Recro Pharma, Inc.
Form 10-Q
November 10, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the Quarterly Period Ended: September 30, 2016

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
Commission File Number: 001-36329

Recro Pharma, Inc.

(Exact name of registrant as specified in its charter)

Pennsylvania	26-1523233
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
490 Lapp Road, Malvern, Pennsylvania	19355
(Address of principal executive offices)	(Zip Code)

(484) 395-2470

(Registrant’s telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 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

As of November 10, 2016, there were 12,163,660 shares of common stock, par value $0.01 per share, outstanding.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

RECRO PHARMA, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

(unaudited)

(amounts in thousands, except share and per share data)	September 30, 2016	December 31, 2015
Assets		
Current assets:		
Cash and cash equivalents	$ 24,752	$ 19,779
Accounts receivable	12,400	8,580
Other receivables	60	36
Inventory	9,812	8,982
Prepaid expenses	1,668	757
Deferred equity costs	316	542
Total current assets	49,008	38,676
Property, plant and equipment, net	36,487	37,922
Deferred income taxes	15,989	15,637
Intangible assets, net	38,079	40,016
Goodwill	6,446	6,446
Total assets	$ 146,009	$ 138,697
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	$ 1,917	$ 1,553
Accrued expenses	7,857	3,418
Current portion of long-term debt	1,498	4,516
Total current liabilities	11,272	9,487
Long-term debt	22,738	25,244
Warrants	3,817	3,770
Contingent consideration-long term	67,551	59,846
Total liabilities	105,378	98,347
Commitments and contingencies (Note 12)		
Shareholders' equity		
Preferred stock, $0.01 par value. Authorized, 10,000,000 shares; none issued and outstanding	—	—
Common stock, $0.01 par value. Authorized, 50,000,000 shares; issued and outstanding, 11,863,660 shares at September 30, 2016 and 9,224,315 shares at December 31, 2015	119	92
Additional paid-in capital	91,378	71,321
Accumulated deficit	(50,866)	(31,063)
Total shareholders' equity	40,631	40,350
Total liabilities and shareholders' equity	$ 146,009	$ 138,697

See accompanying notes to unaudited consolidated financial statements.

RECRO PHARMA, INC. AND SUBSIDIARIES

Consolidated Statements of Operations

(unaudited)

(amounts in thousands, except share and per share data)	For the Three Months Ended September 30, 2016	2015	For the Nine Months Ended September 30, 2016	2015
Revenue:				
Manufacturing, royalty and profit sharing revenue	$16,188	$16,120	$50,260	$32,824
Research and development revenue	763	419	1,713	2,375
Total revenue	16,951	16,539	51,973	35,199
Operating expenses:				
Cost of sales (excluding amortization of intangible assets)	5,745	10,039	25,563	19,228
Research and development	7,046	2,716	23,175	7,260
General and administrative	3,841	3,478	9,263	8,492
Amortization of intangible assets	646	646	1,937	1,238
Change in warrant valuation	402	(762)	47	119
Change in contingent consideration valuation	3,192	586	7,705	2,586
Total operating expenses	20,872	16,703	67,690	38,923
Operating loss	(3,921)	(164)	(15,717)	(3,724)
Other income (expense):				
Interest income	10	2	27	10
Interest expense	(1,450)	(1,990)	(4,279)	(3,888)
Net loss before income taxes	(5,361)	(2,152)	(19,969)	(7,602)
Income tax benefit (expense)	(18)	—	166	—
Net loss	$(5,379)	$(2,152)	$(19,803)	$(7,602)
Basic and diluted net loss per common share	$(0.50)	$(0.24)	$(2.01)	$(0.92)
Weighted average basic and diluted common shares outstanding	10,780,911	9,118,664	9,862,526	8,243,909

See accompanying notes to unaudited consolidated financial statements.

RECRO PHARMA, INC. AND SUBSIDIARIES

Consolidated Statement of Shareholders' Equity

Nine Months Ended September 30, 2016

(unaudited)

(amounts in thousands, except share and per share data)	Common stock Shares	Amount	Additional paid-in capital	Accumulated deficit	Total
Balance, December 31, 2015	9,224,315	$ 92	$ 71,321	$ (31,063)	$40,350
Sale of common stock under Aspire equity facility, net of transaction costs	643,940	7	3,944	—	3,951
Sale of common stock in public offering, net of offering costs	1,986,666	20	13,347		13,367
Issuance of restricted stock units, net of shares withheld for income taxes	8,739	—	(33)		(33)
Stock-based compensation expense	—	—	2,799	—	2,799
Net loss	—	—	—	(19,803)	(19,803)
Balance, September 30, 2016	11,863,660	$ 119	$ 91,378	$ (50,866)	$40,631

See accompanying notes to unaudited consolidated financial statements.

RECRO PHARMA, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

(unaudited)

(amounts in thousands, except share and per share data)	For the Nine Months Ended September 30, 2016	2015
Cash flows from operating activities:		
Net loss	$(19,803)	$(7,602)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Stock-based compensation	2,799	1,725
Depreciation expense	3,756	2,730
Noncash interest expense	800	439
Amortization	1,937	1,238
Change in warrant valuation	47	119
Change in contingent consideration valuation	7,705	2,586
Deferred income taxes	(352)	—
Changes in operating assets and liabilities:		
Inventory	(830)	1,384
Prepaid expenses	(911)	(475)
Accounts receivable and other receivables	(3,844)	3,007
Accounts payable and accrued expenses	4,498	2,688
Net cash (used in) provided by operating activities	(4,198)	7,839
Cash flows from investing activities:		
Acquisition of Gainesville, net of cash acquired	—	(52,690)
Purchase of property and equipment	(2,014)	(1,787)
Net cash used in investing activities	(2,014)	(54,477)
Cash flows from financing activities:		
Proceeds from Aspire facility	4,175	—
Proceeds from sale of common stock, net of transaction costs	13,367	14,812
Proceeds from long-term debt	—	50,000
Payment on long-term debt	(6,324)	(7,838)
Payment of deferred financing costs	—	(1,718)
Payment of deferred equity costs	—	(253)
Payment of withholdings on shares withheld for income taxes	(33)	—
Proceeds from option exercise	—	228
Net cash provided by financing activities	11,185	55,231
Net increase in cash and cash equivalents	4,973	8,593
Cash and cash equivalents, beginning of period	19,779	19,682
Cash and cash equivalents, end of period	$24,752	$28,275
Supplemental disclosure of cash flow information:		
Common stock issued in connection with equity facility	—	$285
Cash paid for interest	$3,479	$3,449
Purchase of property, plant and equipment included in accrued expenses	$307	$179

Amortization of deferred equity costs	$224	—

See accompanying notes to unaudited consolidated financial statements.

RECRO PHARMA, INC. AND SUBSIDIARIES

Notes to unaudited Consolidated Financial Statements

(amounts in thousands, except share and per share data)

(1) Background

Recro Pharma, Inc., or the Company, was incorporated in Pennsylvania on November 15, 2007. The Company is a revenue-generating, specialty pharmaceutical company focused on products for hospital and ambulatory care settings, currently developing non-opioid products for treatment of serious acute pain. On April 10, 2015, the Company acquired from Alkermes plc, or Alkermes, worldwide rights to intravenous and intramuscular, or injectable meloxicam, a proprietary, long-acting preferential COX-2 inhibitor for the treatment of moderate to severe acute pain, as well as a contract manufacturing, royalty and formulation business in Gainesville, Georgia, now operating through the Company's subsidiary, Recro Gainesville, LLC, or Gainesville. The acquisition is referred to herein as the Gainesville Transaction. Gainesville develops and manufactures innovative pharmaceutical products that deliver clinically meaningful benefits to patients, using its proprietary delivery technologies for pharmaceutical companies who commercialize or plan to commercialize these products.

(2) Development-Stage Risks and Liquidity

The Company has incurred losses from operations since its incorporation and has an accumulated deficit of $50,866 as of September 30, 2016. Though its Gainesville business has been profitable, the Company anticipates incurring additional losses on a consolidated basis until such time, if ever, that it can generate significant sales of its products currently in development. Substantial additional financing will be needed by the Company to fund its operations and to commercially develop its product candidates.

The Company's future operations are highly dependent on a combination of factors, including (i) the continued profitability of the Gainesville business, (ii) the timely and successful completion of additional financing and/or alternative sources of capital, debt and partnering transactions; (iii) the success of its research and development, including the results and timing of its clinical trials; (iv) the development of competitive therapies by other biotechnology and pharmaceutical companies; and, ultimately (v) regulatory approval and market acceptance of the Company's proposed future products.

(3) Summary of Significant Accounting Principles

(a) Basis of Presentation and Principles of Consolidation

The accompanying unaudited consolidated financial statements of the Company and its subsidiaries have been prepared in accordance with U.S. generally accepted accounting principles, or U.S. GAAP, for interim financial information. The Company's consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All intercompany accounts and transactions have been eliminated. In the opinion of management, the accompanying consolidated financial statements include all normal and recurring adjustments (which consist primarily of accruals, estimates and assumptions that impact the financial statements) considered necessary to present fairly the Company's financial position as of September 30, 2016 and its results of operations for

the three and nine months ended September 30, 2016 and 2015 and cash flows for the three and nine months ended September 30, 2016 and 2015. Operating results for the three and nine months ended September 30, 2016 are not necessarily indicative of the results that may be expected for the full year ending December 31, 2016. The consolidated interim financial statements, presented herein, do not contain the required disclosures under U.S. GAAP for annual financial statements.

The accompanying unaudited interim consolidated financial statements should be read in conjunction with the annual audited financial statements and related notes as of and for the year ended December 31, 2015 included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2015.

(b) Use of Estimates

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from such estimates.

(c) Cash and Cash Equivalents

The Company considers all highly liquid investments that have maturities of three months or less when acquired to be cash equivalents. Cash equivalents as of September 30, 2016 and December 31, 2015 consisted of money market mutual funds and government and agency bonds.

RECRO PHARMA, INC. AND SUBSIDIARIES

Notes to unaudited Consolidated Financial Statements

(amounts in thousands, except share and per share data)

(d) Fair Value of Financial Instruments

Management believes that the carrying amounts of the Company's financial instruments, including cash equivalents, accounts receivable, accounts payable and accrued expenses, approximate fair value due to the short-term nature of those instruments. Management believes the carrying value of debt approximates fair value as the interest rates are reflective of the rate the Company could obtain on debt with similar terms and conditions.

(e) Inventory

Inventory is stated at the lower of cost or market value. Cost is determined using the first-in, first-out method. Included in inventory are raw materials used in production of commercial products.

(f) Property and Equipment

Property and equipment are recorded at cost less accumulated depreciation and amortization. Depreciation and amortization are computed using the straight-line method over the estimated useful lives of the assets, which are as follows: four to ten years for furniture, office and computer equipment; six to ten years for manufacturing equipment; two to five years for vehicles; 35 to 40 years for buildings; and the shorter of the lease term or useful life for leasehold improvements. Repairs and maintenance costs are expensed as incurred.

(g) Goodwill and Intangible Assets

Goodwill represents the excess of purchase price over the fair value of net assets acquired by the Company. Goodwill is not amortized, but assessed for impairment on an annual basis or more frequently if impairment indicators exist. The impairment model prescribes a two-step method for determining impairment.

The first step compares a reporting unit's fair value to its carrying amount to identify potential goodwill impairment. If the carrying amount of a reporting unit exceeds the reporting unit's fair value, the second step of the impairment test must be completed to measure the amount of the reporting unit's goodwill impairment loss, if any. Step two requires an assignment of the reporting unit's fair value to the reporting unit's assets and liabilities to determine the implied fair value of the reporting unit's goodwill. The implied fair value of the reporting unit's goodwill is then compared with the carrying amount of the reporting unit's goodwill to determine the goodwill impairment loss to be recognized, if any.

Intangible assets include the Company's royalties and contract manufacturing relationships intangible asset as well as an in-process research and development, or IPR&D, asset. The royalties and contract manufacturing relationships intangible asset is considered a definite-lived intangible asset and is amortized on a straight-line basis over a useful life of six years.

Intangible assets related to IPR&D are considered indefinite-lived intangible assets and are assessed for impairment annually or more frequently if impairment indicators exist. If the associated research and development effort is abandoned, the related assets will be written-off and the Company will record a noncash impairment loss on its consolidated statements of operations. For those compounds that reach commercialization, the IPR&D assets will be amortized over their estimated useful lives.

The impairment test for indefinite-lived intangible assets is a one-step test, which compares the fair value of the intangible asset to its carrying value. If the carrying value exceeds its fair value, an impairment loss is recognized in an amount equal to the excess. Based on accounting standards, it is required that these assets be assessed at least

annually for impairment unless a triggering event occurs between annual assessments which would then require an assessment in the period which a triggering event occurred.

(h) Revenue Recognition

The Company generates revenues from manufacturing, packaging and related services for multiple pharmaceutical companies. The agreements that the Company has with its commercial partners provide for manufacturing revenues, royalties and/or profit sharing components.

Manufacturing and other related services revenue is recognized when persuasive evidence of an arrangement exists, shipment has occurred and the title to the product and associated risk of loss has passed to the customer, the sales price is fixed or determinable and collectability is reasonably assured.

RECRO PHARMA, INC. AND SUBSIDIARIES

Notes to unaudited Consolidated Financial Statements

(amounts in thousands, except share and per share data)

In addition to manufacturing and other related services revenue, the customer agreements have royalties and/or profit sharing payments, computed on the net product sales of the partner. Royalty and profit sharing revenues are generally recognized under the terms of the license and supply agreement in the period the products are sold and expenses are incurred by our commercial partner and collectability is reasonably assured.

Revenues related to research and development are generally recognized as the related services or activities are performed, in accordance with the contract terms. To the extent that the agreements specify services are to be performed on a fixed basis, revenues are recognized consistent with the pattern of the work performed.

(i) Concentration of Credit Risk

Financial instruments that potentially subject the Company to significant concentration of credit risk consist primarily of cash, cash equivalents and accounts receivable. The Company's policy is to limit the amount of credit exposure to any one financial institution and place its cash and cash equivalents with financial institutions evaluated as being creditworthy. To date, the Company has not experienced any losses on its cash equivalents.

(j) Research and Development

Research and development costs for the Company's proprietary products/product candidates are charged to expense as incurred. Research and development expenses consist primarily of funds paid to third parties for the provision of services for manufacturing of clinical supplies, drug development, clinical trials, statistical analysis and report writing, and regulatory compliance costs. At the end of the reporting period, the Company compares payments made to third-party service providers to the estimated progress toward completion of the research or development objectives. Such estimates are subject to change as additional information becomes available. Depending on the timing of payments to the service providers and the progress that the Company estimates has been made as a result of the service provided, the Company may record net prepaid or accrued expense relating to these costs.

Upfront and milestone payments made to third parties who perform research and development services on the Company's behalf are expensed as services are rendered. Costs incurred in obtaining technology licenses are charged to research and development expense as acquired in-process research and development if the technology licensed has not reached technological feasibility and has no alternative future use.

(k) Stock-Based Awards

The Company measures employee stock-based awards at grant-date fair value and recognizes employee compensation expense on a straight-line basis over the vesting period of the award.

Determining the appropriate fair value of stock options requires the input of subjective assumptions, including the expected life of the option and expected stock price volatility. The Company uses the Black-Scholes option pricing model to value its stock option awards. The assumptions used in calculating the fair value of stock-based awards represent management's best estimates and involve inherent uncertainties and the application of management's judgment. As a result, if factors change and management uses different assumptions, stock-based compensation expense could be materially different for future awards.

The expected life of stock options was estimated using the "simplified method," as the Company has limited historical information to develop reasonable expectations about future exercise patterns and post vesting employment

termination behavior for its stock options grants. The simplified method is based on the average of the vesting tranches and the contractual life of each grant. For stock price volatility, the Company uses comparable public companies as a basis for its expected volatility to calculate the fair value of options grants. The risk-free interest rate is based on U.S. Treasury notes with a term approximating the expected life of the option.

Nonemployee stock-based awards are revalued until an award vests and the Company recognizes compensation expense on a straight-line basis over the vesting period of each separated vesting tranche of the award, or the accelerated attribution method. The estimation of the number of stock awards that will ultimately vest requires judgment, and to the extent actual results or updated estimates differ from the Company’s current estimates, such amounts are recognized as an adjustment in the period in which estimates are revised.

RECRO PHARMA, INC. AND SUBSIDIARIES

Notes to unaudited Consolidated Financial Statements

(amounts in thousands, except share and per share data)

(l) Income Taxes

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in operations in the period that includes the enactment date. A valuation allowance is recorded to the extent it is more likely than not that some portion or all of the deferred tax assets will not be realized.

Unrecognized income tax benefits represent income tax positions taken on income tax returns that have not been recognized in the consolidated financial statements. The Company recognizes the benefit of an income tax position only if it is more likely than not (greater than 50%) that the tax position will be sustained upon tax examination, based solely on the technical merits of the tax position. Otherwise, no benefit is recognized. The tax benefits recognized are measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. The Company accrues interest and related penalties are classified as income tax expense in the Consolidated Statements of Operations. The Company does not anticipate significant changes in the amount of unrecognized income tax benefits over the next year.

(m) Net Loss Per Common Share

Basic and diluted net loss per common share is determined by dividing net loss applicable to common shareholders by the weighted average common shares outstanding during the period. For all periods presented, the outstanding common stock options and warrants have been excluded from the calculation because their effect would be anti-dilutive. Therefore, the weighted average shares used to calculate both basic and diluted net loss per share are the same.

The following potentially dilutive securities have been excluded from the computations of diluted weighted average shares outstanding as of September 30, 2016 and 2015, as they would be anti-dilutive:

	September 30, 2016	September 30, 2015
Options and restricted stock units outstanding	2,363,794	1,570,982
Warrants	784,928	784,928

Amounts in the table above reflect the common stock equivalents of the noted instruments.

(n) Recent Accounting Pronouncements

In August 2016, the Financial Accounting Standards Board, or FASB, issued updated guidance in the classification of certain cash receipts and payments in the statement of cash flows where diversity in practice exists. This new guidance is effective for annual periods beginning after December 15, 2017, with early adoption permitted. The

Company is currently evaluating the effect that the updated standard will have on its consolidated financial statements and related disclosures.

In March 2016, the FASB issued updated guidance on the accounting for share-based payment transactions including the income tax consequences, classification of awards as either equity or liabilities, employee tax withholding, calculation of shares for use in diluted earnings per share and the classification on the statement of cash flows. The new guidance is effective for annual periods beginning after December 15, 2016, with early adoption permitted. The Company early adopted the guidance effective July 1, 2016. The guidance did not have a material impact to the consolidated financial statements upon adoption.

In November 2015, the FASB issued updated guidance on the presentation requirements for deferred income tax liabilities and assets to be classified as noncurrent in a classified statement of financial position. The update is effective for financial statements issued for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years, and early adoption is permitted for all entities as of the beginning of an interim or annual reporting period. The Company adopted this guidance during the year ended December 31, 2015.

RECRO PHARMA, INC. AND SUBSIDIARIES

Notes to unaudited Consolidated Financial Statements

(amounts in thousands, except share and per share data)

In September 2015, the FASB issued updated guidance regarding the accounting for and disclosure of measurement-period adjustments that occur in periods after a business combination is consummated. This update requires that the acquirer recognize measurement-period adjustments in the reporting period in which they are determined. Prior period information should not be revised. This update also requires an entity to present separately on the face of the income statement or disclose in the notes the amount recorded in the current-period income statement that would have been recorded in previous reporting periods if the adjustments had been recognized as of the acquisition date. The effective date for annual and interim periods begins after December 15, 2015. The adoption of this updated standard did not have a material impact on the Company's consolidated financial statements and related disclosures.

In July 2015, the FASB issued updated guidance which changes the measurement principle for inventory from the lower of cost or market to the lower of cost and net realizable value. The amendments in this guidance do not apply to inventory that is measured using last-in, first-out, or LIFO, or the retail inventory method. The amendments apply to all other inventory, which includes inventory that is measured using first-in, first-out or average cost. Within the scope of this new guidance, an entity should measure inventory at the lower of cost and net realizable value; where, net realizable value is defined as the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. The new guidance is effective for annual periods beginning after December 15, 2016, with early adoption permitted. The new guidance must be applied on a prospective basis. The Company is evaluating the effect that the new guidance will have on its consolidated financial statements and related disclosures.

In April 2015, the FASB issued updated guidance on the presentation requirements for debt issuance costs and debt discount and premium. The update requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The recognition and measurement guidance for debt issuance costs are not affected by the updated guidance. The updated guidance is effective for annual and interim periods beginning after December 15, 2015 and early adoption is permitted for financial statements that have not been previously issued. The Company adopted this guidance during the year ended December 31, 2015.

In August 2014, the FASB issued updated guidance regarding the going concern assumption. The amendments in this update will explicitly require a company's management to assess an entity's ability to continue as a going concern, and to provide related footnote disclosures in certain circumstances. This new guidance is effective for annual periods beginning after December 15, 2016, with early adoption permitted. The Company is currently evaluating the potential impact of the adoption of this standard, but the Company believes the adoption of this guidance will not have a material impact on its consolidated financial statements and related disclosures.

In May 2014, the FASB issued updated guidance regarding the accounting for and disclosures of revenue recognition, with an effective date for annual and interim periods beginning after December 15, 2016. The update provides a single comprehensive model for accounting for revenue from contracts with customers. The model requires that revenue recognized reflect the actual consideration to which the entity expects to be entitled in exchange for the goods or services defined in the contract, including in situations with multiple performance obligations. In July 2015, the FASB deferred the effective date by one year. The guidance will be effective for annual and interim periods beginning after December 15, 2017. The Company is currently evaluating the effect that this guidance may have on its consolidated

financial statements.

(4) Acquisition of Gainesville and Meloxicam

On April 10, 2015, the Company completed the Gainesville Transaction. The consideration paid in connection with the Gainesville Transaction consisted of $50,000 at closing, a $4,010 working capital adjustment and a seven-year warrant to purchase 350,000 shares of the Company's common stock at an exercise price of $19.46 per share. In addition, the Company may be required to pay up to an additional $120,000 in milestone payments (including $10,000 payable upon the new drug application "NDA" filing and $30,000 upon regulatory approval, and other revenue target milestones), and royalties on future product net sales related to injectable meloxicam. Under the acquisition method of accounting, the consideration paid and the fair value of the contingent consideration and royalties are allocated to the fair value of the assets acquired and liabilities assumed. The contingent consideration obligation is remeasured each reporting date with changes in fair value recognized as a period charge within the statement of operations (see note 6 for further information regarding fair value).

RECRO PHARMA, INC. AND SUBSIDIARIES

Notes to unaudited Consolidated Financial Statements

(amounts in thousands, except share and per share data)

The following is the purchase price for the Gainesville Transaction:

	Estimated Fair Value
Purchase price agreement	$50,000
Fair value of warrants	2,470
Fair value of contingent consideration	54,600
Working capital adjustment	4,010
	$111,080

The contingent consideration consists of three separate components. The first component consists of two potential payments, which will be payable upon the submission of the new drug application, or NDA, for meloxicam, and the related regulatory approval, respectively. The second component consists of three potential payments, based on the achievement of specified annual revenue targets. The third component consists of net sales milestones related to injectable meloxicam and royalties on future product sales of injectable meloxicam between 10% and 12% (subject to a 30% reduction when no longer covered by patent).

The fair value of the first contingent consideration component recognized on the acquisition date was estimated by applying a risk adjusted discount rate to the probability adjusted contingent payments and the expected approval dates. The fair value of the second contingent consideration component recognized on the acquisition date was estimated by applying a risk adjusted discount rate to the potential payments resulting from probability weighted revenue projections and expected revenue target attainment dates. The fair value of the third contingent consideration component recognized on the acquisition date was estimated by applying a risk adjusted discount rate to the potential payments resulting from probability weighted revenue projections and the defined royalty percentage.

These fair values are based on significant inputs not observable in the market, which are referred to in the guidance as Level 3 inputs. The contingent consideration components are classified as liabilities and are subject to the recognition of subsequent changes in fair value through the results of operations.

The Gainesville results of operations have been included in the consolidated statement of operations beginning April 10, 2015.

The following is the allocation of fair value to the assets acquired and the liabilities assumed in connection with the Gainesville Transaction, reconciled to the purchase price:

	Amount

Accounts receivable	$12,519
Inventory	10,253
Prepaid expenses	380
Property, plant and equipment	39,424
Intangible assets	41,900
Goodwill	6,446
Total assets acquired	110,922
Accounts payable and accrued expenses	1,162
Warrants	2,470
Contingent consideration	54,600
Total liabilities assumed	58,232
Cash paid, net of $1,320 of cash acquired	$52,690

RECRO PHARMA, INC. AND SUBSIDIARIES

Notes to unaudited Consolidated Financial Statements

(amounts in thousands, except share and per share data)

The fair value of the property, plant and equipment and their weighted-average useful lives are as follows:

	Estimated Fair Value	Estimated Useful Life
Buildings and improvements	$ 16,371	35 years
Land	3,263	N/A
Furniture, office & computer equipment	2,510	4-5 years
Vehicles	30	2 years
Manufacturing equipment	17,250	6-7 years
	$ 39,424	

The estimated fair value of property, plant and equipment was determined using the cost and sales approaches.

The fair value of the identifiable intangible assets and their weighted-average useful lives are as follows:

	Estimated Fair Value	Weighted Average Estimated Useful Life
Royalties and contract manufacturing relationships	$ 15,500	6
In-process research and development	26,400	N/A
Total intangible assets	$ 41,900	

The in-process research and development asset and customer relationships were valued using the multi-period excess earnings method, which is an income approach in which excess earnings are the earnings remaining after deducting the market rates of return on the estimated values of contributory assets, including debt-free net working capital, tangible and intangible assets. The excess earnings are thereby calculated for each quarter of a multi-quarter projection period discounted to a present value utilizing an appropriate discount rate for the subject asset.

(5) Unaudited Pro Forma Results of Operations

The unaudited pro forma combined results of operations for the nine months ended September 30, 2016 (assuming the closing of the Gainesville Transaction had occurred on January 1, 2015) are as follows:

	Nine Months Ended
Net revenue	$ 54,931
Net loss	(6,978)

The pro forma results have been prepared for reporting purposes only and are not necessarily indicative of the actual results of operations had the closing of the Transaction taken place on January 1, 2015. Furthermore, the pro forma results do not purport to project the future results of operations of the Company.

(6) Fair Value of Financial Instruments

The Company follows the FASB accounting guidance on fair value measurements for financial assets and liabilities measured on a recurring basis. The guidance requires fair value measurements to maximize the use of “observable inputs.” The three-level hierarchy of inputs to measure fair value are as follows:

- Level 1: Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities
- Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices in markets that are not active, or inputs that are observable, either directly or indirectly, for substantially the full term of the asset or liability
- Level 3: Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e., supported by little or no market activity)

RECRO PHARMA, INC. AND SUBSIDIARIES

Notes to unaudited Consolidated Financial Statements

(amounts in thousands, except share and per share data)

The Company has classified assets and liabilities measured at fair value on a recurring basis as follows:

	Fair value measurements at reporting date using Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
At December 31, 2015:			
Assets:			
Money market mutual funds	$5,081	—	—
Government and agency bonds	10,250	—	—
Cash equivalents	$15,331	—	—
Liabilities:			
Warrants	—	—	$ 3,770
Contingent consideration	—	—	59,846
	—	—	$ 63,616
At September 30, 2016:			
Assets:			
Money market accounts	$8,585	—	—
Government and agency bonds	9,270	—	—
Cash equivalents	$17,855	—	—
Liabilities:			
Warrants	—	—	$ 3,817
Contingent consideration	—	—	67,551