CRYOLIFE INC
Form 10-Q
July 25, 2017

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 **June 30, 2017**

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: 1-13165

CRYOLIFE, INC.

(Exact name of registrant as specified in its charter)

Florida	**59-2417093**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
1655 Roberts Boulevard, NW, Kennesaw, Georgia	**30144**
(Address of principal executive offices)	(Zip Code)

(770) 419-3355

(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 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, a smaller reporting company or an emerging growth company. See the definitions of large accelerated filer, accelerated filer smaller reporting company and emerging growth 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
Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 7(a)(2)(B) of the Securities Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Class	Outstanding at July 21, 2017
Common Stock	33,446,056 Shares

Part I FINANCIAL INFORMATION

Item 1. Financial Statements.

CRYOLIFE, INC. AND SUBSIDIARIES

SUMMARY CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME

(IN THOUSANDS, EXCEPT PER SHARE DATA)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	**2016**	**2017**	**2016**
	(Unaudited)		(Unaudited)	
Revenues:				
Products	$ 30,094	$ 30,045	$ 57,490	$ 57,063
Preservation services	17,724	17,038	35,387	33,036
Total revenues	**47,818**	**47,083**	**92,877**	**90,099**
Cost of products and preservation services:				
Products	6,959	7,698	14,976	14,701
Preservation services	7,954	9,084	15,484	17,476
Total cost of products and preservation services	**14,913**	**16,782**	**30,460**	**32,177**
Gross margin	**32,905**	**30,301**	**62,417**	**57,922**
Operating expenses:				
General, administrative, and marketing	23,389	22,436	46,260	48,710
Research and development	4,728	3,279	8,821	5,888
Total operating expenses	**28,117**	**25,715**	**55,081**	**54,598**
Gain from sale of business components	--	--	--	(7,915)
Operating income	**4,788**	**4,586**	**7,336**	**11,239**
Interest expense	834	797	1,635	1,514
Interest income	(55)	(18)	(95)	(30)
Other income, net	(134)	(58)	(91)	(167)

Income before income taxes	**4,143**	**3,865**	**5,887**	**9,922**
Income tax expense	980	1,518	501	5,034
Net income	$ **3,163**	$ **2,347**	$ **5,386**	$ **4,888**
Income per common share:				
Basic	$ **0.09**	$ **0.07**	$ **0.16**	$ **0.15**
Diluted	$ **0.09**	$ **0.07**	$ **0.16**	$ **0.15**
Weighted-average common shares outstanding:				
Basic	32,664	32,010	32,552	31,519
Diluted	33,814	32,764	33,739	32,270
Net income	$ **3,163**	$ **2,347**	$ **5,386**	$ **4,888**
Other comprehensive income (loss)	129	(332)	365	(428)
Comprehensive income	$ **3,292**	$ **2,015**	$ **5,751**	$ **4,460**

See accompanying Notes to Summary Consolidated Financial Statements.

CRYOLIFE, INC. AND SUBSIDIARIES

SUMMARY CONSOLIDATED BALANCE SHEETS

(IN THOUSANDS)

	June 30, 2017	December 31, 2016
	(Unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 52,507	$ 56,642
Restricted securities	741	699
Receivables, net	33,317	30,096
Inventories	26,537	26,293
Deferred preservation costs	33,974	30,688
Prepaid expenses and other	5,135	2,815
Total current assets	**152,211**	**147,233**
Property and equipment, net	20,694	18,502
Goodwill	78,294	78,294
Patents, net	862	1,008
Trademarks and other intangibles, net	63,527	65,633
Deferred income taxes	148	--
Investment in company owned life insurance	3,745	2,991
Other	2,740	2,479
Total assets	**$ 322,221**	**$ 316,140**
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 6,571	$ 5,744
Accrued compensation	5,764	8,815
Accrued procurement fees	3,393	4,806
Accrued expenses and other	6,815	6,175
Current portion of long-term debt	3,228	4,562
Total current liabilities	**25,771**	**30,102**
Long-term debt	65,635	67,012
Deferred compensation liability	3,441	2,600
Deferred rent obligations	3,020	2,355

Other		5,293		5,088
Total liabilities		**103,160**		**107,157**
Commitments and contingencies				
Shareholders equity:				
Preferred stock		--		--
Common stock (issued shares of 34,784 in 2017 and 34,230 in 2016)		348		342
Additional paid-in capital		192,204		187,061
Retained earnings		39,291		34,143
Accumulated other comprehensive loss		(64)		(429)
Treasury stock at cost (shares of 1,387 in 2017 and 1,356 in 2016)		(12,718)		(12,134)
Total shareholders equity		**219,061**		**208,983**
Total liabilities and shareholders equity	**$**	**322,221**	**$**	**316,140**

See accompanying Notes to Summary Consolidated Financial Statements.

CRYOLIFE, INC. AND SUBSIDIARIES

SUMMARY CONSOLIDATED STATEMENTS OF CASH FLOWS

(IN THOUSANDS)

	Six Months Ended June 30,	
	2017	**2016**
	(Unaudited)	
Net cash flows from operating activities:		
Net income	$ 5,386	$ 4,888
Adjustments to reconcile net income to net cash from operating activities:		
Gain from sale of business components	--	(7,915)
Depreciation and amortization	4,352	4,089
Non-cash compensation	3,796	2,869
Other non-cash adjustments to income	1,034	4,696
Changes in operating assets and liabilities:		
Receivables	(3,961)	2,097
Inventories and deferred preservation costs	(4,023)	(4,373)
Prepaid expenses and other assets	(3,335)	(426)
Accounts payable, accrued expenses, and other liabilities	(1,227)	(87)
Net cash flows provided by operating activities	**2,022**	**5,838**
Net cash flows from investing activities:		
Acquisition of On-X, net of cash acquired	--	(91,152)
Acquisition of PhotoFix technology	--	(1,226)
Proceeds from sale of business components	740	19,795
Decrease in restricted cash	--	5,000
Capital expenditures	(4,335)	(1,608)
Other	36	30
Net cash flows used in investing activities	**(3,559)**	**(69,161)**
Net cash flows from financing activities:		
Proceeds from issuance of term loan	--	75,000
Repayment of term loan	(2,978)	(469)
Payment of debt issuance costs	--	(2,289)
Proceeds from exercise of stock options and issuance of common stock	1,765	1,027

Redemption and repurchase of stock to cover tax withholdings	(1,552)	(562)
Other	(2)	346
Net cash flows (used in) provided by financing activities	**(2,767)**	**73,053**
Effect of exchange rate changes on cash	169	(383)
(Decrease) increase in cash and cash equivalents	**(4,135)**	**9,347**
Cash and cash equivalents, beginning of period	56,642	37,588
Cash and cash equivalents, end of period	**$ 52,507**	**$ 46,935**

See accompanying Notes to Summary Consolidated Financial Statements.

CRYOLIFE, INC. AND SUBSIDIARIES

NOTES TO SUMMARY CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

1. Basis of Presentation

Overview

The accompanying summary consolidated financial statements include the accounts of CryoLife, Inc. and subsidiaries (CryoLife, the Company, we, or us). All significant intercompany accounts and transactions have been eliminated i consolidation. The accompanying Summary Consolidated Balance Sheet as of December 31, 2016 has been derived from audited financial statements. The accompanying unaudited summary consolidated financial statements as of, and for the three and six months ended, June 30, 2017 and 2016 have been prepared in accordance with (i) accounting principles generally accepted in the U.S. for interim financial information and (ii) the instructions to Form 10-Q and Rule 10-01 of Regulation S-X of the U.S. Securities and Exchange Commission (SEC). Accordingly, such statements do not include all of the information and disclosures required by accounting principles generally accepted in the U.S. for a complete presentation of financial statements. In the opinion of management, all adjustments (including those of a normal, recurring nature) considered necessary for a fair presentation have been included. Operating results for the three and six months ended June 30, 2017 are not necessarily indicative of the results that may be expected for the year ending December 31, 2017. These summary consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in CryoLife s Annual Report on Form 10-K for the year ended December 31, 2016 filed with the SEC on February 16, 2017.

Change in Accounting for Employee Share-Based Payments

As of January 1, 2017 we made an entity-wide accounting policy election in accordance with ASU 2016-09, *Improvements to Employee Share-Based Payment Accounting,* (ASU 2016-09) to change our accounting policy to account for stock compensation forfeitures in the period awards are forfeited rather than estimating the effect of forfeitures. We elected to make this accounting policy change to simplify the accounting for share-based compensation and believe this method provides a more accurate reflection of periodic share-based compensation cost from the grant date forward. We used the modified retrospective transition method to record a net $238,000 cumulative-effect adjustment decrease to retained earnings for the accounting policy change, which included a $379,000 increase to additional paid in capital and a $141,000 increase in deferred tax assets.

Additionally, as of January 1, 2017 and in accordance with the guidance in ASU 2016-09, we made a change to account for excess tax benefits and deficiencies resulting from the settlement or vesting of share-based awards in income tax expense on our Summary Consolidated Statement of Operations and Comprehensive Income, instead of accounting for these effects through additional paid in capital on our Summary Consolidated Balance Sheets. We applied this amendment prospectively and prior periods have not been adjusted.

2. Financial Instruments

The following is a summary of our financial instruments measured at fair value (in thousands):

June 30, 2017	**Level 1**	**Level 2**	**Level 3**	**Total**
Cash equivalents:				

Money market funds	$ 370	$ --	$ --	$ 370
Restricted securities:				
Money market funds	741	--	--	741
Total assets	$ 1,111	$ --	$ --	$ 1,111

December 31, 2016	**Level 1**	**Level 2**	**Level 3**	**Total**
Cash equivalents:				
Money market funds	$ 3,466	$ --	$ --	$ 3,466
Restricted securities:				
Money market funds	699	--	--	699
Total assets	$ 4,165	$ --	$ --	$ 4,165

We used prices quoted from our investment management companies to determine the Level 1 valuation of our investments in money market funds.

3. Cash Equivalents and Restricted Securities

The following is a summary of cash equivalents and restricted securities (in thousands):

June 30, 2017	Cost Basis	Unrealized Holding Gains	Estimated Market Value
Cash equivalents:			
Money market funds	$ 370	$ --	$ 370
Restricted securities:			
Money market funds	741	--	741

December 31, 2016	Cost Basis	Unrealized Holding Gains	Estimated Market Value
Cash equivalents:			
Money market funds	$ 3,466	$ --	$ 3,466
Restricted securities:			
Money market funds	699	--	699

As of June 30, 2017 and December 31, 2016 $741,000 and $699,000, respectively, of our money market funds were designated as short-term restricted securities due to a contractual commitment to hold the securities as pledged collateral relating primarily to international tax obligations.

There were no gross realized gains or losses on cash equivalents in the three and six months ended June 30, 2017 and 2016. As of June 30, 2017 $741,000 of our restricted securities had a maturity date between three months and one year. As of December 31, 2016 $490,000 of our restricted securities had a maturity date within three months and $209,000 had a maturity date between three months and one year.

4. Acquisition of On-X Life Technologies

Overview

On December 22, 2015 we entered into an agreement and plan of merger to acquire On-X Life Technologies Holdings, Inc. (On-X), an Austin, Texas-based, privately held mechanical heart valve company, for approximately $130.0 million, subject to certain adjustments. The transaction closed on January 20, 2016, and On-X is being operated as a wholly owned subsidiary of CryoLife.

The On-X catalogue of products includes the On-X prosthetic aortic and mitral heart valves and the On-X ascending aortic prosthesis. On-X also distributes CarbonAid CO_2 diffusion catheters and manufactures Chord-X ePTFE sutures for mitral chordal replacement. On-X also generates revenue from pyrolytic carbon coating products produced for other medical device manufacturers. We believe that the On-X products fit well into our product portfolio of medical devices for cardiac surgery and that we are capitalizing on the significant opportunity for CryoLife s sales team to leverage their strong relationships with cardiac surgeons to introduce and to expand utilization of the On-X valves in the U.S. and internationally.

Accounting for the Transaction

The purchase price of the On-X transaction totaled approximately $128.2 million, consisting of cash of $93.6 million and 3,703,699 shares of CryoLife common stock, with a value of $34.6 million as determined on the date of the closing. We recorded an allocation of the $128.2 million purchase price to On-X s tangible and identifiable intangible assets acquired and liabilities assumed, based on their estimated fair values as of January 20, 2016. Goodwill was recorded based on the amount by which the purchase price exceeded the fair value of the net assets acquired and is not deductible for tax purposes. Goodwill from this transaction has been allocated to our Medical Devices segment.

The purchase price allocation is as follows (in thousands):

		Opening Balance Sheet
Cash and cash equivalents	$	2,472
Receivables		6,826
Inventories		12,889
Intangible assets		53,950
Goodwill		68,229
Other assets		6,891
Liabilities assumed		(23,040)
Total purchase price	$	128,217

We incurred transaction and integration costs of $7.4 million for the year ended December 31, 2016 related to the acquisition, which include, among other costs, expenses related to the termination of international and domestic distribution agreements. These costs were expensed as incurred and were primarily recorded as general, administrative, and marketing expenses on our Summary Consolidated Statements of Operations and Comprehensive Income.

We paid approximately $10 million of the purchase price into an escrow account upon closing of the On-X transaction. We are currently in litigation with the representative of the former On-X shareholders concerning the resolution of these escrow funds. We believe that we are entitled to recover the escrow funds and additional damages, but the outcome of litigation is inherently uncertain, and we may not recover any of the escrow funds.

Pro Forma Results

On-X revenues were $34.2 million from the date of acquisition through December 31, 2016. Our pro forma results of operations for the years ended December 31, 2016 and 2015, assuming the On-X acquisition had occurred as of January 1, 2015, are presented for comparative purposes below. These amounts are based on available information of the results of operations of On-X prior to the acquisition date and are not necessarily indicative of what the results of operations would have been had the acquisition been completed on January 1, 2015. This unaudited pro forma information does not project operating results post acquisition.

This pro forma information is as follows (in thousands, except per share amounts):

		Twelve Months Ended December 31,		
		2016		2015
Total revenues	$	182,007	$	179,266
Net income (loss)		17,692		(4,787)
Pro forma income (loss) per common share - basic	$	0.54	$	(0.15)

Pro forma income (loss) per common share - diluted	$ 0.53	$ (0.15)

Pro forma net income (loss) was calculated using a normalized tax rate of approximately 38%.

5. Sale of Business Components

Divestiture of the HeRO Graft Product Line

On February 3, 2016 we sold our Hemodialysis Reliable Outflow Graft (HeRO® Graft) product line to Merit Medical Systems, Inc. (Merit) for $18.5 million in cash (HeRO Sale), of which $17.8 million was received on the transaction date and the remaining $740,000 was received in the first quarter of 2017. Under terms of the agreement, Merit acquired the HeRO Graft product line, including worldwide marketing rights, customer relationships, intellectual property, inventory, and certain property and equipment. We continued to manufacture the HeRO Graft under a transition supply agreement until the manufacturing transfer to Merit was completed in the second quarter of 2016. Sales prices under the transition supply agreement were at lower average prices than our previous sales to hospitals at end-user prices. The HeRO Graft product line was included as part of our Medical Devices segment. We recorded a pre-tax gain of approximately $8.8 million on the HeRO Sale.

ProCol Distribution Agreement and Divestiture of the ProCol Product Line

In 2014 we acquired the exclusive worldwide distribution rights to ProCol® Vascular Bioprosthesis (ProCol) from Hancock Jaffe Laboratories, Inc. (Hancock Jaffe). In accordance with the terms of the agreement, we made payments to Hancock Jaffe totaling $3.4 million for which we obtained the right to receive a designated amount of ProCol inventory for resale. As of March 18, 2016 we had received $1.7 million in inventory. The remaining $1.7 million in prepayments for inventory not yet delivered to us were settled as part of the ProCol Sale, described below.

On March 18, 2016 we sold our ProCol distribution rights and purchase option to LeMaitre Vascular, Inc. (LeMaitre) for $2.0 million in cash (ProCol Sale), all of which was received by March 31, 2016. Under the terms of the agreement, LeMaitre acquired the ProCol related assets, including inventory, customer lists, related marketing assets, and our purchase option to acquire ProCol. LeMaitre exercised the option to acquire ProCol from Hancock Jaffe Laboratories. The ProCol product was included as part of our Medical Devices segment. We recorded a pre-tax loss of approximately $845,000 on the ProCol Sale.

Disclosure of the HeRO Sale and the ProCol Sale

Financial Accounting Standards Board ASU 2014-08, *Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity,* (ASU 2014-08) defines the criteria for reporting discontinued operations and requires additional disclosures about discontinued operations. The standard requires that an entity report a disposal as a discontinued operation only if the disposal represents a strategic shift in operations that has a major effect on our operations and financial results.

In the first quarter of 2016 we completed the HeRO Sale and the ProCol Sale. We received cash for these transactions and recorded these sales in March 2016. Therefore, as of March 31, 2016 both transactions met the disposed of by sale criteria under ASU 2014-08.

We evaluated the impact of the HeRO Sale and the ProCol Sale on our business to determine whether these disposals represent a strategic shift that has, or will have, a major effect on our financial position, results of operations, or cash flows. As the HeRO Graft and ProCol product lines combined represented less than 10% of our total revenues for the year ended December 31, 2015 and our total assets as of December 31, 2015, we believe that these transactions did not have a major effect on our operations and financial condition, either individually or in the aggregate, and therefore, we did not disclose these transactions as discontinued operations. The combined net gain from the HeRO Sale and ProCol Sale was therefore reported as gain from sale of business components on our Summary Consolidated Statements of Operations and Comprehensive Income.

6. PhotoFix Distribution Agreement and Acquisition

Overview

In 2014 we entered into an exclusive supply and distribution agreement with Genesee Biomedical, Inc. (GBI) to acquire the distribution rights to PhotoFix™, a bovine pericardial patch stabilized using a dye-mediated photo-fixation process that requires no glutaraldehyde. PhotoFix has received U.S. Food and Drug Administration (FDA) 510(k) clearance and is indicated for use in intracardiac repair, including ventricular repair and atrial repair, great vessel repair and suture line buttressing, and pericardial closure. We believe that PhotoFix fits well into our product portfolio of medical devices for cardiac surgery. In January 2015 we received our initial shipments and launched our distribution of PhotoFix.

The agreement between CryoLife and GBI (the GBI Agreement) had an initial five-year term and was renewable for two one-year periods at our option. Under the terms of the GBI Agreement, we purchased PhotoFix inventory for

resale at an agreed upon transfer price and had the option, which became effective in March 2015, to acquire the PhotoFix product line from GBI.

Accounting for the Transaction

On April 13, 2016 we exercised our right to acquire the PhotoFix technology from GBI for approximately $2.3 million, of which $1.2 million was paid in cash at closing, approximately $600,000 was previously provided to GBI as an advance under the distribution agreement, and approximately $400,000 is payable to GBI within 18 months of signing or earlier, subject to certain conditions. Our allocation of the purchase price to the tangible and identifiable intangible assets acquired, based on their estimated fair values, resulted in the allocation of the majority of the purchase price to amortizable intangible assets. GBI will continue to manufacture PhotoFix until we are able to establish manufacturing operations.

7. Inventories and Deferred Preservation Costs

Inventories at June 30, 2017 and December 31, 2016 are comprised of the following (in thousands):

	June 30, 2017	December 31, 2016
Raw materials and supplies	$ 11,141	$ 9,321
Work-in-process	3,258	3,321
Finished goods	12,138	13,651
Total inventories	$ 26,537	$ 26,293

Deferred preservation costs at June 30, 2017 and December 31, 2016 are comprised of the following (in thousands):

	June 30, 2017	December 31, 2016
Cardiac tissues	$ 17,077	$ 15,768
Vascular tissues	16,897	14,920
Total deferred preservation costs	$ 33,974	$ 30,688

We maintain consignment inventory included in finished goods inventories above, of our On-X heart valves at domestic and international hospital locations to facilitate usage. We retain title to this consignment inventory until the valve is implanted, at which time we invoice the hospital. As of June 30, 2017 we had $5.4 million in consignment inventory, with approximately 83% in domestic locations and 17% in foreign locations. As of December 31, 2016 we had $4.9 million in consignment inventory with approximately 80% in domestic locations and 20% in foreign locations.

8. Goodwill and Other Intangible Assets

Indefinite Lived Intangible Assets

As of June 30, 2017 and December 31, 2016 the carrying values of our indefinite lived intangible assets are as follows (in thousands):

	June 30, 2017	December 31, 2016
Goodwill	$ 78,294	$ 78,294

Procurement contracts and agreements	2,013	2,013
Trademarks	841	841

Based on our experience with similar agreements, we believe that our acquired procurement contracts and agreements have indefinite useful lives, as we expect to continue to renew these contracts for the foreseeable future. We believe that our trademarks have indefinite useful lives as we currently anticipate that these trademarks will contribute to our cash flows indefinitely.

As of June 30, 2017 and December 31, 2016 our entire goodwill balance is related to our Medical Devices segment and there has been no change from the balance recorded as of December 31, 2016.

Definite Lived Intangible Assets

As of June 30, 2017 and December 31, 2016 the gross carrying values, accumulated amortization, and approximate amortization period of our definite lived intangible assets are as follows (in thousands):

June 30, 2017	Gross Value	Accumulated Amortization	Amortization Period
Acquired technology	$ 38,478	$ 7,062	11 22 Years
Patents	3,576	2,714	17 Years
Distribution and manufacturing rights and know-how	4,059	1,676	11 15 Years
Customer lists and relationships	29,140	2,840	13 22 Years
Other	1,370	796	3 Years

December 31, 2016	Gross Value	Accumulated Amortization	Amortization Period
Acquired technology	$ 38,478	$ 5,956	11 22 Years
Patents	3,710	2,702	17 Years
Distribution and manufacturing rights and know-how	4,059	1,532	11 15 Years
Customer lists and relationships	29,140	2,141	13 22 Years
Non-compete agreement	381	381	10 Years
Other	1,262	531	3 Years

Amortization Expense

The following is a summary of amortization expense as recorded in general, administrative, and marketing expenses on our Summary Consolidated Statement of Operations and Comprehensive Income (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Amortization expense	$ 1,141	$ 1,156	$ 2,283	$ 2,118

As of June 30, 2017 scheduled amortization of intangible assets for the next five years is as follows (in thousands):

	Remainder of 2017	2018	2019	2020	2021	2022
Amortization expense	$ 2,280	$ 4,444	$ 4,102	$ 3,939	$ 3,918	$ 3,390

9. Income Taxes

Income Tax Expense

Our effective income tax rate was 24% and 9% for the three and six months ended June 30, 2017, respectively, as compared to 39% and 51% for the three and six months ended June 30, 2016, respectively. Our income tax rate for the three and six months ended June 30, 2017 was favorably affected by excess tax benefits, primarily related to the exercise of non-qualified stock options and the vesting of stock awards, as discussed in Note 1 above, which decreased income tax expense by approximately $532,000 and $1.6 million, respectively.

Our income tax rate for the three and six months ended June 30, 2016 was unfavorably impacted by the tax treatment of certain expenses related to the On-X acquisition, which had a larger impact on the tax rate in first quarter of 2016. Our income tax rate for the six months ended June 30, 2016 was also unfavorably impacted by book/tax basis differences related to the HeRO Sale.

Deferred Income Taxes

We generate deferred tax assets primarily as a result of write-downs of inventory and deferred preservation costs; accruals for product and tissue processing liability claims; investment and asset impairments; and, in prior periods, due to operating losses. We acquired significant deferred tax assets, primarily net operating loss carryforwards, from our acquisitions of On-X in 2016, Hemosphere in 2012, and Cardiogenesis in 2011. We recorded significant deferred tax liabilities in 2016 related to the intangible assets acquired in the On-X acquisition.

As of June 30, 2017 we maintained a total of $2.2 million in valuation allowances against deferred tax assets, related to state net operating loss carryforwards, and had a net deferred tax asset of $148,000. As of December 31, 2016 we had a total of $2.2 million in valuation allowances against deferred tax assets, related to state net operating loss carryforwards, and a net deferred tax liability of $7,000.

10. Debt

Amended Debt Agreement

In connection with the closing of the On-X acquisition, discussed above in Note 4, on January 20, 2016, we and certain of our subsidiaries entered into the Third Amended and Restated Credit Agreement (Amended Debt Agreement) with Capital One, National Association, who acquired GE Capital s Healthcare Financial Services lending business in late 2015. The designated credit parties are Healthcare Financial Solutions, LLC; Fifth Third Bank; and Citizens Bank, National Association. The Amended Debt Agreement amended and restated our prior credit agreement and provides us with a senior secured credit facility in an aggregate principal amount of $95 million, which includes a $75 million term loan and a $20 million revolving credit facility (including a $4 million letter of credit sub-facility and a $3 million swing-line sub-facility). The $75 million term loan was used to finance, in part, the acquisition of On-X and will mature on January 20, 2021.

We and our domestic subsidiaries, subject to certain exceptions and exclusions, have guaranteed the obligations of the Amended Debt Agreement. Borrowings under the Amended Debt Agreement are secured by substantially all of CryoLife s, and certain of our subsidiaries , real and personal property.

The loans under the Amended Debt Agreement (other than the swing-line loans) bear interest, at our option, at either a floating rate equal to the base rate, as defined in the Amended Debt Agreement, plus a margin of between 1.75% and 2.75%, depending on our consolidated leverage ratio, or a per annum rate equal to LIBOR plus a margin of between 2.75% and 3.75%, depending on our consolidated leverage ratio. As of June 30, 2017 the aggregate interest rate was approximately 4.00%. Swing-line loans under the Amended Debt Agreement bear interest at a floating rate equal to the base rate plus a margin of between 1.75% and 2.75%, depending on our consolidated leverage ratio. We are obligated to pay an unused commitment fee equal to 0.50% of the un-utilized portion of the revolving loans. In addition, we are also obligated to pay other customary fees for a credit facility of this size and type. If and while a payment event of default exists, we are obligated to pay a per annum default rate of interest of 2.00% above the applicable interest rate on the past due principal amount of the loans outstanding. If and while a bankruptcy or insolvency event of default exists, we are obligated to pay a per annum default rate of interest of 2.00% above the applicable interest rate on all loans outstanding.

Interest is due and payable, with respect to base rate loans, on a quarterly basis. Interest is due and payable, with respect to LIBOR loans, on the last day of the applicable interest period, if the interest period is shorter than six months, or on the last day of each three month interval, if the interest period is six months or greater.

The Amended Debt Agreement prohibits us from exceeding a maximum consolidated leverage ratio during the term of the Amended Debt Agreement and requires us to maintain a minimum interest coverage ratio. In addition, the

Amended Debt Agreement contains certain customary affirmative and negative covenants, including covenants that limit our ability and the ability of our subsidiaries which are parties to the loan agreement to, among other things, grant liens; incur debt; dispose of assets; make loans and investments; make acquisitions; make certain restricted payments; merge or consolidate; and change our business and accounting or reporting practices, in each case subject to customary exceptions for a credit facility of this size and type. As of July 25, 2017 we and our subsidiaries were in compliance with the covenants of the Amended Debt Agreement.

The Amended Debt Agreement includes certain customary events of default that include, among other things, non-payment of principal, interest or fees; inaccuracy of representations and warranties; violation of covenants; cross-default on certain other indebtedness; bankruptcy and insolvency; and change of control. Upon the occurrence and during the continuance of an event of default, the lenders may declare all outstanding principal and accrued but unpaid interest under the Amended Debt Agreement immediately due and payable, and may exercise the other rights and remedies provided for under the Amended Debt Agreement and related loan documents.

As of both June 30, 2017 and December 31, 2016 there were no outstanding balances on our revolving credit facility and the remaining availability was $20.0 million. The short-term and long-term balances of our term loan are as follows (in thousands):

	June 30, 2017	December 31, 2016
Term loan balance	$ 70,616	$ 73,594
Less unamortized loan origination costs	(1,753)	(2,020)
Net borrowings	68,863	71,574
Less short-term loan balance	(3,228)	(4,562)
Long-term loan balance	$ 65,635	$ 67,012

Interest Expense

Interest expense was $834,000 and $1.6 million for the three and six months ended June 30, 2017, respectively, and $797,000 and $1.5 million for the three and six months ended June 30, 2016, respectively. Interest expense in 2017 and 2016 included interest on debt and uncertain tax positions.

11. Commitments and Contingencies

Liability Claims

Our estimated unreported loss liability was $1.5 million as of both June 30, 2017 and December 31, 2016. As of June 30, 2017 and December 31, 2016, the related recoverable insurance amounts were $686,000 and $626,000, respectively. We accrue our estimate of unreported product and tissue processing liability claims as a component of other long-term liabilities and record the related recoverable insurance amount as a component of other long-term assets, as appropriate. Further analysis indicated that the liability as of June 30, 2017 could have been estimated to be as high as $2.9 million, after including a reasonable margin for statistical fluctuations calculated based on actuarial simulation techniques.

Employment Agreements

The employment agreement of our Chairman, President, and Chief Executive Officer (CEO), Mr. J. Patrick Mackin, provides for a severance payment, which would become payable upon the occurrence of certain employment termination events, including termination by us without cause.

PerClot Technology

On September 28, 2010 we entered into a worldwide distribution agreement (the Distribution Agreement) and a license and manufacturing agreement (the License Agreement) with Starch Medical, Inc. (SMI), for PerClot, a polysaccharide hemostatic agent used in surgery. The Distribution Agreement has a term of 15 years, but can be terminated for any reason before the expiration date by us by providing 180 days notice. The Distribution Agreement also contains minimum purchase requirements that expire upon the termination of the Distribution Agreement or following U.S. regulatory approval for PerClot. Separate and apart from the terms of the Distribution Agreement,

pursuant to the License Agreement, as amended by a September 2, 2011 technology transfer agreement, we can manufacture and sell PerClot, assuming appropriate regulatory approvals, in the U.S. and certain other jurisdictions and may be required to pay royalties to SMI at certain rates on net revenues of products.

We may make contingent payments to SMI of up to $1.0 million if certain U.S. regulatory and certain commercial milestones are achieved.

We are conducting our pivotal clinical trial to gain approval to commercialize PerClot for surgical indications in the U.S. We resumed enrollment into the trial in the fourth quarter of 2016 and, assuming enrollment proceeds as anticipated, we could receive Premarket Approval from the FDA in 2019.

As of June 30, 2017 we had $1.5 million in prepaid royalties, $2.8 million in net intangible assets, and $1.3 million in property and equipment, net on our Summary Consolidated Balance Sheets related to the PerClot product line. If we do not ultimately pursue or receive FDA approval to commercialize PerClot in the U.S., these assets could be materially impaired in future periods.

12. Shareholders Equity

Change in Accounting for Employee Share-Based Payments

As discussed in Note 1 above, as a result of the adoption of ASU 2016-09, we recorded a net $238,000 cumulative-effect adjustment decrease to retained earnings, which included a $379,000 increase to additional paid in capital and a $141,000 increase in deferred tax assets.

Common Shares Issued

In January 2016 we issued 3,703,699 shares of CryoLife common stock, as part of the consideration for the acquisition of On-X. The stock had a value of $34.6 million as determined on the date of the closing. See Note 4 for further discussion of the On-X acquisition.

13. Stock Compensation

Overview

We have stock option and stock incentive plans for employees and non-employee Directors that provide for grants of restricted stock awards (RSAs), performance stock awards (PSAs), restricted stock units (RSUs), performance stock units (PSUs), and options to purchase shares of our common stock at exercise prices generally equal to the fair value of such stock at the dates of grant. We also maintain a shareholder-approved Employee Stock Purchase Plan (the ESPP) for the benefit of our employees. The ESPP allows eligible employees to purchase common stock on a regular basis at the lower of 85% of the market price at the beginning or end of each offering period.

Equity Grants

During the six months ended June 30, 2017 the Compensation Committee of our Board of Directors (the Committee) authorized awards from approved stock incentive plans of RSUs to certain employees and RSAs and PSUs to certain Company officers, which, assuming that performance under the PSUs were to be achieved at target levels, together totaled 312,000 shares and had an aggregate grant date market value of $5.4 million. The PSUs granted in 2017 represent the right to receive from 60% to 150% of the target number of shares of common stock. The performance component of PSU awards granted in 2017 is based on attaining specified levels of adjusted EBITDA, adjusted inventory levels, and trade accounts receivable days sales outstanding, each as defined in the PSU grant documents, for the 2017 calendar year. We currently believe that achievement of the performance component is probable, and we reevaluate this likelihood on a quarterly basis.

During the six months ended June 30, 2016 the Committee authorized awards from approved stock incentive plans of RSUs to certain employees and RSAs and PSUs to certain Company officers, which, including PSUs at target levels, together totaled 463,000 shares of common stock and had an aggregate grant date market value of $5.1 million. The PSUs granted in 2016 represented the right to receive from 60% to 150% of the target number of shares of common stock. The performance component of PSU awards granted in 2016 was based on attaining specified levels of adjusted EBITDA, adjusted inventory levels, and trade accounts receivable days sales outstanding, each as defined in the PSU grant documents, for the 2016 calendar year. The PSUs granted in 2016 earned 142% of the target number of shares.

The Committee authorized, from approved stock incentive plans, grants of stock options to purchase a total of 260,000 and 384,000 shares to certain Company officers during the six months ended June 30, 2017 and 2016, respectively. The exercise prices of the options were equal to the closing stock prices on their respective grant dates.

Employees purchased common stock totaling 45,000 shares in the three and six months ended June 30, 2017 and 38,000 shares in the three and six months ended June 30, 2016 through the ESPP.

Stock Compensation Expense

The following weighted-average assumptions were used to determine the fair value of options:

	Three Months Ended June 30, 2017		Six Months Ended June 30, 2017	
	Stock Options	**ESPP Options**	**Stock Options**	**ESPP Options**
Expected life of options	N/A	0.5 Years	4.75 Years	0.5 Years
Expected stock price volatility	N/A	0.35	0.40	0.35
Risk-free interest rate	N/A	0.62%	1.87%	0.62%

	Three Months Ended June 30, 2016		Six Months Ended June 30, 2016	
	Stock Options	**ESPP Options**	**Stock Options**	**ESPP Options**
Expected life of options	N/A	0.5 Years	4.75 Years	