CRYOLIFE INC
Form 10-Q
April 30, 2013

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 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 **March 31, 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: 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)

Not Applicable

(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 x 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 x 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 x
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 x

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 April 26, 2013**
Common Stock, $.01 par value per share	27,469,778 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 March 31,	
	2013	**2012**
	(Unaudited)	
Revenues:		
Products	$ 19,796	$ 16,454
Preservation services	15,677	15,659
Other	63	188
Total revenues	**35,536**	**32,301**
Cost of products and preservation services:		
Products	3,465	2,513
Preservation services	8,795	8,496
Total cost of products and preservation services	**12,260**	**11,009**
Gross margin	**23,276**	**21,292**
Operating expenses:		
General, administrative, and marketing	17,977	17,970
Research and development	1,988	1,693
Total operating expenses	**19,965**	**19,663**
Operating income	**3,311**	**1,629**
Interest expense	50	65
Interest income	(2)	(2)
Other expense (income), net	219	(15)
Income before income taxes	**3,044**	**1,581**
Income tax expense	852	590

Net income				
	$	**2,192**	$	**991**
Income per common share:				
Basic	$	**0.08**	$	**0.04**
Diluted	$	**0.08**	$	**0.04**
Dividends declared per share	$	**0.025**	$	--
Weighted-average common shares outstanding:				
Basic		26,861		27,180
Diluted		27,488		27,530
Net income	$	**2,192**	$	**991**
Other comprehensive (loss) income		(33)		2
Comprehensive income	$	**2,159**	$	**993**

See accompanying Notes to Summary Consolidated Financial Statements.

CRYOLIFE, INC. AND SUBSIDIARIES

SUMMARY CONSOLIDATED BALANCE SHEETS

(IN THOUSANDS)

	March 31, 2013 (Unaudited)	December 31, 2012
ASSETS		
Current assets:		
Cash and cash equivalents	$ 8,632	$ 13,009
Restricted securities	303	323
Receivables, net	19,878	16,520
Deferred preservation costs	26,869	27,954
Inventories	10,208	10,557
Deferred income taxes	5,637	6,100
Prepaid expenses and other	2,221	3,040
Total current assets	**73,748**	**77,503**
Property and equipment, net	11,744	11,667
Investment in equity securities	5,908	5,908
Restricted cash and securities	5,000	5,000
Goodwill	11,365	11,365
Patents, net	2,057	2,114
Trademarks and other intangibles, net	21,541	21,968
Notes receivable	2,000	2,000
Deferred income taxes	16,840	16,564
Other	3,513	3,067
Total assets	**$ 153,716**	**$ 157,156**
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 2,864	$ 3,775
Accrued compensation	2,807	5,055
Accrued procurement fees	4,409	4,762
Accrued expenses and other	5,190	6,437
Deferred income	1,313	1,401
Total current liabilities	**16,583**	**21,430**
Contingent consideration liability	1,951	1,912
Other	6,200	5,702
Total liabilities	**24,734**	**29,044**
Commitments and contingencies		

Shareholders equity:				
Preferred stock		--		--
Common stock (issued shares of 27,726 in 2013 and 27,486 in 2012)		277		275
Additional paid-in capital		123,284		122,414
Retained earnings		7,041		5,536
Accumulated other comprehensive loss		(72)		(39)
Treasury stock at cost (shares of 257 in 2013 and 14 in 2012)		(1,548)		(74)
Total shareholders equity		**128,982**		**128,112**
Total liabilities and shareholders equity	**$**	**153,716**	**$**	**157,156**

See accompanying Notes to Summary Consolidated Financial Statements.

CRYOLIFE, INC. AND SUBSIDIARIES

SUMMARY CONSOLIDATED STATEMENTS OF CASH FLOWS

(IN THOUSANDS)

	Three Months Ended March 31,	
	2013	**2012**
	(Unaudited)	
Net cash flows from operating activities:		
Net income	$ 2,192	$ 991
Adjustments to reconcile net income to net cash from operating activities:		
Depreciation and amortization	1,453	1,378
Non-cash compensation	782	753
Deferred income taxes	187	162
Other non-cash adjustments to income	398	136
Changes in operating assets and liabilities:		
Receivables	(3,321)	(802)
Deferred preservation costs and inventories	1,153	(736)
Prepaid expenses and other assets	373	74
Accounts payable, accrued expenses, and other liabilities	(4,386)	(151)
Net cash flows (used in) provided by operating activities	**(1,169)**	**1,805**
Net cash flows from investing activities:		
Capital expenditures	(988)	(700)
Other	(84)	(89)
Net cash flows used in investing activities	**(1,072)**	**(789)**
Net cash flows from financing activities:		
Cash dividends paid	(687)	--
Proceeds from exercise of stock options and issuance of common stock	229	142
Repurchases of common stock	(1,203)	(1,643)
Other	(474)	(66)
Net cash flows used in financing activities	**(2,135)**	**(1,567)**
Decrease in cash and cash equivalents	**(4,376)**	**(551)**
Effect of exchange rate changes on cash	(1)	(8)
Cash and cash equivalents, beginning of period	13,009	21,705

Cash and cash equivalents, end of period	**$**	**8,632**	**$**	**21,146**

See accompanying Notes to Summary Consolidated Financial Statements.

CRYOLIFE, INC. AND SUBSIDIARIES

NOTES TO SUMMARY CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

1. Basis of Presentation

The accompanying summary consolidated financial statements include the accounts of CryoLife, Inc. and its subsidiaries (CryoLife, the Company, we, or us). All significant intercompany accounts and transactions have been eliminated in consolidation. The accompanying Summary Consolidated Balance Sheet as of December 31, 2012 has been derived from audited financial statements. The accompanying unaudited summary consolidated financial statements as of and for the three months ended March 31, 2013 and 2012 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 months ended March 31, 2013 are not necessarily indicative of the results that may be expected for the year ending December 31, 2013. 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, 2012.

2. Financial Instruments

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

March 31, 2013	**Level 1**	**Level 2**	**Level 3**	**Total**
Cash equivalents:				
Money market funds	$ 716	$ --	$ --	$ 716
Restricted securities:				
Money market funds	303	--	--	303
Total assets	1,019	--	--	1,019
Long-term liabilities:				
Contingent consideration	--	--	(1,951)	(1,951)
Total liabilities	--	--	(1,951)	(1,951)
Net assets (liabilities)	$ 1,019	$ --	$ (1,951)	$ (932)

December 31, 2012	**Level 1**	**Level 2**	**Level 3**	**Total**
Cash equivalents:				
Money market funds	$ 1,319	$ --	$ --	$ 1,319
Restricted securities:				
Money market funds	323	--	--	323
Total assets	1,642	--	--	1,642
Long-term liabilities:				
Contingent consideration			(1,912)	(1,912)

Total liabilities	--	--	(1,912)	(1,912)
Net assets (liabilities)	$ 1,642	$ --	$ (1,912)	$ (270)

The Company used prices quoted from its investment management companies to determine the Level 1 valuation of its investments in money market funds and securities. The Company has changed the presentation of its December 31, 2012 money market funds to Level 1 from Level 2, consistent with its current year presentation. The Company recorded a contingent consideration liability, classified as Level 3, as a result of its acquisition of Hemosphere, Inc. (Hemosphere) in May 2012. Refer to Note 4 for further discussion of the Level 3 contingent consideration liability.

Changes in fair value of Level 3 liabilities are listed below (in thousands):

	Contingent Consideration
Balance as of December 31, 2012	$ 1,912
Loss on remeasurement of contingent consideration	39
Balance as of March 31, 2013	$ 1,951

3. Cash Equivalents and Restricted Cash and Securities

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

March 31, 2013	Cost Basis	Unrealized Holding Gains	Estimated Market Value
Cash equivalents:			
Money market funds	$ 716	$ --	$ 716
Restricted cash and securities:			
Cash	5,000	--	5,000
Money market funds	303	--	303
December 31, 2012			
Cash equivalents:			
Money market funds	$ 1,319	$ --	$ 1,319
Restricted cash and securities:			
Cash	5,000	--	5,000
Money market funds	323	--	323

As of March 31, 2013 and December 31, 2012 $303,000 and $323,000, respectively, of the Company s money market funds were designated as short-term restricted securities due to a contractual commitment to hold the securities as pledged collateral relating to international tax obligations. As of March 31, 2013 and December 31, 2012 $5.0 million of the Company s cash was designated as long-term restricted cash and securities due to a financial covenant requirement under the Company s credit agreement with General Electric Capital Corporation (GE Capital) as discussed in Note 11. This restriction lapses upon expiration of the credit agreement with GE Capital on October 28, 2014.

There were no gross realized gains or losses on cash equivalents in the three months ended March 31, 2013 and 2012. As of March 31, 2013 $303,000 of restricted securities had a maturity date of between three months and one year. As of December 31, 2012 $323,000 of restricted securities had a maturity date within three months. As of March 31, 2013 and December 31, 2012 $5.0 million of the Company s restricted cash had no maturity date.

4. Hemosphere Acquisition

Overview

On May 16, 2012 CryoLife completed its acquisition of 100% of the outstanding equity of Hemosphere, a privately held company, for $17.0 million in cash, an additional $3.2 million to pay for cash acquired, and contingent consideration with a fair value estimated to be approximately $1.8 million at acquisition, for a total purchase price of approximately $22.0 million. CryoLife used cash on hand to fund the transaction and operates Hemosphere as a wholly owned subsidiary.

Hemosphere is the developer and marketer of the Hemodialysis Reliable Outflow Graft (HeRO® Graft), a proprietary graft-based solution for end-stage renal disease hemodialysis patients with limited access options and central venous obstruction.

Contingent Consideration

As of the acquisition date, CryoLife recorded a contingent consideration liability of $1.8 million in long-term liabilities on its Summary Consolidated Balance Sheet, representing the estimated fair value of the contingent consideration expected to be paid to the

former shareholders of Hemosphere upon the achievement of certain revenue-based milestones. The acquisition agreement provides for a maximum of $4.5 million in future consideration payments through December 2015 based on specified sales targets.

The fair value of the contingent consideration liability was based on unobservable inputs, including management estimates and assumptions about future revenues, and is, therefore, classified as Level 3 within the fair value hierarchy presented in Note 2. The Company will remeasure this liability at each reporting date and will record changes in the fair value of the contingent consideration in other expense (income), net on the Company s Summary Consolidated Statement of Operations and Comprehensive Income. Increases or decreases in the fair value of the contingent consideration liability can result from changes in discount periods and rates, as well as changes in the timing and amount of Company revenue estimates.

The Company recorded a loss of $39,000 for the three months ended March 31, 2013 on the remeasurement of the contingent consideration liability. The balance of the contingent consideration liability was $2.0 million as of March 31, 2013.

Accounting for the Transaction

The Company recorded an allocation of the $22.0 million purchase price to Hemosphere s tangible and identifiable intangible assets acquired and liabilities assumed based on their fair values as of May 16, 2012. Goodwill has been recorded based on the amount by which the purchase price exceeds the fair value of the net assets acquired, and is not deductible for tax purposes. Goodwill from this transaction has been allocated to the Company s medical devices segment. The purchase price allocation was finalized as of December 31, 2012.

CryoLife incurred transaction and integration costs related to the acquisition of approximately $2.4 million for the year ended December 31, 2012. These costs were expensed as incurred and were primarily recorded as general, administrative, and marketing expenses on the Company s Summary Consolidated Statement of Operations and Comprehensive Income. The Company incurred integration costs during the three months ended March 31, 2013 related to the transfer of manufacturing operations, which may continue into the second quarter of 2013. The Company does not expect to continue to incur significant transaction or integration costs in the second half of 2013.

5. ValveXchange Investment

In July 2011 the Company purchased shares of series A preferred stock of ValveXchange, Inc. (ValveXchange) for approximately $3.5 million. ValveXchange is a private medical device company that was spun off from Cleveland Clinic to develop a lifetime heart valve replacement technology platform featuring exchangeable bioprosthetic leaflets. The Company s carrying value of this investment includes the purchase price and certain transaction costs, and CryoLife s investment represents an approximate 19% equity ownership in ValveXchange. As ValveXchange s stock is not actively traded on any public stock exchange and as the Company s investment is in preferred stock, the Company accounts for this investment using the cost method. The Company recorded its investment as a long-term asset, investment in equity securities, on the Company s Summary Consolidated Balance Sheets.

During the quarter ended March 31, 2013 the Company reviewed available information and determined that no factors were present indicating that the Company should evaluate the carrying value of its cost method investment in ValveXchange preferred stock for impairment. The carrying value of the Company s 2.4 million shares of ValveXchange preferred stock was $3.2 million as of March 31, 2013.

Loan Agreement

In July 2011 the Company entered into an agreement with ValveXchange, as amended, to make available up to $2.0 million to ValveXchange in debt financing through a revolving credit facility (ValveXchange Loan). The ValveXchange Loan includes various affirmative and negative covenants, including financial covenant requirements, and expires on July 30, 2018, unless terminated earlier. Amounts loaned under the ValveXchange Loan will earn interest at an 8% annual rate and are secured by substantially all of the tangible and intangible assets of ValveXchange. The Company incurred loan origination costs, net of fees charged to ValveXchange, of approximately $117,000, which are being expensed on a straight-line basis over the life of the loan facility. The Company advanced $1.0 million to ValveXchange under this loan in July 2012 and advanced the remaining $1.0 million in October 2012. The $2.0 million advance is recorded as long-term notes receivable on the Company s Summary Consolidated Balance Sheet as of March 31, 2013. The Company may decide to allow ValveXchange to issue shares in payment of some or all of the outstanding debt balance in connection with a future round of financing.

Option Agreement

Concurrently with the ValveXchange Loan described above, CryoLife entered into an option agreement with ValveXchange through which CryoLife obtained the right of first refusal to acquire ValveXchange during a period that extends through the completion of initial commercialization milestones and the right to negotiate with ValveXchange for European distribution rights. The Company s rights may be modified or reduced in connection with a future round of financing.

6. CardioFocus Settlement

On June 14, 2012 Cardiogenesis Corporation (Cardiogenesis) entered into a settlement agreement with respect to its litigation with CardioFocus, Inc. (CardioFocus). Pursuant to the terms of the settlement agreement, Cardiogenesis paid $4.5 million in cash to CardioFocus. Cardiogenesis and CardioFocus agreed and acknowledged that each party would bear its own costs and expenses, including attorneys fees, incurred in or as a result of the litigation. On June 14, 2012 the parties filed a stipulation of dismissal with prejudice in the U.S. District Court for the District of Massachusetts.

As a result of the settlement, the Company recorded an additional loss of $3.6 million in general, administrative, and marketing expenses on its Summary Consolidated Statement of Operations and Comprehensive Income in the second quarter of 2012 for a total of $4.1 million in legal settlement expenses for the year ended December 31, 2012. The Company paid the $4.5 million settlement payment to CardioFocus in July 2012 using cash on hand.

7. Medafor Matters

Investment in Medafor Common Stock

In 2009 and 2010 CryoLife purchased shares of common stock in Medafor, Inc. (Medafor). As financial information for Medafor is not readily available and as the Company does not exert significant influence over the operations of Medafor, the Company accounted for its investment in Medafor common stock using the cost method. The Company recorded the stock as a long-term asset, investment in equity securities, on the Company s Summary Consolidated Balance Sheets.

During the quarter ended March 31, 2013 the Company reviewed available information and determined that no factors were present indicating that the Company should evaluate the carrying value of its cost method investment in Medafor common stock for impairment. The carrying value of the Company s 2.4 million shares of Medafor common stock was approximately $2.6 million as of both March 31, 2013 and December 31, 2012.

In connection with its purchase of Medafor common stock, the Company entered into agreements with the sellers that could require CryoLife to make additional payments to the sellers if CryoLife acquired or merged with Medafor within a specified time period. The last of these provisions will expire in June 2013. The Company accounted for these provisions as an embedded derivative. CryoLife used a Black-Scholes model to value the embedded derivative, using assumptions as to the likelihood and the valuation of any additional required payments. The Company recorded the fair value of the embedded derivative as an increase to the investment in equity securities and a corresponding derivative liability on the Company s Summary Consolidated Balance Sheets.

As of March 31, 2013 and December 31, 2012 the Company believed that the likelihood of a Triggering Event was remote and the value of the Medafor Derivative was zero.

Distribution Agreement and Legal Action

CryoLife distributed a powdered hemostat for Medafor from 2008 to 2010. CryoLife filed a lawsuit against Medafor in 2009 in the U.S. District Court for the Northern District of Georgia (Georgia Court). In 2010 Medafor filed counterclaims against CryoLife in the same case. The litigation related to an exclusive distribution agreement that the parties entered into in April 2008.

In June 2012 the parties entered into a settlement agreement. Per the settlement, Medafor paid $3.5 million in cash to CryoLife in the third quarter of 2012. On June 29, 2012 the parties jointly filed stipulated dismissals with prejudice with the Georgia Court. As a result of the settlement, CryoLife recorded a gain of $4.7 million as a reduction in general, administrative, and marketing expenses on its Summary Consolidated Statement of Operations and Comprehensive Income in the second quarter of 2012 and recorded a reduction in accounts payable of $1.2 million to write off a payable for previous inventory purchases, which was discharged pursuant to the settlement agreement.

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CryoLife received a letter from Medafor in September 2012 stating that PerClot®, when introduced in the U.S., will, when used in accordance with the method published in CryoLife s literature and with the instructions for use, infringe Medafor s U.S. patent. CryoLife does not believe that it will infringe Medafor s patent. There have been no further communications between CryoLife and Medafor related to the September letter.

8. Deferred Preservation Costs and Inventories

Deferred preservation costs at March 31, 2013 and December 31, 2012 are comprised of the following (in thousands):

	March 31, 2013	December 31, 2012
Cardiac tissues	$ 12,146	$ 11,950
Vascular tissues	14,723	16,004
Total deferred preservation costs	$ 26,869	$ 27,954

Inventories at March 31, 2013 and December 31, 2012 are comprised of the following (in thousands):

	March 31, 2013	December 31, 2012
Raw materials and supplies	$ 6,537	$ 5,836
Work-in-process	797	830
Finished goods	2,874	3,891
Total inventories	$ 10,208	$ 10,557

9. Goodwill and Other Intangible Assets

Indefinite Lived Intangible Assets

As of March 31, 2013 and December 31, 2012 the carrying values of the Company s indefinite lived intangible assets are as follows (in thousands):

	March 31, 2013	December 31, 2012
Goodwill	$ 11,365	$ 11,365
Procurement contracts and agreements	2,013	2,013
Trademarks	876	870
Other	250	250

Based on its experience with similar agreements, the Company believes that its acquired contracts and procurement agreements have an indefinite useful life, as the Company expects to continue to renew these contracts for the foreseeable future. The Company believes that its trademarks and other acquired technology have an indefinite useful life as the Company currently anticipates that these trademarks and other acquired technology will contribute to cash flows of the Company indefinitely.

As of March 31, 2013 and December 31, 2012 the Company s entire goodwill balance is related to the Company s Medical Devices segment and there has been no change from the balance recorded as of December 31, 2012.

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Definite Lived Intangible Assets

As of March 31, 2013 and December 31, 2012 the gross carrying values, accumulated amortization, and approximate amortization period of the Company s indefinite lived intangible assets are as follows (in thousands):

March 31, 2013	**Gross Carrying Value**	**Accumulated Amortization**	**Amortization Period**
Acquired technology	$ 14,020	$ 1,823	11-16 Years
Patents	4,666	2,609	17 Years
Distribution and manufacturing rights and know-how	3,559	534	15 Years
Customer lists and relationships	3,370	391	13-17 Years
Non-compete agreement	381	238	10 Years
Other	189	131	1-3 Years

December 31, 2012	**Gross Carrying Value**	**Accumulated Amortization**	**Amortization Period**
Acquired technology	$ 14,020	$ 1,538	11-16 Years
Patents	4,644	2,530	17 Years
Distribution and manufacturing rights and know-how	3,559	473	15 Years
Customer lists and relationships	3,370	330	13-17 Years
Non-compete agreement	381	229	10 Years
Other	198	123	1-3 Years

Amortization Expense

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

	Three Months Ended March 31,	
	2013	**2012**
Amortization expense	$ 514	$ 459

As of March 31, 2013 scheduled amortization of intangible assets for the next five years is as follows (in thousands):

	Remainder of 2013	**2014**	**2015**	**2016**	**2017**	**2018**
Amortization expense	$ 1,495	$ 1,953	$ 1,911	$ 1,903	$ 1,854	$ 1,847

10. Income Taxes

The Company s effective income tax rate was approximately 28% for the three months ended March 31, 2013 as compared to 37% for the three months ended March 31, 2012. The Company s income tax rate in 2013 was favorably impacted by the full year 2012 research and development tax credit, which was enacted in January 2013 and, therefore, reduced the Company s tax expense during the first quarter of 2013. The Company s income tax rate in 2012 was negatively impacted by the absence of a research and development tax credit, which was not enacted for the 2012 tax year during 2012.

Deferred income taxes reflect the net tax effect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and tax return purposes. The Company generates deferred tax assets primarily as a result of book write-downs, reserves, or impairments which are not immediately deductible for tax return purposes. The Company acquired significant deferred tax assets, primarily net operating loss carryforwards, from its acquisitions of Hemosphere and Cardiogenesis in the second quarters of 2012 and 2011, respectively. The Company currently estimates that a portion of its state net operating loss carryforwards will not be recoverable and has, therefore, recorded a valuation allowance against these state net operating loss carryforwards.

As of March 31, 2013 the Company maintained a total of $2.3 million in valuation allowances against deferred tax assets, related to state net operating loss carryforwards, and a net deferred tax asset of $22.5 million. As of December 31, 2012 the Company had a total of $2.3 million in valuation allowances against deferred tax assets and a net deferred tax asset of $22.7 million.

11. Debt

GE Credit Agreement

CryoLife s amended and restated credit agreement with GE Capital (the GE Credit Agreement) provides revolving credit for working capital, acquisitions, and other corporate purposes. The GE Credit Agreement has a borrowing capacity of $20.0 million (including a letter of credit subfacility) and expires on October 28, 2014. The commitment may be reduced or increased from time to time pursuant to the terms of the GE Credit Agreement.

The GE Credit Agreement places limitations on the amount that the Company may borrow and includes various affirmative and negative covenants, including financial covenants such as a requirement that CryoLife (i) not exceed a defined leverage ratio, (ii) maintain a minimum adjusted earnings subject to defined adjustments as of specified dates, and (iii) not make or commit capital expenditures in excess of a defined limitation. The agreement also limits the payment of cash dividends, up to a maximum of $3.0 million per year, subject to satisfaction of specified conditions. As required under the terms of the GE Credit Agreement, the Company is maintaining cash and cash equivalents of at least $5.0 million in accounts in which GE Capital has a first priority perfected lien. These amounts are recorded as restricted cash as of March 31, 2013 and December 31, 2012 on the Company s Summary Consolidated Balance Sheets, as they are restricted for the term of the GE Credit Agreement. Also, the GE Credit Agreement requires that after giving effect to a stock repurchase the Company maintain liquidity, as defined within the agreement, of at least $20.0 million. The GE Credit Agreement includes customary conditions on incurring new indebtedness. Commitment fees are paid based on the unused portion of the facility. As of March 31, 2013 the Company was in compliance with the covenants of the GE Credit Agreement.

Amounts borrowed under the GE Credit Agreement are secured by substantially all of the tangible and intangible assets of CryoLife and its subsidiaries and bear interest as determined by GE Capital at either LIBOR, with a minimum rate of 4.25%, or GE Capital s base rate, with a minimum rate of 3.25% each, plus the applicable margin. As of March 31, 2013 and December 31, 2012 the outstanding balance of the GE Credit Agreement was zero, the aggregate interest rate was 6.50%, and the remaining availability was $20.0 million.

Other

Interest expense was $50,000 and $65,000 for the three months ended March 31, 2013 and March 31, 2012, respectively, which included interest on debt and uncertain tax positions.

12. Commitments and Contingencies

Liability Claims

The estimated unreported tissue processing and product loss liability and any related recoverable insurance amounts are as follows (in thousands):

	March 31, 2013	December 31, 2012
Short-term liability	$ 871	$ 895
Long-term liability	797	755
Total liability	1,668	1,650
Short-term recoverable	314	320
Long-term recoverable	321	300

Total recoverable		635		620
Total net unreported loss liability	$	1,033	$	1,030

Further analysis indicated that the liability as of March 31, 2013 could be estimated to be as high as $3.1 million, after including a reasonable margin for statistical fluctuations calculated based on actuarial simulation techniques.

Employment Agreement

The Company has an employment agreement with its Chief Executive Officer (CEO) that confers benefits which become payable upon the occurrence of certain events, including the voluntary retirement of the CEO or termination of the CEO s employment in conjunction with certain change in control events. As of both March 31, 2013 and December 31, 2012 the Company had $2.1 million in accrued expenses and other current liabilities on the Summary Consolidated Balance Sheets representing benefits payable upon the CEO s voluntary retirement, for which he is currently eligible. The CEO s current employment agreement took effect on January 1, 2013 and terminates on December 31, 2015. A payment of $100,000 was made to the CEO in January 2013 in accordance with the terms of the new employment agreement.

13. Shareholders Equity

Common Stock Repurchase

On November 1, 2011 the Company announced that its Board of Directors had authorized the Company s purchase of $15.0 million of its common stock; this program expired on December 31, 2012. In February 2013 the Company s Board of Directors authorized the purchase of up to $15.0 million of its common stock through October 31, 2014.

For the three months ended March 31, 2013 the Company purchased approximately 199,000 shares for an aggregate purchase price of $1.2 million and had $13.8 million in remaining authorizations under the repurchase program. For the year ended December 31, 2012 the Company purchased approximately 639,000 shares for an aggregate purchase price of $3.3 million. These shares were recorded, at cost, as part of treasury stock on the Company s Summary Consolidated Balance Sheets.

Treasury Stock

On August 7, 2012 the Company retired 2.7 million shares of treasury stock with an aggregate value of $15.1 million. The retirement was recorded as a reduction of $15.1 million in treasury stock, $27,000 in common stock, and approximately $15.1 million in additional paid in capital. These shares remain available for issuance as authorized unissued shares.

Cash Dividends

On August 21, 2012 the Company announced that its Board of Directors had approved the initiation of a quarterly cash dividend of $0.025 per share of common stock outstanding. The Company paid dividend payments from cash on hand of $687,000 for the three months ended March 31, 2013 and zero for the three months ended March 31, 2012. The dividend payments were recorded as a reduction to retained earnings on the Company s Summary Consolidated Balance Sheet.

14. Stock Compensation

Overview

The Company has stock option and stock incentive plans for employees and non-employee Directors that provide for grants of restricted stock awards (RSA s), restricted stock units (RSU s), performance stock units (PSU s), and options to purchase shares of Company common stock at exercise prices generally equal to the fair values of such stock at the dates of grant. The Company also maintains a shareholder approved Employee Stock Purchase Plan (the ESPP) for the benefit of its employees. The ESPP allows eligible employees the right 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

The Compensation Committee of the Company s Board of Directors authorized awards from approved stock incentive plans of RSAs and PSUs to certain Company officers, which, counting PSUs at target levels, together totaled 324,000 shares and had an aggregate market value of $1.9 million during the three months ended March 31, 2013. The PSUs granted in 2013 represent the right to receive from 50% to 150% of the target numbers of shares of common stock. The performance component of PSU awards granted in 2013 is based on attaining specified levels of adjusted EBITDA, as defined in the grant, for the 2013 calendar year. The Company currently believes that achievement of the performance component is probable, and will reevaluate this likelihood on a quarterly basis.

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The Compensation Committee of the Company s Board of Directors authorized awards from approved stock incentive plans of RSAs and PSUs to certain Company officers which, counting PSUs at target levels, together totaled 317,000 shares of common stock and had an aggregate market value of $1.7 million during the three months ended March 31, 2012. The PSU s granted in 2012 earned approximately 125% of the target number of shares.

The Compensation Committee of the Company s Board of Directors authorized grants of stock options from approved stock incentive plans to certain Company officers totaling 162,000 and 159,000 shares during the three months ended March 31, 2013 and 2012, respectively, with exercise prices equal to the stock prices on the respective grant dates.

Employees purchased common stock totaling 49,000 and 35,000 shares in the three months ended March 31, 2013 and 2012, respectively, through the Company s ESPP.

Stock Compensation Expense

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

	Three Months Ended March 31, 2013		Three Months Ended March 31, 2012	
	Stock Options	**ESPP Options**	**Stock Options**	**ESPP Options**
Expected life of options	4.25 Years	.50 Years	4.25 Years	.50 Years
Expected stock price volatility	0.60	0.43	0.60	0.54
Dividends	1.91%	1.61%	N/A	N/A
Risk-free interest rate	0.70%	0.16%	0.71%	0.06%

The following table summarizes stock compensation expenses (in thousands):

	Three Months Ended March 31,	
	2013	**2012**
RSA, RSU, and PSU expense	$ 635	$ 491
Stock option and ESPP option expense	211	317
Total stock compensation expense	$ 846	$ 808

Included in the total stock compensation expense, as applicable in each period, were expenses related to RSAs, RSUs, PSUs, and stock options issued in each respective year, as well as those issued in prior periods that continue to vest during the period, and compensation related to the Company s ESPP. These amounts were recorded as stock compensation expense and were subject to the Company s normal allocation of expenses to deferred preservation costs and inventory costs. The Company capitalized $64,000 and $55,000 in the three months ended March 31, 2013 and 2012, respectively, of the stock compensation expense into its deferred preservation costs and inventory costs.

As of March 31, 2013 the Company had total unrecognized compensation costs of $1.1 million related to unvested stock options and $3.7 million related to RSAs, RSUs, and PSUs, before considering the effect of expected forfeitures. As of March 31, 2013 this expense is expected to be recognized over a weighted-average period of 1.86 years for stock options, 1.55 years for RSAs, 2.00 years for RSUs, and 1.56 years for PSUs.

15. Income Per Common Share

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

	Three Months Ended March 31,	
Basic income per common share	**2013**	**2012**
Net income	$ 2,192	$ 991
Net income allocated to participating securities	(50)	(21)
Net income allocated to common shareholders	$ 2,142	$ 970
Basic weighted-average common shares outstanding	26,861	27,180
Basic income per common share	$ 0.08	$ 0.04

	Three Months Ended March 31,	
Diluted income per common share	**2013**	**2012**
Net income	$ 2,192	$ 991
Net income allocated to participating securities	(50)	(21)
Net income allocated to common shareholders	$ 2,142	$ 970
Basic weighted-average common shares outstanding	26,861	27,180
Effect of dilutive stock options and awards[a]	627	350
Diluted weighted-average common shares outstanding	27,488	27,530
Diluted income per common share	$ 0.08	$ 0.04

[a] The Company excluded stock options from the calculation of diluted weighted-average common shares outstanding if the per share value, including the sum of (i) the exercise price of the options and (ii) the amount of the compensation cost attributed to future services and not yet recognized, was greater than the average market price of the shares because the inclusion of these stock options would be antidilutive to income per common share. Accordingly, stock options to purchase a weighted-average 1.2 million shares and 1.8 million shares for the three months ended March 31, 2013 and 2012, respectively, were excluded from the calculation of diluted weighted-average common shares outstanding.

16. Segment Information

The Company has two reportable segments organized according to its products and services: Medical Devices and Preservation Services. The Medical Devices segment includes external revenues from product sales of BioGlue® Surgical Adhesive (BioGlue), BioFoam® Surgical Matrix (BioFoam), PerClot, revascularization technologies, and HeRO Graft. The Preservation Services segment includes external services revenues from the preservation of cardiac and vascular tissues. There are no intersegment revenues.

The primary measure of segment performance, as viewed by the Company s management, is segment gross margin, or net external revenues less cost of products and preservation services. The Company does not segregate assets by segment; therefore, asset information is excluded from the segment disclosures below. The following table summarizes revenues, cost of products and services, and gross margins for the Company s operating segments (in thousands):

	Three Months Ended March 31,	
	2013	2012
Revenues:		
Medical devices	$ 19,796	$ 16,454
Preservation services	15,677	15,659
Other[a]	63	188
Total revenues	35,536	32,301
Cost of products and preservation services:		
Medical devices	3,465	2,513
Preservation services	8,795	8,496
Total cost of products and preservation services	12,260	11,009
Gross margin:		
Medical devices	16,331	13,941
Preservation services	6,882	7,163
Other[a]	63	188
Total gross margin	$ 23,276	$ 21,292

The following table summarizes net revenues by product and service (in thousands):

	Three Months Ended March 31,	
	2013	2012
Products:		
BioGlue and BioFoam	$ 15,464	$ 13,696
PerClot	864	644
Revascularization technologies	2,191	2,114
HeRO Graft	1,277	--
Total products	19,796	16,454
Preservation services:		
Cardiac tissue	6,645	7,080
Vascular tissue	9,032	8,579
Total preservation services	15,677	15,659
Other[a]	63	188
Total revenues	$ 35,536	$ 32,301

[a] For the three months ended March 31, 2013 and 2012 the Other designation includes grant revenue.

PART I - FINANCIAL INFORMATION

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

Overview

CryoLife, Inc. (CryoLife, the Company, we, or us), incorporated in 1984 in Florida, develops, manufactures, and commercializes medical devices for cardiac and vascular applications and preserves and distributes human tissues for transplantation. CryoLife s surgical sealants and hemostats include BioGlue® Surgical Adhesive (BioGlue), BioFoam® Surgical Matrix (BioFoam), and PerClot®, an absorbable powdered hemostat, which the Company distributes for Starch Medical, Inc. in the European Community and other select international markets. CryoLife s subsidiary, Cardiogenesis Corporation (Cardiogenesis), specializes in the treatment of coronary artery disease using a laser console system and single use, fiber-optic handpieces to treat patients with severe angina. CryoLife and its subsidiary, Hemosphere, Inc. (Hemosphere), market the Hemodialysis Reliable Outflow Graft (HeRO® Graft), which is a solution for end-stage renal disease in certain hemodialysis patients. The cardiac and vascular human tissues distributed by CryoLife include the CryoValve® SG pulmonary heart valve (CryoValve SGPV) and the CryoPatch® SG pulmonary cardiac patch tissue (CryoPatch SG), both processed using CryoLife s proprietary SynerGraft® technology.

For the quarter ended March 31, 2013 CryoLife had all time record quarterly revenues of $35.5 million, led by sales of BioGlue. BioGlue revenues were $15.4 million during the quarter, which is the Company s largest BioGlue quarter ever. Revascularization technologies revenues were $2.2 million for the quarter, an increase over both the prior quarter and the previous year s first quarter. Preservation services revenues were flat in the first quarter of 2013 as compared to the same quarter in 2012. The Company experienced a decrease in its cash position during the quarter as increased working capital needs drove a $1.2 million decrease in operating cash during the quarter. See the Results of Operations section below for additional analysis of the three months ended March 31, 2013.

Recent Events

On January 30, 2013 CryoLife received a warning letter (Warning Letter) dated January 29, 2013 from the U.S. Food and Drug Administration (FDA). The Warning Letter followed a Form 483, Notice of Inspectional Observations from the FDA (Form 483) related to the Company s processing, preservation, and distribution of human tissue and the manufacture of medical devices. The Form 483 followed a routine quality system inspection of the Company s facilities by the FDA during the period September 17, 2012 to October 16, 2012. The Warning Letter relates to certain Observations from the Form 483 that the FDA believes were either inadequately addressed by the Company s responses or for which the FDA required further information to fully assess the Company s corrective actions. The Company has responded to the FDA s requests and has implemented and continues to implement changes that it believes will address the FDA s notice of violations contained in the Warning Letter; however, it is possible that the Company may not be able to do so in a manner satisfactory to the FDA. The Company believes that the Warning Letter and its actions regarding the Warning Letter and Form 483 will not have a material impact on the Company. However, it is possible that actions it may be required to take in response to the Form 483 and Warning Letter could materially, adversely impact the availability of the Company s tissues and products and cost structure, which could impact the Company s revenues, financial condition, profitability, or cash flows.

Following the receipt of the Warning Letter, CryoLife received a letter from the Human Tissue Authority (HTA) in London, UK, on March 28, 2013 which governs the distribution of tissues by the Company s subsidiary CryoLife Europa, Ltd. (Europa) into markets in Europe. The letter temporarily suspended Europa s license to import human tissue, due to concerns the HTA had related to the FDA Warning Letter, and directs Europa to issue a recall for tissues previously distributed which have not been implanted. The HTA subsequently issued a variance to allow Europa to continue to import tissue into Europe under certain circumstances for critically ill patients. This three month suspension could be extended or ended earlier based on the Company s ability to address the HTA s concerns. The suspension is expected to decrease European preservation services revenues, which totaled $2.3 million in 2012 and $444,000 in the first quarter of 2013, and were primarily related to the shipment of cardiac tissues. However, due to the low fees and high costs of distributing tissues into Europe, CryoLife does not believe that this suspension, including the related recall expenses, will have a material, adverse impact on the Company s financial condition, profitability, or cash flows.

In March 2013 the Company received FDA 510(k) clearance for a next generation HeRO device. CryoLife anticipates launching the next generation HeRO device during the fourth quarter of 2013 following scale up and validation of the manufacturing process.

Critical Accounting Policies

A summary of the Company s significant accounting policies is included in Note 1 of the Notes to Consolidated Financial Statements, contained in the Company s Form 10-K for the year ended December 31, 2012. Management believes that the consistent application of these policies enables the Company to provide users of the financial statements with useful and reliable information about the Company s operating results and financial condition. The summary consolidated financial statements are prepared in accordance with accounting principles generally accepted in the U.S., which require the Company to make estimates and assumptions. The Company did not experience any significant changes during the quarter ended March 31, 2013 in any of its Critical Accounting Policies from those contained in the Company s Form 10-K for the year ended December 31, 2012.

New Accounting Pronouncements

In January 2013 the Company adopted Accounting Standards Update (ASU), 2012-02, Intangibles-Goodwill and Other (Topic 350): *Testing Indefinite-Lived Intangible Assets for Impairment*, which gives entities testing indefinite-lived intangible assets for impairment the option of performing a qualitative assessment before performing the quantitative impairment test as well as the option to bypass the qualitative assessment in any period and proceed directly to performing the quantitative impairment test. The adoption of ASU 2012-02 did not have a material effect on the Company s financial condition, profitability, or cash flows.

In February 2013 the Company adopted ASU 2013-02, Comprehensive Income (Topic 220): *Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*, which requires separate presentation of the components that are reclassified out of accumulated other comprehensive income either on the face of the financial statements or in the notes to the financial statements. This update also requires companies to disclose the income statement line items impacted by any significant reclassifications.

Results of Operations

(Tables in thousands)

Revenues

	Revenues for the Three Months Ended March 31,		Revenues as a Percentage of Total Revenues for the Three Months Ended March 31,	
	2013	**2012**	**2013**	**2012**
Products:				
BioGlue and BioFoam	$ 15,464	$ 13,696	44%	42%
PerClot	864	644	2%	2%
Revascularization technologies	2,191	2,114	6%	7%
HeRO Graft	1,277	--	4%	--%
Total products	19,796	16,454	56%	51%
Preservation services:				
Cardiac tissue	6,645	7,080	19%	22%
Vascular tissue	9,032	8,579	25%	26%
Total preservation services	15,677	15,659	44%	48%
Other	63	188	--%	1%
Total	$ 35,536	$ 32,301	100%	100%

Revenues increased 10% for the three months ended March 31, 2013 as compared to the three months ended March 31, 2012. A detailed discussion of the changes in product revenues, preservation services revenues, and other revenues for the three months ended March 31, 2013 is presented below.

Products

Revenues from products increased 20% for the three months ended March 31, 2013 as compared to the three months ended March 31, 2012. This increase for the three months ended March 31, 2013 was primarily due to an increase in BioGlue revenues and the addition of HeRO Graft revenues as a result of the Company s acquisition of Hemosphere in the second quarter of 2012.

A detailed discussion of the changes in product revenues for BioGlue and BioFoam; PerClot; revascularization technologies; and HeRO Graft are presented below.

BioGlue and BioFoam

Revenues from the sale of surgical sealants, consisting of BioGlue and BioFoam, increased 13% for the three months ended March 31, 2013 as compared to the three months ended March 31, 2012. This increase was primarily due to a 15% increase in the volume of milliliters sold, which increased revenues by 11%, and by an increase in average sales prices, which increased revenues by 2%.

The increase in sales volume of surgical sealants for the three months ended March 31, 2013 was due to an increase in shipments of BioGlue in certain international markets, primarily Japan and, to a lesser extent, Europe. Revenues from shipments to Japan were $2.4 million and $1.2 million for the three months ended March 31, 2013 and 2012, respectively. These increases were partially offset by volume decreases in the Company s more mature domestic markets.

Management believes that the decrease in BioGlue shipments in its domestic markets is a result of various factors, including: continued economic pressures on hospitals and the resulting attempts by hospitals to control costs by reducing spending on consumable items such as BioGlue, the efforts of some large competitors in imposing and enforcing contract purchasing requirements for competing non-CryoLife products, and the U.S. market introduction of sealant products with approved indications for use in clinical applications in which BioGlue has been used off-label previously.

The Company s sales of surgical sealants through its direct sales force to U.K. hospitals are denominated in British Pounds, and its sales to German, Austrian, and Irish hospitals and certain distributors are denominated in Euros and are, therefore, subject to changes in foreign exchange rates. If the exchange rates between the U.S. Dollar and the British Pound or Euro decline materially in the future, this would have a material, adverse impact on the Company s revenues denominated in these currencies.

Domestic revenues accounted for 52% of total BioGlue revenues for the three months ended March 31, 2013, and 60% of total BioGlue revenues for the three months ended March 31, 2012. BioFoam sales accounted for less than 1% of surgical sealant sales for the three months ended March 31, 2013 and 2012. BioFoam is currently approved for sale in certain international markets.

BioGlue is a mature product in the U.S. and Europe that has experienced increasing competitive pressures. Management believes that BioGlue sales volume in domestic markets will continue to be impacted by the factors discussed above, which may likely cause a continued decrease in BioGlue sales volume. Economic conditions in Europe could negatively impact sales in future periods. Management also believes that international BioGlue sales will be positively impacted by increased shipments to Japan for the full year 2013 as compared to 2012, although this increase will be less than the increase experienced in 2012 over 2011.

PerClot

Revenues from the sale of PerClot increased 34% for the three months ended March 31, 2013 as compared to the three months ended March 31, 2012. This increase was primarily due to a 35% increase in the volume of grams sold, which increased revenues by 35%. Revenues during these three month periods were for sales in certain international markets, as PerClot is not yet approved for domestic distribution or widespread international distribution. This increase was primarily due to increased sales into the Company s markets in Europe.

The Company will not be able to sell PerClot in the U.S. unless and until FDA approval is granted. On March 30, 2012 CryoLife refiled for an investigational device exemption (IDE) with the FDA seeking approval to begin clinical trials for the purpose of obtaining Premarket Approval to distribute PerClot in the U.S. The FDA responded to the Company s IDE during the second quarter of 2012, and the Company filed a revised IDE in November 2012. CryoLife is working to address questions raised by the FDA in their response to the revised IDE. CryoLife anticipates submitting this revised IDE application to the FDA in the second quarter of 2013.

The Company s sales of hemostats through its direct sales force to U.K. hospitals are denominated in British Pounds, and its sales to German, Austrian, and Irish hospitals and certain distributors are denominated in Euros and are, therefore, subject to changes in foreign exchange rates. If the exchange rates between the U.S. Dollar and the British Pound or Euro decline materially in future periods, this would have a material, adverse impact on the Company s revenues denominated in these currencies. Changes in exchange rates will have a more material impact on hemostat revenues than the Company s other product lines, as a larger percentage of the Company s hemostat sales are denominated in foreign currencies.

Management believes that PerClot revenues will increase for the remainder of 2013 as compared to the corresponding prior year periods. However, competitive pressures and economic conditions in Europe could negatively impact PerClot sales during 2013. Continued weak economic growth conditions and their constraining effect on hospital budgets are

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expected to drive continued pricing pressures, especially due to the many hemostatic agents currently competing for market share in Europe.

Revascularization Technologies

Revenues from revascularization technologies include revenues related primarily to the sale of handpieces and, in certain periods, revenues from the sale of laser consoles. Revenues from revascularization technologies increased 4% for the three months ended March 31, 2013 as compared to the three months ended March 31, 2012. Revenues from the sale of laser consol