUNA INNOVATIONS INC - Form 10-Q

Diluted	\$	(0.06)	\$	(0.03)	\$	(0.14)	\$	(0.08)
---------	----	--------	----	--------	----	--------	----	--------

Net (loss)/income per share from discontinued operations:

Basic	\$	(0.01)	\$	0.01	\$	0.27	\$	0.04
Diluted	\$	(0.01)	\$	0.01	\$	0.23	\$	0.03

Net (loss)/income per share attributable to common stockholders:

Basic	\$	(0.07)	\$	(0.02)	\$	0.13	\$	(0.05)
Diluted	\$	(0.07)	\$	(0.02)	\$	0.11	\$	(0.05)

Weighted average common shares and common equivalent shares outstanding:

Basic	14,362,494	13,892,816	14,206,598	13,885,684
Diluted	14,362,494	16,314,620	16,558,357	16,325,402

The accompanying notes are an integral part of these condensed consolidated financial statements.

Table of Contents**Luna Innovations Incorporated****Condensed Consolidated Statements of Cash Flows**

	Six months ended June 30,	
	2013	2012
	(unaudited)	
Cash flows used in operating activities		
Net income/(loss)	\$ 1,833,515	\$ (577,268)
Adjustments to reconcile net income/(loss) to net cash used in operating activities		
Depreciation and amortization	489,244	528,113
Share-based compensation	618,084	928,368
Warrant expense		12,032
Gain on sale of discontinued operations, net of income taxes	(3,868,114)	
Allowance for doubtful accounts or bad debt expense	124,810	
Tax benefit from utilization of net operating loss carryforward	(1,021,538)	
Change in assets and liabilities:		
Accounts receivable	834,122	(1,212,864)
Inventory	(309,217)	(69,186)
Other current assets	(40,647)	150,289
Other assets	72,584	37,583
Accounts payable and accrued expenses	174,916	(847,341)
Deferred credits	(221,553)	(328,491)
Net cash used in operating activities	(1,313,794)	(1,378,765)
Cash flows provided by/(used in) investing activities		
Acquisition of property and equipment	(69,108)	(123,732)
Intangible property costs	(145,858)	(55,847)
Proceeds from sale of discontinued operations, net of fees	4,522,460	
Net cash provided by/(used in) investing activities	4,307,494	(179,579)
Cash flows used in financing activities		
Payments on capital lease obligations	(26,641)	(25,094)
Payment of debt obligations	(625,000)	(750,000)
Proceeds from the exercise of options and warrants	60,349	33,830
Net cash used in financing activities	(591,292)	(741,264)
Net increase/(decrease) in cash and cash equivalents	2,402,408	(2,299,608)
Cash and cash equivalents beginning of period	6,340,461	8,939,127
Cash and cash equivalents end of period	\$ 8,742,869	\$ 6,639,519
Supplemental disclosure of cash flow information		
Cash paid for interest	\$ 84,917	\$ 150,708
Dividend on preferred stock, 39,646 shares of common stock issuable at June 30, 2013 and 2012	\$ 49,995	\$ 60,880
Cash paid for income taxes	\$ 14,010	\$

The accompanying notes are an integral part of these condensed consolidated financial statements.

Table of Contents

Luna Innovations Incorporated

Notes to Unaudited Condensed Consolidated Financial Statements

1. Basis of Presentation and Significant Accounting Policies

Nature of Operations

Luna Innovations Incorporated (we, Luna Innovations or the Company) is incorporated in the State of Delaware and headquartered in Roanoke, Virginia. We develop, manufacture and market fiber optic test & measurement, sensing, and instrumentation products and are focused on bringing new and innovative technology solutions to measure, monitor, protect and improve critical processes in the telecommunications, medical, composite and defense industries. We are organized into two main groups, which work closely together to turn ideas into products: our Technology Development segment and our Products and Licensing segment. Our business model is designed to accelerate the process of bringing new and innovative technologies to market. We have a history of net losses from continuing operations from 2005 through the six months ended June 30, 2013 attributable to our operations and other charges. We have historically managed our liquidity through cost reduction initiatives, debt financings and capital market transactions.

Since the second half of 2008, the increased turmoil in the U.S. and global capital markets and a global slowdown of economic growth created a substantially more difficult business environment. Our ability to access the capital markets may be limited. Economic and market conditions may not improve significantly during the remainder of 2013 and could get worse.

Although there can be no guarantees, we believe that our current cash balance, in addition to the funds available to us under the Credit Facilities described in Note 4 below, will provide adequate liquidity for us to meet our working capital needs over the next twelve months.

Unaudited Interim Financial Information

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP) and with the instructions to Form 10-Q and Article 10 of Regulation S-X of the Securities Exchange Act of 1934. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for annual financial statements. The unaudited condensed consolidated financial statements have been prepared on the same basis as the annual financial statements and in the opinion of management reflect all adjustments, consisting of only normal recurring accruals considered necessary to present fairly our financial position at June 30, 2013, results of operations for the three and six months ended June 30, 2013 and 2012, and cash flows for the six months ended June 30, 2013 and 2012. The results of operations for the three and six months ended June 30, 2013 are not necessarily indicative of the results that may be expected for the year ending December 31, 2013.

The consolidated interim financial statements, including our significant accounting policies, should be read in conjunction with the audited Consolidated Financial Statements and the notes thereto for the year ended December 31, 2012, included in the Company's Annual Report on Form 10-K as filed with the Securities and Exchange Commission on March 29, 2013. As used herein, the terms Luna, the Company, we, our and us mean Luna Innovations Incorporated and its consolidated subsidiaries.

Consolidation Policy

Our consolidated financial statements are prepared in accordance with U.S. GAAP and include the accounts of the Company and our wholly owned subsidiaries. We eliminate from our financial results all significant intercompany transactions. We do not have any investments in entities we believe are variable interest entities for which we are the primary beneficiary.

Fair Value Measurements

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in the principal or most advantageous market in an orderly transaction between marketplace participants. Various valuation approaches can be used to determine fair value, each requiring different valuation inputs. The following hierarchy classifies the inputs used to determine fair value into three levels:

Edgar Filing: LUNA INNOVATIONS INC - Form 10-Q

Level 1 Quoted prices for identical instruments in active markets

Level 2 Quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-derived valuations in which all significant inputs and significant value drivers are observable in active markets

Level 3 Valuations derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable. The carrying values of cash and cash equivalents, accounts receivable and accounts payable approximate fair value because of the short-term nature of these instruments. The carrying value of our debt approximates fair value, as we consider the floating interest rate on our credit facilities with Silicon Valley Bank to be at market. Certain nonfinancial assets and liabilities are measured at fair value on a nonrecurring basis in accordance with U.S. GAAP. This includes items such as nonfinancial assets and liabilities initially measured at fair value in a business combination and nonfinancial long-lived asset groups measured at fair value for an impairment assessment. In general, nonfinancial assets including intangible assets and property and equipment are measured at fair value when there is an indication of impairment and are recorded at fair value only when any impairment is recognized.

Table of Contents

Use of Estimates

The preparation of our consolidated financial statements in accordance with U.S. GAAP requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and the disclosure of contingent assets and liabilities in our consolidated financial statements and accompanying notes. Although these estimates are based on our knowledge of current events and actions we may undertake in the future, actual results may differ from such estimates and assumptions.

Per Share Net Income/(Loss) from Continuing Operations and Net Income/(Loss) Available to Common Stockholders

Basic net income/(loss) per share from continuing operations and net income/(loss) per share available to common stockholders are calculated by dividing net loss from continuing operations or net income/(loss) by the weighted average number of common shares outstanding for the applicable period. Diluted net income/(loss) per share from continuing operations and net income/(loss) per share available to common stockholders are computed based on the weighted average number of common shares outstanding increased to include, if dilutive, the number of additional common share equivalents that would have been outstanding if potential common shares had been issued using the treasury stock method. Diluted per share data would also include the potential common share equivalents relating to convertible securities by application of the if-converted method.

For the three and six months ended June 30, 2013, there were approximately 2.4 million and 2.4 million common share equivalents, respectively, which included conversion of preferred stock, outstanding warrants and incremental shares from assumed exercise of in-the-money stock options that would have been dilutive to net income from continuing operations had we recorded positive net income from continuing operations. For each of these periods, there were approximately 4.9 million out-of-the-money options to purchase shares that would have been anti-dilutive.

For the three months ended June 30, 2013, there were approximately 2.4 million common share equivalents, which included conversion of preferred stock, outstanding warrants and incremental shares from assumed exercise of in-the-money stock options, that would have been dilutive to net income available to common stockholders had we recorded positive net income available to common stockholders. For the six months ended June 30, 2013, there were approximately 2.4 million common share equivalents, which included conversion of preferred stock, outstanding warrants and incremental shares from assumed exercise of in-the-money stock options, that were dilutive to net income available to common stockholders. For each of these periods, there were approximately 4.9 million out-of-the-money options to purchase shares that would have been anti-dilutive.

Share-Based Compensation

We recognize share-based compensation expense based upon the fair value of the underlying equity award on the date of the grant. For restricted stock awards and restricted stock units, we recognize expense based upon the price of our underlying stock at the date of the grant. We have elected to use the Black-Scholes option pricing model to value any option or warrant awards granted. We amortize share-based compensation for such awards on a straight-line basis over the related service period of the awards taking into account the effects of the employees' expected exercise and post-vesting employment termination behavior. To compute the volatility used in this model we use the historical volatility of our common stock over the expected life of options granted. The risk-free interest rate is based on U.S. Treasury interest rates, the terms of which are consistent with the expected life of the stock options. The expected life and estimated post employment termination behavior is based upon historical experience of homogeneous groups within our company. We also assume an expected dividend yield of zero for all periods, as we have never paid a dividend on our common stock and do not have any plans to do so in the future.

The fair value of each option granted during the six months ended June 30, 2013 and 2012 was estimated as of the grant date using the Black-Scholes option pricing model with the following assumptions:

	Six months ended June 30, 2013	Six months ended June 30, 2012
Risk-free interest rate	1.27 - 1.33%	1.20 - 1.49%
Expected life of options (in years)	7.5	7.5
Expected stock price volatility	108%	108%

	Options Outstanding				Options Exercisable		
	Number of Shares	Price per Share Range	Weighted Average Exercise Price	Aggregate Intrinsic Value (1)	Number of Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value (1)
Balance, December 31, 2012	5,422,130	\$ 0.35 - \$6.74	\$ 2.19	\$ 639,904	3,775,388	\$ 2.37	\$ 604,292
Granted	664,591	\$ 1.20 - \$1.31	\$ 1.29				
Exercised	(34,425)	\$ 0.35 - \$1.18	\$ 0.71				
Canceled	(673,565)	\$ 0.35 - \$6.74	\$ 2.24				
Balance, June 30, 2013	5,378,731	\$ 0.35 - \$6.55	\$ 2.07	\$ 682,849	3,718,293	\$ 2.30	\$ 651,598

Table of Contents**2. Discontinued Operations**

On March 1, 2013, we completed the sale of our Secure Computing and Communications group (SCC), which was part of our Technology Development segment, to an unaffiliated third party for a gross sales price of \$6.1 million of cash. Prior to the sale, SCC provided innovative solutions designed to secure critical technologies within the U.S. government. SCC conducted applied research and provided services to the government in this area, with its revenues primarily derived from U.S. government contracts and purchase orders. Of the purchase price, we received approximately \$5.4 million at closing and are to receive \$110,000 on December 31, 2013. An additional \$600,000 was placed in escrow to be released in tranches over 18 months, subject to certain events and dates and to any indemnification claims of the acquirer. In connection with the sale, we incurred approximately \$0.8 million in transaction costs that included various charges related to investment banker and legal fees. In addition, the acquirer has entered into a sublease with us for the facilities historically occupied by SCC through December 31, 2013 for a total of \$0.3 million. In the transaction, we sold the equipment, contracts and intellectual property associated with SCC. Approximately 20 employees of the SCC group transferred to the acquirer. Included in the transaction were current assets of approximately \$0.2 million and long term assets with a net book value of approximately \$0.1 million, at February 28, 2013. SCC accounted for 18.5% of our revenues, and 20.7% of our cost of revenues for the year ended December 31, 2012. We recorded an aggregate after-tax gain on the sale of this group of \$4.0 million or \$0.24 per diluted share in our first quarter 2013 results.

We have reported the results of operations of SCC as discontinued operations in our consolidated financial statements. We allocated a portion of the consolidated tax expense to discontinued operations based on the ratio of the discontinued group's income or loss before allocations.

Following the sale of SCC, we have continued to act on behalf of the purchaser and bill the government for certain contracts that have not yet been transferred by the government to the purchaser. We record these amounts as revenues, with an offsetting amount as cost of revenues, within (loss)/income from discontinued operations. We expect to continue recording such revenues and costs until all of these contracts are transferred to the purchaser by the government.

The loss from discontinued operations is the result of the allocation of the alternative minimum tax computation on the company's results as a whole at June 30, 2013.

The key components of (loss)/income from discontinued operations were as follows:

	Three Months Ended		Six Months Ended	
	June 30, 2013	June 30, 2012	June 30, 2013	June 30, 2012
Net revenues	\$ 589,863	\$ 1,439,474	\$ 1,231,438	\$ 3,156,270
Cost of revenues	589,863	1,038,973	1,162,814	2,242,675
Operating expenses		201,233	229,745	354,951
Income/(loss) before income taxes		199,268	(161,121)	558,644
Allocated tax expense/(benefit)	389		(65,483)	
Operating (loss)/ income from discontinued operations	(389)	199,268	(95,638)	558,644
(Loss)/gain on sale, net of \$0.2 million, and \$1.1 million, of related income taxes, respectively	(161,096)		3,868,114	
(Loss)/income from discontinued operations, net of income taxes	\$ (161,485)	\$ 199,268	\$ 3,772,476	\$ 558,644

Table of Contents**3. Inventory**

Inventory consists of finished goods, work-in-process and parts valued at the lower of cost (determined on the first-in, first-out basis) or market. We provide reserves for estimated obsolescence or unmarketable inventory equal to the difference between the cost of the inventory and the estimated market value based upon assumptions about future demand and market conditions.

Components of inventory are as follows:

	June 30, 2013	December 31, 2012
Finished goods	\$ 677,109	\$ 195,578
Work-in-process	352,886	252,227
Parts	2,724,714	2,975,297
	3,754,709	3,423,102
Less: Inventory reserves	108,576	86,186
Total inventory, net	\$ 3,646,133	\$ 3,336,916

4. Debt*Silicon Valley Bank Credit Facilities*

We currently have a Loan and Security Agreement with Silicon Valley Bank (SVB) in which we have a term loan with an original borrowing amount of \$6.0 million (the Term Loan). The Term Loan is to be repaid by us in 48 monthly installments, plus accrued interest payable monthly in arrears, and unless earlier terminated, matures on the earlier of either May 1, 2015 or an event of a default under the loan agreement. The term loan carries a floating annual interest rate equal to SVB's prime rate then in effect plus 2%. We may repay amounts due under the Term Loan at any time with no penalties.

In addition to the terms and conditions of the Term Loan, we also have a revolving credit facility (the Line of Credit and together with the Term Loan the Credit Facilities) with a maximum borrowing capacity of \$1.0 million. The interest rate on the Line of Credit is SVB's prime rate plus 1.25%, payable monthly in arrears, and we are required to pay an unused Line of Credit fee of one-quarter of one percent (0.25%), payable monthly. We may terminate the Line of Credit for a termination fee of \$10,000, which fee would not be payable in the event that the Line of Credit is replaced by another loan facility with SVB. The Line of Credit has a maturity date of May 17, 2014.

Amounts due under the Credit Facilities are secured by substantially all of our assets, including intellectual property, personal property and bank accounts.

On March 21, 2013, we entered into a Fourth Loan Modification Agreement with SVB that replaced the existing financial covenants with a single covenant that we maintain a minimum cash balance of \$5.0 million with SVB. The Credit Facilities also require us to observe a number of operational covenants, including protection and registration of intellectual property rights, and certain customary negative covenants. As of June 30, 2013, we were in compliance with all covenants under the Credit Facilities.

In addition, the Credit Facilities contain customary events of default, including nonpayment of principal, interest or other amounts, violation of covenants, material adverse change, an event of default under any subordinated debt documents, incorrectness of representations and warranties in any material respect, bankruptcy, judgments in excess of a threshold amount, and violations of other agreements in excess of a threshold amount. If any event of default occurs SVB may declare due immediately all borrowings under the Credit Facilities and foreclose on the collateral. Furthermore, an event of default under the Credit Facilities would result in an increase in the interest rate on any amounts outstanding. As of June 30, 2013, there were no events of default on our Credit Facilities.

The balance under the Term Loan at June 30, 2013 was \$3.0 million of which \$1.4 million was classified as long-term and \$1.6 million was classified as short-term. No amounts were outstanding under the Line of Credit and the available credit capacity is \$1.0 million at June 30, 2013.

Table of Contents**5. Capital Stock and Additional Paid-in Capital**

The following details our equity transactions during the six months ended June 30, 2013:

	Preferred Stock		Common Stock		Additional Paid-in Capital
	Shares	\$	Shares	\$	\$
Balances, December 31, 2012	1,321,514	1,322	14,009,280	14,245	61,361,505
Exercise of stock options			66,605	66	60,283
Share-based compensation			337,500	337	617,747
Stock dividends to Carilion Clinic(1)				40	49,955
Balances, June 30, 2013	1,321,514	1,322	14,413,385	14,688	62,089,490

- (1) The stock dividends payable in connection with Carilion Clinic's Series A Preferred Stock will be issued subsequent to June 30, 2013. For the period from January 12, 2010, the original issue date of the Series A Preferred Stock, through June 30, 2013, the Series A Preferred Stock issued to Carilion has accrued \$657,843 in dividends. The accrued and unpaid dividends as of June 30, 2013 will be paid by the issuance of 274,879 shares of our common stock upon Carilion's written request.

6. Operating Segments

Our operations are divided into two operating segments: Technology Development and Products and Licensing.

The Technology Development segment provides applied research to customers in our areas of focus. Our engineers and scientists collaborate with our network of government, academic and industry experts to identify technologies and ideas with promising market potential. We then compete to win fee-for-service contracts from government agencies and industrial customers who seek innovative solutions to practical problems that require new technology. The Technology Development segment derives its revenue primarily from services. This segment previously included SCC, which we sold on March 1, 2013, and the amounts below do not include the revenues, expenses and assets of SCC.

The Products and Licensing segment derives its revenue from product sales, funded product development and technology licenses.

Through June 30, 2013, our Chief Executive Officer and his direct reports collectively represented our chief operating decision makers, and they evaluated segment performance based primarily on revenue and operating income or loss. The accounting policies of our segments are the same as those described in the summary of significant accounting policies (see Note 1 to our Financial Statements, Organization and Summary of Significant Accounting Policies, presented in our Annual Report on Form 10-K as filed with the Securities and Exchange Commission on March 29, 2013).

Table of Contents

The table below presents revenues and operating loss for reportable segments not including discontinued operations:

	Three Months Ended		Six Months Ended	
	2013	June 30, 2012 (unaudited)	2013	June 30, 2012 (unaudited)
Revenues:				
Technology development revenues	\$ 2,807,296	\$ 3,894,846	\$ 5,434,537	\$ 7,837,546
Products and licensing revenues	3,165,764	2,845,864	5,035,439	5,559,677
Total revenues	\$ 5,973,060	\$ 6,740,710	\$ 10,469,976	\$ 13,397,223
Technology development operating loss	\$ (611,946)	\$ (425,053)	\$ (1,563,708)	\$ (874,235)
Products and licensing operating (loss)/income	(305,032)	34,357	(1,309,888)	(148,396)
Total operating loss	\$ (916,978)	\$ (390,696)	\$ (2,873,596)	\$ (1,022,631)
Depreciation, technology development	\$ 57,736	\$ 57,505	\$ 157,939	\$ 128,738
Depreciation, products and licensing	\$ 80,355	\$ 62,001	\$ 146,340	\$ 130,369
Amortization, technology development	\$ 66,043	\$ 39,656	\$ 96,008	\$ 86,390
Amortization, products and licensing	\$ 60,037	\$ 22,891	\$ 88,957	\$ 47,004

The table below presents assets for reportable segments:

	June 30, 2013	December 31, 2012
Total segment assets:		
Technology development	\$ 11,586,331	\$ 13,342,725
Products and licensing	10,735,461	7,115,043
Total	\$ 22,321,792	\$ 20,457,768
Property plant and equipment, and intangible assets, Technology development	\$ 1,307,525	\$ 1,868,235
Property plant and equipment, and intangible assets, Products and licensing	\$ 1,211,503	\$ 996,242

There are no material inter-segment revenues for any period presented.

The United States Government accounted for approximately 48% and 47% of total consolidated revenues for the three months ended June 30, 2013 and 2012, respectively, and 54% and 60% of total consolidated revenues for the six months ended June 30, 2013 and 2012, respectively.

International revenues (customers outside the United States) accounted for approximately 28% and 20% of total consolidated revenues for the three months ended June 30, 2013 and 2012, respectively, and 27% and 17% of total consolidated revenue for the six months ended June 30, 2013 and 2012, respectively.

Table of Contents

7. Contingencies and Guarantees

We are from time to time involved in certain legal proceedings in the ordinary course of conducting our business. While the ultimate liability pursuant to these actions cannot currently be determined, we believe these legal proceedings will not have a material adverse effect on our financial position or results of operations.

In September 2011 we executed a non-cancelable \$1.2 million purchase order for multiple shipments of tunable lasers to be delivered over a 12-month period beginning in 2012. At June 30, 2013, we had fulfilled the purchase requirement for these tunable lasers.

In April of this year we executed a non-cancelable \$0.3 million purchase order for multiple shipments of tunable lasers to be delivered over a five month period beginning in 2013. At June 30, 2013, we had \$0.2 million outstanding on this purchase order.

We have entered into indemnification agreements with our officers and directors, to the extent permitted by law, pursuant to which we have agreed to reimburse the officers and directors for legal expenses in the event of litigation and regulatory matters. The terms of these indemnification agreements provide for no limitation to the maximum potential future payments. We have a directors and officers insurance policy that may, in certain instances, mitigate the potential liability and payments.

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

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and the related notes to those statements included elsewhere in this report. In addition to historical financial information, the following discussion and analysis contains forward-looking statements that involve risks, uncertainties and assumptions. Our actual results and timing of selected events may differ materially from those anticipated in these forward-looking statements as a result of many factors, including those discussed under Risk Factors and elsewhere in this report.

Overview

We develop, manufacture and market fiber optic test & measurement, sensing, and instrumentation products and are focused on bringing new and innovative technology solutions to measure, monitor, protect and improve critical processes in the telecommunications, medical, composite and defense industries. Our business model is designed to accelerate the process of bringing new and innovative products to market. We use our in-house technical expertise across a range of technologies to perform applied research services for companies and government-funded projects. We continue to invest in product development and commercialization, which we anticipate will lead to increased product sales growth.

Our corporate strategy focuses on two key objectives for growth as we seek to commercialize our technologies:

Develop and become the leading supplier of fiber optic shape sensing technology for robotic and minimally invasive surgical systems.

Become the leading provider of fiber optic sensing systems and standard test methods for composite materials.

We are organized into two main business segments, our Products and Licensing segment and our Technology Development segment. A breakdown of our operating loss by segment, as well as our total assets by segment, is provided in footnote 6 to our condensed consolidated financial statements included in this report.

Our Products and Licensing segment develops, manufactures and markets our fiber optic test and measurement, sensing, and instrumentation products and also conducts applied research in the fiber optic sensing area for both corporate and government customers. Revenues in this segment are currently largely derived from sales of test and measurement equipment for optical components and networks and equipment for measuring strain and temperature using optical fiber. Our Products and Licensing segment is also focused on our two key strategic objectives. We are working to develop and commercialize our fiber optic shape sensing technology in the medical industry with the goal of supplying fiber optic shape sensing components for use in robotic and minimally invasive surgical systems. We are also working to increase the sales of our fiber optic technology for strain and temperature sensing applications for the composite materials industry. Our Products and Licensing segment revenues represented approximately 53% and 42% of our total revenues for the quarters ended June 30, 2013 and 2012, respectively, and approximately 48% and 41% for the six months ended June 30, 2013 and 2012, respectively.

Table of Contents

Our Technology Development segment performs applied research for government funded projects and previously included our secure computing and communications group, or SCC. Our Technology Development segment, excluding SCC, represented approximately 47% and 58% of our total revenues for the quarters ended June 30, 2013 and 2012, respectively and approximately 52% and 59% for the six months ended June 30, 2013 and 2012, respectively. Our Technology Development segment predominantly performs applied research in the various areas of sensing applications and technologies, innovative materials and biomedical activities. Most of the government funding for our Technology Development segment is derived from the Small Business Innovation Research, or SBIR, program coordinated by the U.S. Small Business Administration, or SBA.

We generate revenues through technology development services provided under contractual arrangements, product sales, product development under contractual relationships and license fees. Our Technology Development segment revenues have historically accounted for a large portion of our total revenues, and we expect that they will continue to represent a significant portion of our total revenues for the foreseeable future. Our Technology Development segment revenues decreased to \$2.8 million for the three months ended June 30, 2013 as compared to \$3.9 million for the same period in 2012 and they decreased to \$5.4 million for the six months ended June 30, 2013 as compared to \$7.8 million for the same period in 2012, due primarily to our Optical Systems group completing certain large contracts in 2012 that were not renewed or replaced in 2013.

Within the Technology Development segment, we have historically had a backlog of contracts for which work has been scheduled, but for which a specified portion of work has not yet been completed. We define backlog as the dollar amount of obligations payable to us under negotiated contracts upon completion of a specified portion of work that has not yet been completed, exclusive of revenues previously recognized for work already performed under these contracts, if any. Total backlog includes funded backlog, which is the amount for which money has been directly authorized by the U.S. Congress and for which a purchase order has been received by a commercial customer, and unfunded backlog, representing firm orders for which funding has not yet been appropriated. Indefinite delivery and quantity contracts and unexercised options are not reported in total backlog. The approximate value of our Technology Development segment backlog was \$11.3 million at June 30, 2013, compared to \$10.3 million at December 31, 2012, excluding a backlog of \$3.3 million related to discontinued operations and \$15.2 million at June 30, 2012, excluding a backlog of \$2.5 million related to discontinued operations.

Our product and licensing segment includes primarily sales of our sensing systems and products that make use of light-transmitting optical fibers, or fiber optics and revenues earned from the funded development of our fiber optic shape sensing systems for medical applications. We continue to invest in product development and commercialization, which we anticipate will lead to increased product sales growth. Although we have been successful in licensing certain technology in past years, we do not expect license revenues to represent a significant portion of future revenues. Over time, however, we do intend to gradually increase such revenues. In the near term, we expect revenues from product sales and product development to be primarily in areas associated with our fiber optic instrumentation, test and measurement and sensing platforms. In the long term, we expect that revenues from product sales will represent a larger portion of our total revenues and that, as we develop and commercialize new products, these revenues will reflect a broader and more diversified mix of products.

As described below, on March 1, 2013, we sold our SCC business. As a result of the sale, we have reported the results of operations from SCC as discontinued operations in our condensed consolidated financial statements included elsewhere in this report. Net loss from continuing operations was \$0.8 million for the three months ended June 30, 2013, compared to \$0.4 million for the three months ended June 30, 2012. Net loss from continuing operations was \$1.9 million for the six months ended June 30, 2013, compared to \$1.1 million for the six months ended June 30, 2012. After giving effect to the results of discontinued operations, including the \$3.9 million gain, net of taxes, we recognized on the sale of SCC, we recorded net income attributable to common stockholders of approximately \$1.8 million for the six months ended June 30, 2013, compared to a net loss attributable to common stockholders of approximately \$0.6 million for the six months ended June 30, 2012, and a net loss attributable to common stockholders of approximately \$1.0 million for the three months ended June 30, 2013, compared to a net loss attributable to common stockholders of approximately \$0.3 million for the three months ended June 30, 2012.

Table of Contents

We expect to continue to incur increasing expenses as we expand our business, including expenses for research and development, sales and marketing and manufacturing capabilities. We may also grow our business in part through acquisitions of additional companies and complementary technologies, which could cause us to incur transaction expenses, amortization or write-offs of intangible assets and other acquisition-related expenses. As a result, we expect to incur net losses for the foreseeable future, and these losses could be substantial.

Global economic conditions have experienced a significant prolonged downturn and remain uncertain. This slowing of the economy has reduced the financial capacities of our customers and possibly our potential customers, thereby slowing spending on the products and services we provide. The outlook for the economy for 2013 and beyond remains uncertain.

Sale of Secured Computing and Communications Group

On March 1, 2013, we entered into an Asset Purchase Agreement with MacAulay-Brown, Inc. (Mac-B) under which we sold SCC to Mac-B for \$6.1 million in cash. Of the purchase price, \$0.1 million will be payable on December 31, 2013 and an additional \$0.6 million was placed in escrow to be released in tranches over 18 months, subject to certain events and dates and to any indemnification claims of Mac-B. Mac-B acquired all of the assets of SCC, including SCC's intellectual property, in the transaction. We estimate that the net proceeds received upon the closing of the transaction, after the payment of our transaction expenses and assuming our receipt of the \$0.7 million of aggregate purchase price payable in the future as described above, will be approximately \$5.2 million. In connection with the transaction, Mac-B also entered into a sublease with us that will permit Mac-B to continue operating the SCC business in our Roanoke, Virginia headquarters through December 31, 2013. During 2013, we expect to collect approximately \$0.3 million in sublease payments from Mac-B.

In light of the significance of SCC to our business, we expect the sale of SCC will have a significant impact on our financial results. SCC accounted for 18.5% of our revenues, and 20.7% of our cost of revenues for the year ended December 31, 2012. Additionally, we expect the sale of SCC to result in a reduction in annual operating expenses of approximately \$0.8 million, including the effects of the sublease described above.

Description of Our Revenues, Costs and Expenses

Revenues

We generate revenues from technology development, product sales and commercial product development and licensing activities. We derive Technology Development segment revenues from providing research and development services to third parties, including government entities, academic institutions and corporations, and from achieving milestones established by some of these contracts and in collaboration agreements. In general, we complete contracted research over periods ranging from six months to three years, and recognize these revenues over the life of the contract as costs are incurred or upon the achievement of certain milestones built into the contracts. Our Technology Development segment revenues represented approximately 47% and 58% of our total revenues for the quarters ended June 30, 2013 and 2012, respectively, and approximately 52% and 59% for the six months ended June 30, 2013 and 2012, respectively.

Our Product and License segment revenues reflect amounts that we receive from sales of our products or development of products for third parties, as well as fees paid to us in connection with licenses or sublicenses of certain patents and other intellectual property, and represented approximately 53% and 42% of our total revenues for the quarters ended June 30, 2013 and 2012, respectively, and approximately 48% and 41% for the six months ended June 30, 2013 and 2012, respectively.

Cost of Revenues

Cost of revenues associated with Technology Development segment revenues consists of costs associated with performing the related research activities including direct labor, amounts paid to subcontractors and overhead allocated to Technology Development segment activities.

Cost of revenues associated with our Products and Licensing segment revenues consists of: license fees for use of certain technologies; product manufacturing costs including all direct material and direct labor costs; amounts paid to our contract manufacturers; manufacturing, shipping and handling; provisions for product warranties; and inventory obsolescence and overhead allocated to each of these activities.

Table of Contents*Operating Expense*

Operating expense consists of selling, general and administrative expenses, as well as expenses related to research, development and engineering, depreciation of fixed assets and amortization of intangible assets. These expenses also include: compensation for employees in executive and operational functions including certain non-cash charges related to expenses from option grants, facilities costs, professional fees, salaries, commissions, travel expense and related benefits of personnel engaged in sales, product management and marketing activities; costs of marketing programs and promotional materials; salaries, bonuses and related benefits of personnel engaged in our own research and development beyond the scope and activities of our Technology Development segment; product development activities not provided under contracts with third parties; and overhead costs related to these activities.

Interest Expense

Interest expense is composed of interest paid under our bank loans as well as interest accrued on our capital lease obligations.

Critical Accounting Policies and Estimates

Our 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 U.S. GAAP. The preparation of these financial statements requires us to make estimates, assumptions and judgments that affect the amounts reported in our financial statements and the accompanying notes. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or judgments. Our critical accounting policies are described in the Management's Discussion and Analysis section and the notes to our audited consolidated financial statements previously included in our Annual Report on Form 10-K for the period ended December 31, 2012, as filed with the Securities and Exchange Commission on March 29, 2013. There have been no material changes to the descriptions therein.

Results of Operations*Three Months Ended June 30, 2013 Compared to Three Months Ended June 30, 2012**Revenues*

	Three months ended June 30,		Change	
	2013	2012		
Revenues:				
Technology development revenues	\$ 2,807,296	\$ 3,894,846	\$ (1,087,550)	(28)%
Products and licensing revenues	3,165,764	2,845,864	319,900	11%
Total revenues	\$ 5,973,060	\$ 6,740,710	\$ (767,650)	(11)%

Revenues from our Technology Development segment decreased by \$1.1 million from \$3.9 million in the quarter ended June 30, 2012 to \$2.8 million for the same period in 2013. This was due primarily to a decrease in our research revenues from our Optical Systems group caused by a reduced amount of contract work.

Our Products and Licensing segment revenues increased due in part to a \$0.1 million increase in sales of our fiber optic test and measurement equipment in the second quarter of 2013 as compared to the second quarter of 2012, resulting primarily from increased orders of our ODiSI products. We also experienced a \$0.2 million increase in product development work in the second quarter of 2013 as compared to the second quarter of 2012.

Table of Contents*Cost of Revenues and Gross Profit*

	Three months ended June 30,		Change	
	2013	2012		
Cost of revenues:				
Technology development costs	\$ 2,209,158	\$ 2,729,108	\$ (519,950)	(19)%
Products and licensing costs	1,355,643	1,267,201	88,442	7%
Total cost of revenues	\$ 3,564,801	\$ 3,996,309	\$ (431,508)	(11)%
Gross Profit	\$ 2,408,259	\$ 2,744,401	\$ (336,142)	(12)%

The cost of our Technology Development segment revenues decreased primarily due to a reduction of \$0.2 million in direct labor due to staff reductions in our Optical Systems group earlier this year, a reduction of \$0.2 million in direct subcontractor cost and a reduction of \$0.1 million in other direct costs.

The slight increase in cost of revenues in our Products and Licensing segment was primarily the result of the \$0.1 million increase in revenue from product sales described above, which resulted in a corresponding increase in cost of revenue. While our revenue from product development work increased, the costs associated with this work decreased slightly, thereby positively affecting our gross margins, as described below.

Because of the overall decrease in revenues of 11% compared to the quarter ended June 30, 2012, which was partially offset by a decrease in costs of revenue of 11%, our resulting gross profit was \$2.4 million for the quarter ended June 30, 2013, compared to \$2.7 million for the corresponding quarter in 2012.

Operating Expense

	Three months ended June 30,		Change	
	2013	2012		
Operating expense:				
Selling, general and administrative	\$ 2,658,605	\$ 2,526,638	\$ 131,967	5%
Research, development, and engineering	666,632	608,459	58,173	10%
Total operating expense	\$ 3,325,237	\$ 3,135,097	\$ 190,140	6%

Our selling, general and administrative costs increased 5% during the second quarter of 2013, as compared to the same period in 2012. The increase was primarily due to an increase in bad debt expense of approximately \$125,000 and consulting fees of approximately \$107,000, partially offset by a decrease in share-based compensation expense of approximately \$170,000.

Research, development, and engineering expense increased by 10% during the second quarter of 2013 as compared to the same period in 2012, primarily due to increased engineering expenses in our Products and Licensing segment due to internal product development.

Other Income

During the three months ended June 30, 2013, we recognized other income of approximately \$15,000, which consisted primarily of the amortization of the discount on the Hansen debt, which was fully amortized during the second quarter of 2013.

During the three months ended June 30, 2012, we recognized \$23,000 of other income as a result of the amortization of the discount on the Hansen debt.

Interest Expense

Edgar Filing: LUNA INNOVATIONS INC - Form 10-Q

Interest expense for the three months ended June 30, 2013 was approximately \$50,000 compared to interest expense of approximately \$74,000 during the same period in 2012. The monthly average loan balance during the second quarter of 2013 was \$3.0 million compared to \$4.5 million for the same period in 2012. The lower average loan balance accounted for the decrease in interest expense.

Table of Contents*Loss from Continuing Operations*

As a result of the foregoing, during the three months ended June 30, 2013, we incurred a net loss from continuing operations of approximately \$0.8 million, compared to a net loss of approximately \$0.4 million for the three months ended June 30, 2012.

Loss/Income from Discontinued Operations

For the three months ended June 30, 2013, we recognized a net loss from discontinued operations of \$0.2 million, due to the allocation of the alternative minimum income tax calculation. For the three months ended June 30, 2012, we recognized net income from discontinued operations of \$0.2 million.

*Six Months Ended June 30, 2013 Compared to Six Months Ended June 30, 2012**Revenues*

	Six months ended June 30,		Change	
	2013	2012		
Revenues:				
Technology development revenues	\$ 5,434,537	\$ 7,837,546	\$ (2,403,009)	(31)%
Products and licensing revenues	5,035,439	5,559,677	(524,238)	(9)%

Total revenues \$ 10,469,976 \$ 13,397,223 \$ (2,927,247) (22)%
Revenues from our Technology Development segment decreased by \$2.4 million from \$7.8 million in the six months ended June 30, 2012 to \$5.4 million for the same period in 2013. This decrease was due primarily to a decline in revenues from our optical systems group of \$1.9 million due to the completion of certain large contracts during the second half of 2012, which contracts were not renewed or replaced in 2013.

Our Products and Licensing segment revenues decreased primarily due to a \$0.8 million decrease in sales of our fiber optic test and measurement equipment in the first half of 2013 as compared to the first half of 2012. This decrease resulted primarily from fewer orders of our OBR and OVA products in 2013 as compared to 2012, which was partially offset by an increase of \$0.3 million in revenues from ODISI sales during the first half of 2013, as compared to the same period in 2012. Revenue for product development was virtually unchanged for the first half of 2013 as compared to the same period in 2012.

Cost of Revenues and Gross Profit

	Six months ended June 30,		Change	
	2013	2012		
Cost of revenues:				
Technology development costs	\$ 4,381,135	\$ 5,428,304	\$ (1,047,169)	(19)%
Products and licensing costs	2,288,062	2,514,696	(226,634)	(9)%
Total cost of revenues	\$ 6,669,197	\$ 7,943,000	\$ (1,273,803)	(16)%
Gross Profit	\$ 3,800,779	\$ 5,454,223	\$ (1,653,444)	(30)%

The cost of our Technology Development segment revenues decreased due to a reduction of \$0.4 million in each of direct labor and direct subcontractor costs and a reduction of \$0.3 million in other direct costs.

The cost of revenues in our Products and Licensing segment decreased due to the decrease in product sales described above in addition to decreased cost of our commercial development projects. The decrease in costs of products sold was less than the decrease in the corresponding revenues due to the higher cost of the lasers utilized in products in the first quarter of 2013. The decreased cost of our commercial development

work was primarily the result of cost overruns we experienced in completing a fixed price contract in 2012.

Table of Contents

Our resulting gross profit was \$3.8 million for the six months ended June 30, 2013 compared to \$5.5 million for the corresponding six months in 2012. The decline in gross profit was primarily the result of the smaller decrease in cost of revenues than the decrease in revenue, in connection with the declining product sales described above. In addition, we also experienced a decrease in revenue and cost of revenues in our Technology Development segment for the six months ended June 30, 2013 compared to the same period in 2012.

Operating Expense

	Six months ended June 30,		Change	
	2013	2012		
Operating expense:				
Selling, general and administrative	\$ 5,167,251	\$ 5,183,614	\$ (16,363)	<1%
Research, development, and engineering	1,507,124	1,293,240	213,884	17%

Total operating expense \$ 6,674,375 \$ 6,476,854 \$ 197,121 3%

Our selling, general and administrative costs were virtually unchanged during the first six months of 2013 compared to the same period in 2012.

Research, development, and engineering expense increased by 17% during the first six months of 2013 as compared to the same period in 2012, primarily due to increased engineering expenses in our Products and Licensing segment due primarily to increased work on internal product development.

Other Income

During the six months ended June 30, 2013, we recognized other income of approximately \$87,000, which consisted primarily of the amortization of the discount on the Hansen debt of approximately \$38,000, which was fully amortized during the second quarter of 2013, and an insurance policy profit share of approximately \$48,000.

During the six months ended June 30, 2012, we recognized approximately \$47,000 of other income as a result of the amortization of the discount on the Hansen debt.

Interest Expense

Interest expense for the six months ended June 30, 2013 was approximately \$108,000 compared to interest expense of approximately \$154,000 during the same period in 2012. The monthly average loan balance during the first six months of 2013 was \$3.3 million compared to \$4.7 million for the same period in 2012. The lower average loan balance accounted for the decrease in interest expense.

Loss from Continuing Operations

As a result of the foregoing, during the six months ended June 30, 2013, we incurred a net loss from continuing operations of approximately \$1.9 million, compared to a net loss of approximately \$1.1 million for the six months ended June 30, 2012.

Income from Discontinued Operations

For the six months ended June 30, 2013, we recognized net income from discontinued operations of \$3.8 million, compared to net income from discontinued operations of \$0.6 million for the same period in 2012. For the six months ended June 30, 2013, this income consisted of the \$3.9 million gain on the sale of SCC business, net of taxes, which occurred during the quarter ended March 31, 2013, which gain was partially offset by an operating loss \$0.1 million from the SCC business for the two months prior to the sale on March 1, 2013. The decrease in operating income of the SCC business in 2013 was primarily a result of a significant decline in revenue within our SCC business as a result a decrease in revenue from the DARPA IRIS contract.

Table of Contents**Liquidity and Capital Resources**

At June 30, 2013, our total cash and cash equivalents were \$8.7 million.

We have a term loan with SVB which at June 30, 2013 had a balance of \$3.0 million. This term loan matures on May 1, 2015. We also maintain a revolving line of credit of up to \$1.0 million with SVB, under which no amounts are outstanding and the full borrowing capacity of \$1.0 million remains available. The line of credit is currently scheduled to expire on May 18, 2014. The terms and conditions of our term loan and line of credit are described in Note 4 of our condensed consolidated financial statements included in this report.

We believe that our current cash balance, combined with our expected operating cash flows and the funds available to us under the line of credit with SVB, provide adequate liquidity for us to meet our working capital needs over the next twelve months.

Discussion of Cash Flows*Recent Activity*

	Six months ended June 30,		
	2013	2012	Change
Net cash used in operating activities	\$ (1,313,794)	\$ (1,378,765)	\$ 64,971
Net cash provided by/(used in) investing activities	4,307,494	(179,579)	4,487,073
Net cash used in financing activities	(591,292)	(741,264)	149,972
Net change in cash	\$ 2,402,408	\$ (2,299,608)	\$ 4,702,016

During the first six months of 2013, operations used \$1.3 million of net cash, as compared to the same period in 2012 in which operations used \$1.4 million of net cash. During the first half of 2013, our net income of \$1.8 million was primarily the result of the after-tax gain on the sale of SCC of \$3.9 million and a tax benefit of \$1.0 million. Without the effects of that gain and tax benefit, our pre-tax loss from continuing operations was approximately \$2.9 million. The pre-tax loss from continuing operations included charges for depreciation and amortization of \$0.5 million, share-based compensation of \$0.6 million and allowance for doubtful accounts of \$0.1 million, all of which are non-cash items that do not impact cash flow for the period. Additionally, changes in working capital provided net cash inflow of \$0.5 million, consisting of a \$0.8 million decrease in accounts receivable due to improved collection efforts, and a \$0.2 million increase in accounts payable, which was partially offset by an increase in inventory items of \$0.3 million and a decrease in deferred credits of \$0.2 million.

In the first half of 2012, we had a net loss of \$0.6 million and \$2.3 million of net cash outflows from changes in operating assets and liabilities, due primarily to timing of our products sales coming later in the period, which in turn did not become due for collection until after June 30, 2012. These amounts were partially offset by \$1.5 million in non-cash expenses.

Our cash provided by/(used in) investing activities is composed of purchases of equipment and capitalized costs associated with the prosecution of patents and in 2013 the sale of SCC. During the six months ended June 30, 2013, we had a net cash inflow of \$4.5 million due to the sale of SCC. Also, during the six months ended June 30, 2013, we made \$69,000 in equipment purchases, compared to \$124,000 during the same period of 2012, and we incurred \$146,000 in patent costs associated with certain intangible assets, primarily associated with our fiber optic platform, compared to \$56,000 in such costs during the first six months of 2012.

Net cash used in financing activities during the six months ended June 30, 2013 included the scheduled repayments of principal for our debt and lease obligations, which in the aggregate resulted in net cash outflows of \$0.7 million as compared to \$0.8 million for the same period of 2012. These cash outflows were partially offset by our receipt of \$60,000 and \$34,000 upon the exercise of stock options during the six months ended June 30, 2013 and 2012, respectively.

Off-Balance Sheet Arrangements

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

Table of Contents

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

Interest Rate Risk

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

We are exposed to interest rate fluctuations as a result of our term loan and line of credit with SVB each having a variable interest rate. However, the loan facility has a minimum fixed interest rate of 6%, which has been the actual interest rate in effect since 2011. We do not currently use derivative instruments to alter the interest rate characteristics of our debt. For the principal amount of \$3.0 million outstanding under the term loan as of June 30, 2013, a change in the interest rate by one percentage point for one year would result in a change in our annual interest expense of \$22,000.

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

Foreign Currency Exchange Rate Risk

As of June 30, 2013, all payments made under our research contracts have been denominated in United States dollars. Our product sales to foreign customers are also generally denominated in U.S. dollars, and we generally do not receive payments in foreign currency. As such, we are not directly exposed to currency gains or losses resulting from fluctuations in foreign exchange rates.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

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

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

Under the supervision and with the participation of our management, including our principal executive officer and our principal financial officer, we evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report. Based on this evaluation, our principal executive officer and our principal financial officer have concluded that, as of June 30, 2013, our disclosure controls and procedures were effective at the reasonable assurance level.

Table of Contents

Changes in Internal Control over Financial Reporting

No change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) occurred during the quarter ended June 30, 2013 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

None.

ITEM 1A. RISK FACTORS

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

RISKS RELATING TO OUR BUSINESS GENERALLY

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

We compete as a small business for some of our government contracts. As described above, our revenues derived from the SBIR program account for a significant portion of our consolidated total revenues, and contract research, including SBIR contracts, will remain a significant portion of our consolidated total revenues for the foreseeable future.

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

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

Also, in order to be eligible for SBIR contracts and grants, the number of our employees, including those of any entities that are considered to be affiliated with us, cannot exceed 500. As of June 30, 2013, we had approximately 124 full-time employees. In determining whether we are affiliated with any other entity, the SBA may analyze whether another entity controls or has the power to control us. Carilion Clinic is our largest institutional stockholder. The SBA has, since early 2011, been in the process of performing a formal size determination that focused on whether or not Carilion is or was our affiliate. Although we do not believe that Carilion has or had the power to control our company, we cannot assure you that the SBA will interpret its regulations in our favor on this

Table of Contents

question. Under its then-existing regulations, the SBA could conclude that a stockholder that was large compared to others had the power to control us and is our affiliate. If the SBA were to make a determination that we are or were affiliated with Carilion, we would exceed the size limitations, as Carilion has over 500 employees. In that case, we would lose eligibility for new SBIR contracts and grants and other awards that are set aside for small businesses based on the criterion of number of employees, and the relevant government agency would have the discretion to suspend performance on existing SBIR grants.

In addition, it is possible that the sale of common stock in the future by our founder, Dr. Kent Murphy, could negatively affect the interpretation of SBA regulations on this question of affiliation, as well as possibly result in an increase in our institutional ownership. Dr. Murphy has requested to exercise his right to require us to register his shares for resale in a registered offering on Form S-3. If Dr. Murphy pursues the registration of his shares, and sells a substantial portion of his shares to institutions, large business concerns, or non-U.S. citizens, we may no longer meet the 50% ownership requirement described above, in which case we would become ineligible to receive SBIR contract awards. The loss of our eligibility to receive SBIR awards would have a material adverse effect on our revenues, cash flows and ability to fund our growth.

Moreover, as we grow our business, it is foreseeable that we will eventually exceed the SBIR size limitations, in which case we may be required to seek alternative sources of revenues or capital.

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

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

Pursuant to an Investor Rights Agreement, Carilion, Dr. Kent Murphy and certain other stockholders have rights to require us, subject to certain conditions, to file one or more registration statements providing for the sale of up to an aggregate of approximately 6.5 million shares of our common stock (which number includes approximately 2.8 million shares of common stock owned by Dr. Murphy, approximately 2.2 million shares of common stock owned by Carilion, approximately 1.2 million shares of common stock issuable to Carilion upon conversion of shares of Series A Preferred Stock it currently holds and approximately 275,000 shares of common stock issuable to Carilion as dividends on that preferred stock). Under the agreement, these stockholders also have the right to include their shares in registration statements that we may file for ourselves or other stockholders. Once we register the resale of these shares, they can generally be freely sold in the public market. Dr. Murphy has requested that we register his shares for resale on a Form S-3 registration statement. If Dr. Murphy continues to pursue the registration of his shares for resale or if Dr. Murphy or Carilion elect to pursue registration in the future, as described above, we may also be obligated to register shares held by the other for resale pursuant to our Investor Rights Agreement. Sales of shares by Dr. Murphy or Carilion, or even the filing of a registration statement registering the resale of such shares, may have a material adverse effect on the market price of our stock.

If Carilion, Dr. Murphy or any of our other significant stockholders seeks to sell their shares at any time, it could have an adverse effect on the market price of our stock. Any such continuing material adverse effect on the market price of our stock could impair our ability to comply with NASDAQ's continuing listing standards in respect of our minimum stock price, as further described below.

A decline in government research contract awards or government funding for existing or future government research contracts, including SBIR contracts, could adversely affect our revenues, cash flows and ability to fund our growth.

Technology development revenue, which consists primarily of government-funded research, accounted for approximately 52% and 59% of our consolidated total revenues for the six months ended June 30, 2013 and 2012, respectively. As a result, we are vulnerable to adverse changes in our revenues and cash flows if a significant number of our research contracts and subcontracts were to be simultaneously delayed or canceled for budgetary, performance or other reasons. For example, the U.S. government may cancel these contracts at any time without cause and without penalty or may change its requirements, programs or contract budget, any of which could reduce our revenues and cash flows from U.S. government research contracts. Our revenues and cash flows from U.S.

Table of Contents

government research contracts and subcontracts could also be reduced by declines or other changes in U.S. defense, homeland security and other federal agency budgets. In addition, we compete as a small business for some of these contracts, and in order to maintain our eligibility to compete as a small business, we, together with any affiliates, must continue to meet size and revenue limitations established by the U.S. government.

Our contract research customer base includes government agencies, corporations and academic institutions. Our customers are not obligated to extend their agreements with us and may elect not to do so. Also, our customers' priorities regarding funding for certain projects may change and funding resources may no longer be available at previous levels.

In addition, the Budget Control Act commits the U.S. Government to reduce the federal deficit by \$1.2 trillion over ten years through a combination of automatic, across-the-board spending cuts and caps on discretionary spending. This sequestration under the Budget Control Act is split equally between defense and non-defense programs. Originally scheduled to take effect on January 2, 2013, the deadline for averting sequestration was delayed until March 1, 2013 by the American Taxpayer Relief Act of 2012. Congress and the Administration continue to debate these issues. Any automatic across-the-board cuts required by sequestration could have a material adverse effect on our technology development revenue and, consequently, our results of operations. While the exact manner in which this sequestration may impact our business remains unclear, funding for programs in which we participate could be reduced, delayed or cancelled. Our ability to obtain new contract awards also could be negatively affected.

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

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

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

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

Table of Contents

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

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

Global economic and political conditions affect our customers' businesses and the markets they serve. A severe or prolonged economic downturn or a negative or uncertain political climate could adversely affect our customers' financial conditions and the timing or levels of business activity of our customers and the industries we serve. This may reduce the demand for our products or depress pricing for our products and have a material adverse effect on our results of operations. Changes in global economic conditions could also shift demand to products or services for which we do not have competitive advantages, and this could negatively affect the amount of business we are able to obtain. In addition, if we are unable to successfully anticipate changing economic and political conditions, we may be unable to effectively plan for and respond to those changes, and our business could be negatively affected as a result.

There was a rapid softening of the economy and tightening of the financial markets in the second half of 2008 that has continued into 2013. This slowing of the economy has reduced the financial capacity of our customers and possibly our potential customers, thereby slowing spending on the products and services we provide. The outlook for the economy for the remainder of 2013 and beyond remains uncertain, and until there is a sustained economic recovery our revenues and results of operations could be negatively impacted.

We have a history of losses, and because our strategy for expansion may be costly to implement, we may experience continuing losses and may never achieve or maintain profitability or positive cash flow.

We realized a consolidated net loss from continuing operations of \$1.9 million for the six months ended June 30, 2013 and net loss attributable to common stockholders of \$1.5 million for each of the years ended December 31, 2012, and 2011. We expect to continue to incur significant expenses as we pursue our strategic initiatives, including increased expenses for research and development, sales and marketing and manufacturing. We may also grow our business in part through acquisitions of additional companies and complementary technologies which could cause us to incur greater than anticipated transaction expenses, amortization or write-offs of intangible assets and other acquisition-related expenses. As a result, we expect to incur net losses for the foreseeable future, and these losses could be substantial. At a certain level, continued net losses could impair our ability to comply with NASDAQ continued listing standards, as described further below.

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

We have obtained capital by borrowing money under a credit facility and we might require additional capital to support and expand our business; our credit facility has various loan covenants with which we must comply and if we need any such additional capital or we fail to comply with our loan covenants, this capital might not be available or only available on unfavorable terms.

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

Table of Contents

If we are successful in raising additional funds through issuances of equity or convertible debt securities, our existing stockholders could suffer significant dilution, including as the result of the issuance of warrants in connection with the financing, and any new equity securities we issue could have rights, preferences and privileges superior to those of our existing common stock. Furthermore, such financings may jeopardize our ability to apply for SBIR grants or qualify for SBIR contracts or grants, and our dependence on SBIR grants may restrict our ability to raise additional outside capital. If we raise additional funds through debt financings, these financings may involve significant cash payment obligations and covenants that restrict our ability to operate our business and make distributions to our stockholders.

We maintain a credit facility with Silicon Valley Bank, or SVB, which requires us to observe certain financial and operational covenants, including maintenance of a specified cash balance, protection and registration of intellectual property rights, and certain customary negative covenants, as well as other customary events of default. If any event of default occurs SVB may declare due immediately all borrowings under our credit facility and foreclose on the collateral. Furthermore, an event of default would result in an increase in the interest rate on any amounts outstanding.

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

RISKS RELATING TO OUR OPERATIONS AND BUSINESS STRATEGY

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

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

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

While historically we have developed and commercialized only a few products at a time, we plan to grow our revenues by developing and commercializing multiple products concurrently across many industries, technologies and markets. Our ability to expand our business by developing and commercializing multiple products simultaneously requires that we manage a diverse range of projects and expand our personnel resources. Our inability to do any of these could prevent us from successfully implementing our growth strategy, causing our revenues and profits to be adversely affected.

To advance the development of multiple promising potential products concurrently, we need to manage effectively the logistics of maintaining the requisite corporate, operational, administrative and financing functions for each of these product opportunities. Potentially expanding our operations into new geographic areas and relying on multiple facilities to develop and manufacture different products concurrently pose additional challenges. We have little experience in managing these functions simultaneously for multiple projects in development or in building new infrastructure and integrating the operations of various facilities. If we cannot manage this process successfully, we may experience operating difficulties, additional expenditures and limited revenue growth.

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

Table of Contents

We may not be successful in identifying market needs for new technologies and developing new products to meet those needs.

The success of our business model depends on our ability to correctly identify market needs for new technologies. We intend to identify new market needs, but we may not always have success in doing so in part because our contract research largely centers on identification and development of unproven technologies, often for new or emerging markets. Furthermore, we must identify the most promising technologies from a sizable pool of projects. If our commercialization strategy process fails to identify projects with commercial potential or if management does not ensure that such projects advance to the commercialization stage, we may not successfully commercialize new products and grow our revenues.

Our growth strategy requires that we not only identify new technologies that meet market needs, but that we also develop successful commercial products that address those needs. We face several challenges in developing successful new products. Many of our existing products and those currently under development are technologically innovative and require significant and lengthy product development efforts. These efforts include planning, designing, developing and testing at the technological, product and manufacturing-process levels. These activities require us to make significant investments. Although there are many potential applications for our technologies, our resource constraints require us to focus on specific products and to forgo other opportunities. We expect that one or more of the potential products we choose to develop will not be technologically feasible or will not achieve commercial acceptance, and we cannot predict which, if any, of our products we will successfully develop or commercialize. The technologies we research and develop are new and steadily changing and advancing. The products that are derived from these technologies may not be applicable or compatible with the state of technology or demands in existing markets. Our existing products and technologies may become uncompetitive or obsolete if our competitors adapt more quickly than we do to new technologies and changes in customers' requirements. Furthermore, we may not be able to identify if and when new markets will open for our products given that future applications of any given product may not be readily determinable, and we cannot reasonably estimate the size of any markets that may develop. If we are not able to successfully develop new products, we may be unable to increase our product revenues.

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

We primarily rely on third-party vendors for the manufacture of the specialized components used in our products. The highly specialized nature of our supply requirements poses risks that we may not be able to locate additional sources of the specialized components required in our business. For example, there are few manufacturers who produce the special lasers used in our optical test equipment. Our reliance on these vendors subjects us to a number of risks that could negatively affect our ability to manufacture our products and harm our business, including interruption of supply. Although we are now manufacturing tunable lasers in low-rate initial production, we expect our overall reliance on third-party vendors to continue. Any significant delay or interruption in the supply of components, or our inability to obtain substitute components or materials from alternate sources at acceptable prices and in a timely manner could impair our ability to meet the demand of our customers and could harm our business.

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

We face and will face substantial competition from a variety of companies in several different markets. Our competitors in contract research include, but are not limited to, companies such as General Dynamics Corporation, Lockheed Martin Corporation, SAIC, Inc. and SRA International, Inc. In the instrumentation and test and measurement products market, our competitors include, but are not limited to, large companies such as Agilent Technologies, Inc., Analog Devices, Inc., Freescale Semiconductor, Inc., JDS Uniphase Corp., Robert Bosch GmbH and Silicon Sensing, as well as emerging companies.

The products that we have developed or are currently developing will compete with other technologically innovative products as well as products incorporating conventional materials and technologies. We expect that our products will face competition in a wide range of industries, including telecommunications, industrial instrumentation, healthcare, military and security applications.

Table of Contents

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

We have limited experience manufacturing our products in commercial quantities in a cost-effective manner, which could adversely impact our business.

In the past, we produced most of our products on a custom order basis rather than pursuant to large contracts that require production on a large volume basis. Accordingly, other than the commercial manufacture of products by our Products and Licensing segment, we have no experience manufacturing products in large volumes. Because our experience in large scale manufacturing is limited, we may encounter unforeseen difficulties in our efforts to manufacture other products or materials in commercial quantities or have to rely on third-party contractors over which we may not have direct control to manufacture our products. We may also encounter difficulties and delays in manufacturing our products for any of the following reasons:

we may need to expand our manufacturing operations, and our production processes may have to change to accommodate this growth;

to increase our manufacturing output significantly, we will have to attract and retain qualified employees, who are in short supply, for the assembly and testing operations;

we might have to sub-contract to outside manufacturers which might limit our control of costs and processes; and

our manufacturing operations may have to comply with government or customer-mandated specifications.

If we are unable to keep up with demand for our products, our revenues could be impaired, market acceptance of our products could be adversely affected and our customers might instead purchase our competitors' products. Moreover, failure to develop and maintain a U.S. market for goods developed with U.S. government-licensed technology may result in the cancellation of the relevant U.S. government licenses. Our inability to manufacture our products successfully would have a material adverse effect on our revenues.

Even if we are able to manufacture our products on a commercial scale, the cost of manufacturing our products may be higher than we expect. If the costs associated with manufacturing are not significantly less than the prices at which we can sell our products, we may not be able to operate at a profit.

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

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

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

Table of Contents

We face risks associated with our international business.

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

having to comply with U.S. export control regulations and policies that restrict our ability to communicate with non-U.S. employees and supply foreign affiliates and customers;

changes in or interpretations of foreign regulations that may adversely affect our ability to sell our products, perform services or repatriate profits to the United States;

the imposition of tariffs;

hyperinflation or economic or political instability in foreign countries;

imposition of limitations on, or increase of withholding and other taxes on remittances and other payments by foreign subsidiaries or joint ventures;

conducting business in places where business practices and customs are unfamiliar and unknown;

the imposition of restrictive trade policies;

the imposition of inconsistent laws or regulations;

the imposition or increase of investment and other restrictions or requirements by foreign governments;

uncertainties relating to foreign laws and legal proceedings;

having to comply with a variety of U.S. laws, including the Foreign Corrupt Practices Act; and

having to comply with licensing requirements.

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

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

We face the risk, as does any company, of a security breach, whether through cyber attack or cyber intrusion over the Internet, malware, computer viruses, attachments to e-mails, persons inside our organization or persons with access to systems inside our organization, or other significant disruption of our IT networks and related systems. The risk of a security breach or disruption, particularly through cyber attack or

Edgar Filing: LUNA INNOVATIONS INC - Form 10-Q

cyber intrusion, including by computer hackers, foreign governments and cyber terrorists, has increased as the number, intensity and sophistication of attempted attacks and intrusions from around the world have increased.

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

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

Table of Contents

RISKS RELATING TO OUR REGULATORY ENVIRONMENT

As a provider of contract research to the U.S. government, we are subject to federal rules, regulations, audits and investigations, the violation or failure of which could adversely affect our business.

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

In addition, U.S. government agencies, including the Defense Contract Audit Agency and the Department of Labor, routinely audit and investigate government contractors. These agencies review a contractor's performance under its contracts, cost structure and compliance with applicable laws, regulations and standards. The U.S. government also may review the adequacy of, and a contractor's compliance with, its internal control systems and policies, including the contractor's purchasing, property, estimating, compensation and management information systems. Any costs found to be improperly allocated to a specific contract will not be reimbursed, while such costs already reimbursed must be refunded. If an audit uncovers improper or illegal activities, we may be subject to civil and criminal penalties and administrative sanctions, including termination of contracts, forfeiture of profits, suspension of payments, fines and suspension or prohibition from doing business with the U.S. government. In addition, our reputation could suffer serious harm if allegations of impropriety were made against us.

In addition to the risk of government audits and investigations, U.S. government contracts and grants impose requirements on contractors and grantees relating to ethics and business practices, which carry civil and criminal penalties including monetary fines, assessments, loss of the ability to do business with the U.S. government and certain other criminal penalties.

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

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

Our operations, particularly our international sales, subject us to numerous U.S. and foreign laws and regulations, including, without limitation, regulations relating to imports, exports (including the Export Administration Regulations and the International Traffic in Arms Regulations), technology transfer restrictions, anti-boycott provisions, economic sanctions and the Foreign Corrupt Practices Act. The number of our various emerging technologies, the development of many of which has been funded by the Department of Defense, presents us with many regulatory challenges. Failure by us or our sales representatives or consultants to comply with these laws and regulations could result in administrative, civil, or criminal liabilities and could result in suspension of our export privileges, which could have a material adverse effect on our business. Changes in regulation or political environment may affect our ability to conduct business in foreign markets including investment, procurement and repatriation of earnings.

Our healthcare and medical products are and may continue to be subject to a lengthy and uncertain domestic regulatory approval process. If we do not obtain and maintain the necessary domestic regulatory approvals or clearances, we will not be able to market and sell our products for clinical use in the United States. Complying with applicable regulations is an expensive and time-consuming process and any failure to fully comply with such regulations could subject us to enforcement actions.

Table of Contents

Certain of our current and potential products could require regulatory clearances or approvals prior to commercialization. For example, any nanomaterial-based MRI contrast agent is likely to be considered a drug under the Federal Food, Drug and Cosmetic Act, or the FDC Act. Drugs and some medical devices are subject to rigorous preclinical testing and other approval requirements by the U.S. Food and Drug Administration, or the FDA, pursuant to the FDC Act, and regulations under the FDC Act, as well as by similar health authorities in foreign countries.

Various federal statutes and regulations also govern or influence the testing, manufacturing, safety, labeling, packaging, advertising, storage, registration, listing and recordkeeping related to marketing of pharmaceuticals. The process of obtaining these clearances or approvals and the subsequent compliance with appropriate federal statutes and regulations require the expenditure of substantial resources, which we may not be able to obtain on favorable terms, if at all. We cannot be certain that any required FDA or other regulatory approval will be granted or, if granted, will not be withdrawn. Our failure to obtain the necessary regulatory approvals, or our failure to obtain them in a timely manner, will prevent or delay our commercialization of new products and our business or our stock price could be adversely affected as a result.

Our commercially distributed medical device products will be subject to various post-market regulatory requirements, compliance with which will be expensive and time-consuming.

We will also become subject to inspection and marketing surveillance by the FDA to determine our compliance with regulatory requirements. If the FDA determines that we have failed to comply, it can institute a wide variety of enforcement actions ranging from a regulatory letter to a public warning letter to more severe civil and criminal sanctions. Our failure to comply with applicable requirements could lead to an enforcement action that may have an adverse effect on our financial condition and results of operations.

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

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

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

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

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

Table of Contents

Our facilities and current and proposed activities involve the use of a broad range of materials that are considered hazardous under applicable laws and regulations. Accordingly, we are subject to a number of foreign, federal, state and local laws and regulations relating to health and safety, protection of the environment and the storage, use, disposal of, and exposure to, hazardous materials and wastes. We could incur costs, fines and civil and criminal penalties, personal injury and third party property damage claims, or could be required to incur substantial investigation or remediation costs, if we were to violate or become liable under environmental, health and safety laws. Moreover, a failure to comply with environmental laws could result in fines and the revocation of environmental permits, which could prevent us from conducting our business. Liability under environmental laws can be joint and several and without regard to fault. There can be no assurance that violations of environmental health and safety laws will not occur in the future as a result of the inability to obtain permits, human error, equipment failure or other causes. Environmental laws could become more stringent over time, imposing greater compliance costs and increasing risks and penalties associated with violations, which could harm our business. Accordingly, violations of present and future environmental laws could restrict our ability to expand facilities, pursue certain technologies, and could require us to acquire costly equipment or incur potentially significant costs to comply with environmental regulations.

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

RISKS RELATING TO OUR INTELLECTUAL PROPERTY

Our proprietary rights may not adequately protect our technologies.

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

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

we or our licensors might not have been the first to make the inventions covered by each of our pending patent applications and issued patents;

we or our licensors might not have been the first to file patent applications for these inventions;

others may independently develop similar or alternative technologies or duplicate any of our technologies;

it is possible that none of our pending patent applications or the pending patent applications of our licensors will result in issued patents;

patents may issue to third parties that cover how we might practice our technology;

Edgar Filing: LUNA INNOVATIONS INC - Form 10-Q

our issued patents and issued patents of our licensors may not provide a basis for commercially viable technologies, may not provide us with any competitive advantages, or may be challenged and invalidated by third parties; and

we may not develop additional proprietary technologies that are patentable.

Table of Contents

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

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

If we are not able to defend the patent or trade secret protection position of our technologies, then we will not be able to exclude competitors from developing or marketing competing technologies and we may not generate enough revenues from product sales to justify the cost of developing our technologies and to achieve or maintain profitability.

We also rely on trademarks to establish a market identity for our company and our products. To maintain the value of our trademarks, we might have to file lawsuits against third parties to prevent them from using trademarks confusingly similar to or dilutive of our registered or unregistered trademarks. Also, we might not obtain registrations for our pending trademark applications, and we might have to defend our registered trademark and pending trademark applications from challenge by third parties. Enforcing or defending our registered and unregistered trademarks might result in significant litigation costs and damages, including the inability to continue using certain trademarks.

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

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

Table of Contents

third parties may be awarded substantial damages as well as injunctive or other equitable relief against us, which could effectively block our ability to make, use, sell, distribute or market our products and services in the United States or abroad.

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

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

A substantial portion of our technology is licensed from academic institutions, corporations and government agencies. Under these licensing arrangements, a licensor may obtain rights over the technology, including the right to require us to grant a license to one or more third parties selected by the licensor or that we provide licensed technology or material to third parties for non-commercial research. The grant of a license for any of our core technologies to a third party could have a material and adverse effect on our business. In addition, some of our licensors retain certain rights under the licenses, including the right to grant additional licenses to a substantial portion of our core technology to third parties for non-commercial academic and research use. It is difficult to monitor and enforce such non-commercial academic and research uses, and we cannot predict whether the third-party licensees would comply with the use restrictions of such licenses. We have incurred and could incur substantial expenses to enforce our rights against them. We also may not fully control the ability to assert or defend those patents or other intellectual property which we have licensed from other entities, or which we have licensed to other entities.

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

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

Table of Contents

RISKS RELATING TO OUR COMMON STOCK

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

Our common stock is listed on the NASDAQ Capital Market. In order to maintain that listing, we must satisfy minimum financial and other continued listing requirements and standards. There can be no assurances that we will be able to comply with applicable listing standards. In the event that our common stock is not eligible for quotation on another market or exchange, trading of our common stock could be conducted in the over-the-counter market or on an electronic bulletin board established for unlisted securities such as the Pink Sheets or the OTC Bulletin Board. In such event, it could become more difficult to dispose of, or obtain accurate price quotations for, our common stock, and there would likely also be a reduction in our coverage by security analysts and the news media, which could cause the price of our common stock to decline further. Also, it may be difficult for us to raise additional capital if we are not listed on a major exchange.

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

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

changes in earnings estimates, investors' perceptions, recommendations by securities analysts or our failure to achieve analysts' earnings estimates;

changes in our status as an entity eligible to receive SBIR contracts and grants;

sales of our common stock by our significant stockholders, or the perception that such sales may occur, including as a result of the registration for resale of shares of common stock owned by Dr. Kent Murphy and/or Carilion Clinic;

quarterly variations in our or our competitors' results of operations;

general market conditions and other factors unrelated to our operating performance or the operating performance of our competitors;

announcements by us, or by our competitors, of acquisitions, new products, significant contracts, commercial relationships or capital commitments;

litigation;

any major change in our board of directors or management or any competing proxy solicitations for director nominees;

changes in governmental regulations or in the status of our regulatory approvals;

announcements related to patents issued to us or our competitors;

a lack of, limited or negative industry or securities analyst coverage;

discussions of our company or our stock price by the financial and scientific press and online investor communities such as chat rooms;
and

general developments in our industry.

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

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

Table of Contents

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

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

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

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

a classified board of directors serving staggered terms;

advance notice requirements to stockholders for matters to be brought at stockholder meetings;

a supermajority stockholder vote requirement for amending certain provisions of our amended and restated certificate of incorporation and bylaws; and

the right to issue preferred stock without stockholder approval, which could be used to dilute the stock ownership of a potential hostile acquirer.

We are also subject to provisions of the Delaware corporation law that, in general, prohibit any business combination with a beneficial owner of 15% or more of our common stock for five years unless the holder's acquisition of our stock was approved in advance by our board of directors.

The existence of these provisions could adversely affect the voting power of holders of common stock and limit the price that investors might be willing to pay in the future for shares of our common stock.

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

The stock market has from time to time experienced significant price and volume fluctuations that have affected the market prices for the common stock of technology companies. These broad market fluctuations may cause the market price of our common stock to decline. In the past, following periods of volatility in the market price of a particular company's securities, securities class action litigation has often been brought against that company. Securities class litigation also often follows certain significant business transactions, such as the sale of a business division or a change in control transaction. We may become involved in this type of litigation in the future. Litigation often is expensive and diverts management's attention and resources, which could adversely affect our business.

Table of Contents

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

(a) Unregistered Sales of Equity Securities during the Six-Month Period Ended June 30, 2013

Common Stock Dividend Payable to Carilion

The Company issued 1,321,514 shares of Series A Preferred Stock, par value \$0.001 per share, to Carilion Clinic in January 2010, which shares were issued in reliance on the exemptions from registration under the Securities Act provided by Sections 3(a)(9) and 4(2) thereof. The Series A Preferred Stock accrues dividends at the rate of approximately \$0.2815 per share per annum, payable quarterly in arrears. Accrued dividends are payable in shares of the Company's common stock, with the number of shares being equal to the quotient of (i) the cumulative aggregate balance of accrued but unpaid dividends on each share of Series A Preferred Stock divided by (ii) the conversion price of the Series A Preferred Stock, which is currently \$4.69159 per share. For the period from January 12, 2010, the original issue date of the Series A Preferred Stock, through June 30, 2013, the Series A Preferred Stock issued to Carilion has accrued \$657,843 in dividends. The accrued dividend as of June 30, 2013 will be paid by the issuance of 274,879 shares of the Company's common stock, which the Company will issue at Carilion's written request. As the Series A Preferred Stock was issued in reliance on the exemption provided by Section 3(a)(9), the shares of common stock payable as dividends will also be exempt from registration in reliance on Section 3(a)(9) of the Securities Act.

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

Not applicable.

(c) Purchases of Equity Securities by the Issuer and Affiliated Purchasers

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

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

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.

Luna Innovations Incorporated

Date: August 8, 2013

By: /s/ Dale Messick

Dale Messick

Chief Financial Officer

(principal financial and accounting officer and duly authorized officer)

Table of Contents

EXHIBIT INDEX

Exhibit	
Number	Description
10.1*	2013 Senior Management Incentive Plans
10.2*	Amendment No. 6 to the Intuitive-Luna Development and Supply Agreement, dated December 15, 2012, by and between Luna Innovations Incorporated and Intuitive Surgical Operations, Inc., a successor in interest to Intuitive Surgical, Inc.
10.3*	Amendment No. 7 to the Intuitive-Luna Development and Supply Agreement, entered into on June 28, 2013, by and between Luna Innovations Incorporated and Intuitive Surgical Operations, Inc., a successor in interest to Intuitive Surgical, Inc.
31.1	Certification of the Principal Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of the Principal Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1**	Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2**	Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101***	The following materials from the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2013, formatted in XBRL (eXtensible Business Reporting Language): (i) Condensed Consolidated Balance Sheets at June 30, 2013 and December 31, 2012, (ii) Condensed Consolidated Statements of Operations for the three and six months ended June 30, 2013 and 2012, (iii) Condensed Consolidated Statements of Cash Flows for the six months ended June 30, 2013 and 2012, and (iv) Notes to Unaudited Condensed Consolidated Financial Statements.
*	Confidential treatment has been requested with respect to portions of this exhibit, indicated by asterisks, which have been filed separately with the Securities and Exchange Commission.
**	These certifications are being furnished solely to accompany this quarterly report pursuant to 18 U.S.C. Section 1350, and are not being filed for purposes of Section 18 of the Securities Exchange Act of 1934 and are not to be incorporated by reference into any filing of the registrant, whether made before or after the date hereof, regardless of any general incorporation language in such filing.
***	Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files on Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.