

STEMCELLS INC  
Form 10-Q  
May 10, 2013  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

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

For the quarter ended: March 31, 2013

Commission File Number: 0-19871

**STEMCELLS, INC.**

(Exact name of registrant as specified in its charter)

DELAWARE  
(State or other jurisdiction of

94-3078125  
(I.R.S. Employer

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incorporation or organization)

identification No)

7707 Gateway Blvd

Newark, CA 94560

(Address of principal executive offices including zip code)

(510) 456-4000

(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 twelve months (or for such shorter periods that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

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

Large accelerated filer

Accelerated filer

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

Smaller reporting company

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

At May 7, 2013, there were 38,980,145 shares of Common Stock, \$.01 par value, issued and outstanding.

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Throughout this Form 10-Q, the words "we," "us," "our," and "StemCells" refer to StemCells, Inc., including our directly and indirectly wholly-owned subsidiaries. "Common stock" refers to the common stock, \$.01 par value, of StemCells, Inc.

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## ITEM 1. FINANCIAL STATEMENTS

STEMCELLS, INC.

## CONDENSED CONSOLIDATED BALANCE SHEETS

(unaudited)

	March 31, 2013	December 31, 2012
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 7,231,078	\$ 8,471,275
Marketable securities, current	9,817,509	13,900,678
Trade receivables	61,613	110,159
Other receivables	251,227	200,788
Prepaid assets	434,003	537,590
Other assets, current	818,081	820,827
<b>Total current assets</b>	<b>18,613,511</b>	<b>24,041,317</b>
Property, plant and equipment, net	1,519,687	1,375,329
Other assets, non-current	1,059,687	947,301
Goodwill	1,853,042	1,983,426
Other intangible assets, net	1,718,265	1,822,904
<b>Total assets</b>	<b>\$ 24,764,192</b>	<b>\$ 30,170,277</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 1,429,083	\$ 999,365
Accrued expenses and other current liabilities	1,418,397	2,707,441
Accrued wind-down expenses, current	628,760	1,102,762
Deferred revenue, current	48,595	74,426
Capital lease obligation, current	7,014	6,888
Bonds payable, current	210,000	206,250
<b>Total current liabilities</b>	<b>3,741,849</b>	<b>5,097,132</b>
Capital lease obligations, non-current	10,845	12,646
Bonds payable, non-current	71,250	125,000
Fair value of warrant liability	9,035,131	9,265,365
Other long-term liabilities	216,439	216,439
Deferred rent, non-current	1,404,917	1,389,342
Deferred revenue, non-current	75,529	79,736
<b>Total liabilities</b>	<b>14,555,960</b>	<b>16,185,660</b>
Commitments and contingencies (Note 7)		
Stockholders' equity:		
Common stock, \$0.01 par value; 75,000,000 shares authorized; issued and outstanding 38,887,586 at March 31, 2013 and 37,506,305 at December 31, 2012	388,874	375,063
Additional paid-in capital	377,366,468	374,507,552
Accumulated deficit	(367,507,622)	(361,091,175)
Accumulated other comprehensive income (loss)	(39,488)	193,177

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Total stockholders' equity	10,208,232	13,984,617
Total liabilities and stockholders' equity	\$ 24,764,192	\$ 30,170,277

See Notes to Condensed Consolidated Financial Statements.

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STEMCELLS, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited)

	<b>Three months ended March 31,</b>	
	<b>2013</b>	<b>2012</b>
<b>Revenue:</b>		
Revenue from licensing agreements, grants and other	\$ 75,642	\$ 372,677
Revenue from product sales	208,558	271,359
<b>Total revenue</b>	<b>284,200</b>	<b>644,036</b>
Cost of product sales	66,841	71,959
<b>Gross profit</b>	<b>217,359</b>	<b>572,077</b>
<b>Operating expenses:</b>		
Research and development	4,563,890	3,938,391
Selling, general and administrative	1,887,757	1,924,325
Wind-down expenses	22,859	35,155
<b>Total operating expenses</b>	<b>6,474,506</b>	<b>5,897,871</b>
Loss from operations	(6,257,147)	(5,325,794)
<b>Other income (expense):</b>		
Change in fair value of warrant liability	(188,607)	(4,941,177)
Interest income	6,846	4,210
Interest expense	(10,148)	(14,447)
Other income (expense), net	32,609	47,769
<b>Total other income (expense), net</b>	<b>(159,300)</b>	<b>(4,903,645)</b>
<b>Net loss</b>	<b>\$ (6,416,447)</b>	<b>\$ (10,229,439)</b>
Basic and diluted net loss per share	\$ (0.17)	\$ (0.45)
Weighted average number of common shares outstanding, basic and diluted	38,263,434	22,958,498

See Notes to Condensed Consolidated Financial Statements.

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STEMCELLS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(unaudited)

	<b>Three months ended March 31,</b>	
	<b>2013</b>	<b>2012</b>
Net loss	\$ (6,416,447)	\$ (10,229,439)
Other comprehensive income (loss)		
Foreign currency translation adjustments	(234,104)	95,886
Unrealized gains on marketable securities	1,439	2,753
Other comprehensive income (loss)	(232,665)	98,639
Comprehensive loss	\$ (6,649,112)	\$ (10,130,800)

See Notes to Condensed Consolidated Financial Statements.

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STEMCELLS, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

	Three months ended March 31,	
	2013	2012
Cash flows from operating activities:		
Net loss	\$ (6,416,447)	\$ (10,229,439)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	239,550	271,397
Stock-based compensation	686,582	736,545
Gain on disposal of fixed assets	(38,500)	
Change in fair value of warrant liability	188,607	4,941,177
Changes in operating assets and liabilities:		
Other receivables	(53,784)	20,921
Trade receivables	41,601	(44,791)
Prepaid and other current assets	97,752	134,673
Other assets, non-current	(112,386)	8,081
Accounts payable and accrued expenses	(798,212)	(1,163,949)
Accrued wind-down expenses	(474,002)	(315,466)
Deferred revenue	(28,399)	(8,859)
Deferred rent	15,575	19,031
Net cash used in operating activities	(6,652,063)	(5,630,679)
Cash flows from investing activities:		
Purchase of marketable securities	(471,392)	(2,076,356)
Proceeds from the sale and maturity of marketable securities	4,556,000	3,212,000
Purchases of property, plant and equipment	(319,915)	(4,300)
Proceeds from sale of property, plant and equipment	38,500	
Acquisition of other assets	(100,000)	
Net cash provided by investing activities	3,703,193	1,131,344
Cash flows from financing activities:		
Proceeds from issuance of common stock, net of issuance costs	1,568,178	
Proceeds from the exercise of warrants, net of issuance costs	447,715	728,623
Payments related to net share issuance of stock based awards	(248,589)	(13,536)
Repayment of capital lease obligations	(1,676)	(17,979)
Repayment of bonds payable	(50,000)	(46,250)
Net cash provided by financing activities	1,715,628	650,858
Decrease in cash and cash equivalents	(1,233,242)	(3,848,477)
Effects of foreign exchange rate changes on cash	(6,955)	(8,031)
Cash and cash equivalents, beginning of period	8,471,275	13,311,261
Cash and cash equivalents, end of period	\$ 7,231,078	\$ 9,454,753
Supplemental disclosure of cash flow information:		
Interest paid	\$ 10,148	\$ 14,447

See Notes to Condensed Consolidated Financial Statements.





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**Notes to Condensed Consolidated Financial Statements (Unaudited)**

**March 31, 2013 and 2012**

**Note 1. Summary of Significant Accounting Policies**

**Nature of Business**

StemCells, Inc., a Delaware corporation, is a biopharmaceutical company that operates in one segment, the research, development, and commercialization of stem cell therapeutics and related technologies.

The accompanying financial data as of March 31, 2013 and for the three months ended March 31, 2013 and 2012 have been prepared by us, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States (U.S. GAAP) have been condensed or omitted pursuant to these rules and regulations. The December 31, 2012 condensed consolidated balance sheet was derived from audited financial statements, but does not include all disclosures required by U.S. GAAP. However, we believe that the disclosures are adequate to make the information presented not misleading. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2012.

We have incurred significant operating losses since inception. We expect to incur additional operating losses over the foreseeable future. We have very limited liquidity and capital resources and must obtain significant additional capital and other resources in order to provide funding for our product development efforts, the acquisition of technologies, businesses and intellectual property rights, preclinical and clinical testing of our products, pursuit of regulatory approvals, acquisition of capital equipment, laboratory and office facilities, establishment of production capabilities, selling, general and administrative expenses and other working capital requirements. We rely on our cash reserves, proceeds from equity and debt offerings, proceeds from the transfer or sale of intellectual property rights, equipment, facilities or investments, government grants and funding from collaborative arrangements, to fund our operations. If we exhaust our cash reserves and are unable to obtain adequate financing, we may be unable to meet our operating obligations and we may be required to initiate bankruptcy proceedings. The financial statements do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classification of liabilities that may result from the outcome of this uncertainty.

**Principles of Consolidation**

The condensed consolidated financial statements include the accounts of StemCells, Inc., and our wholly-owned subsidiaries, including StemCells California, Inc., Stem Cell Sciences Holdings Ltd, and Stem Cell Sciences (UK) Ltd. All significant intercompany accounts and transactions have been eliminated.

**Use of Estimates**

The preparation of financial statements in conformity with U.S. GAAP requires management to make judgments, assumptions and estimates that affect the amounts reported in our condensed consolidated financial statements and accompanying notes. Actual results could differ materially from these estimates.

Significant estimates include the following:

the grant date fair value of stock-based awards recognized as compensation expense (see Note 5, *Stock-Based Compensation* );

accrued wind-down expenses (see Note 6, *Wind-Down Expenses* );

the fair value of warrants recorded as a liability (see Note 8, *Warrant Liability* ); and

the fair value of goodwill and other intangible assets (see Note 4, Goodwill and Other Intangible Assets ).

**Financial Instruments**

*Cash and Cash Equivalents*

Cash equivalents are money market accounts, money market funds and investments with maturities of 90 days or less from the date of purchase.

*Marketable Securities*

Our existing marketable securities are designated as available-for-sale securities. These securities are carried at fair value (see Note 2, Financial Instruments ), with the unrealized gains and losses reported as a component of stockholders' equity. Management determines the appropriate designation of its investments (current or non-current) in marketable securities at the time of purchase and reevaluates such designation as of each balance sheet date. The cost of securities sold is based upon the specific identification method.

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If the estimated fair value of a security is below its carrying value, we evaluate whether we have the intent and ability to retain our investment for a period of time sufficient to allow for any anticipated recovery to the cost of the investment, and whether evidence indicating that the cost of the investment is recoverable within a reasonable period of time outweighs evidence to the contrary. Other-than-temporary declines in estimated fair value of all marketable securities are charged to Other income (expense), net in the accompanying condensed consolidated statements of operations. No such impairment was recognized during the three months ended March 31, 2013 or 2012.

*Trade and Other Receivables*

Our receivables generally consist of interest income on our financial instruments, revenue from licensing agreements and grants, revenue from product sales, and rent from our sub-lease tenants.

*Warrant Liability*

We account for our warrants in accordance with U.S. GAAP which defines how freestanding contracts that are indexed to and potentially settled in a company's own stock should be measured and classified. Authoritative accounting guidance prescribes that only warrants issued by us under contracts that cannot be net-cash settled, and are both indexed to and settled in our common stock, can be classified as equity. As part of both our November 2008 and November 2009 financings, we issued warrants with five year terms to purchase 1,034,483 and 400,000 shares of our common stock at \$23.00 and \$15.00 per share, respectively. As part of our December 2011 financing, we issued Series A Warrants with a five year term to purchase 8,000,000 shares at \$1.40 per share and Series B Warrants with a ninety trading day term to purchase 8,000,000 units at \$1.25 per unit. Each unit underlying the Series B Warrants consisted of one share of our common stock and one Series A Warrant. In the first and second quarter of 2012, an aggregate of 2,700,000 Series B Warrants were exercised. For the exercise of these warrants, we issued 2,700,000 shares of our common stock and 2,700,000 Series A Warrants. The remaining 5,300,000 Series B Warrants expired unexercised by their terms on May 2, 2012. As terms of the warrants issued in 2008 and 2009, as well as the Series A and Series B Warrants, do not meet the specific conditions for equity classification, we are required to classify the fair value of these warrants as a liability, with subsequent changes in fair value to be recorded as income (loss) due to change in fair value of warrant liability. The fair value of the warrants issued in the 2008 and 2009 financings is determined using the Black-Scholes-Merton (Black-Scholes) option pricing model and the fair value of the Series A and Series B Warrants is determined using a Monte Carlo simulation model (see Note 8, Warrant Liability). The fair value is affected by changes in inputs to these models including our stock price, expected stock price volatility, the contractual term, and the risk-free interest rate. The use of a Monte Carlo simulation model requires input of additional assumptions including the progress of our R&D programs and its affect on potential future financings. We will continue to classify the fair value of the warrants as a liability until the warrants are exercised, expire or are amended in a way that would no longer require these warrants to be classified as a liability. The estimated fair value of our warrant liability at March 31, 2013, was approximately \$9,035,000.

**Goodwill and Other Intangible Assets**

Goodwill and intangible assets deemed to have indefinite lives are not amortized but are subject to annual impairment tests. If the assumptions and estimates used to allocate the purchase price are not correct, or if business conditions change, purchase price adjustments or future asset impairment charges could be required. We test goodwill for impairment on an annual basis or more frequently if we believe indicators of impairment exist. Impairment evaluations involve management estimates of asset useful lives and future cash flows. Significant management judgment is required in the forecasts of future operating results that are used in the evaluations, and it is possible, even likely, that the plans and estimates used may be incorrect. If our actual results, or the plans and estimates used in future impairment analysis are lower than the original estimates used to assess the recoverability of these assets, we could incur additional impairment charges in a future period. We completed our annual impairment testing during the fourth quarter of 2012, and determined that there was no impairment of goodwill.

Prior to fiscal year 2001, we capitalized certain patent costs, which are being amortized over the estimated life of the patent and would be expensed at the time such patents are deemed to have no continuing value. Since 2001, all patent costs are expensed as incurred. License costs are capitalized and amortized over the estimated life of the related license agreement.

**Revenue Recognition**

We currently recognize revenue resulting from the licensing and use of our technology and intellectual property, from government grants, from services provided to third parties, and from product sales. Licensing agreements may contain multiple elements, such as upfront fees, payments related to the achievement of particular milestones and royalties. Revenue from upfront fees for licensing agreements that contain multiple elements are generally deferred and recognized on a straight-line basis over the term of the agreement. Fees associated with substantive at risk performance-based milestones are recognized as revenue upon completion of the scientific or regulatory event specified in the agreement, and royalties received are recognized as earned. Revenue from licensing agreements is recognized net of a fixed percentage due to licensors as

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royalties. Grant revenue from government agencies are funds received to cover specific expenses and are recognized as earned upon either the incurring of reimbursable expenses directly related to the particular research plan or the completion of certain development milestones as defined within the terms of the relevant collaborative agreement or grant. Revenue from services to third parties is recognized when we have provided the agreed upon services. Revenue from product sales are recognized when the product is shipped and the order fulfilled.

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Compensation expense for stock-based payment awards to employees is based on their grant date fair value as calculated and amortized over their vesting period. See Note 5, **Stock-Based Compensation** for further information.

We use the Black-Scholes model to calculate the fair value of stock-based awards.

**Per Share Data**

Basic net income or loss per share is computed by dividing net income or loss by the weighted average number of shares of common stock outstanding during the period. Diluted net income or loss per share is computed based on the weighted average number of shares of common stock and other dilutive securities. To the extent these securities are anti-dilutive, they are excluded from the calculation of diluted earnings per share.

The following is a reconciliation of the numerators and denominators of the basic and diluted net income or loss per share computations:

	<b>Three months ended March 31,</b>	
	<b>2013</b>	<b>2012</b>
Net loss	\$ (6,416,447)	\$ (10,229,439)
Weighted average shares outstanding used to compute basic and diluted net income or loss per share	38,263,434	22,958,498
Basic and diluted net loss per share	\$ (0.17)	\$ (0.45)

The following outstanding potentially dilutive common stock equivalents were excluded from the computation of diluted net income or loss per share because the effect would have been anti-dilutive as of March 31:

	<b>2013</b>	<b>2012</b>
Options	443,926	872,032
Restricted stock units	1,236,982	1,542,676
Warrants	9,601,378	17,434,483
Total	11,282,286	19,849,191

**Comprehensive Income (Loss)**

Comprehensive income (loss) is comprised of net income or loss and other comprehensive income or loss (OCL). OCL includes certain changes in stockholders' equity that are excluded from net income or loss. Specifically, we include in OCL changes in unrealized gains and losses on our marketable securities and unrealized gains and losses on foreign currency translations. Accumulated other comprehensive loss was \$39,488, as of March 31, 2013, and accumulated other comprehensive income was \$193,177, as of December 31, 2012.

**Note 2. Financial Instruments**

The following table summarizes the fair value of our cash, cash equivalents and available-for-sale marketable securities held in our current investment portfolio:

	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized (Losses)</b>	<b>Fair Value</b>
<b>March 31, 2013</b>				
Cash	\$ 622,831	\$	\$	\$ 622,831
Cash equivalents	6,608,247			6,608,247
Marketable securities, current	9,818,948		(1,439)	9,817,509
Total cash, cash equivalents, and marketable securities	\$ 17,050,026	\$	\$ (1,439)	\$ 17,048,587
<b>December 31, 2012</b>				
Cash	\$ 254,267	\$	\$	\$ 254,267

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Cash equivalents	8,217,259		(252)	8,217,007
Marketable securities, current	13,901,782		(1,104)	13,900,678
Total cash, cash equivalents, and marketable securities	\$ 22,373,308	\$	\$ (1,356)	\$ 22,371,952

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At March 31, 2013, our investment in money market accounts are composed primarily of U.S. Treasury debt securities, which are classified as cash equivalents in the accompanying Consolidated Balance Sheet due to their short maturities. Our investment in short-term marketable securities are composed primarily of commercial paper and corporate debt securities. From time to time, we carry cash balances in excess of federally insured limits. Our cash balance at March 31, 2013 includes approximately 76,000 British pounds held by our U.K. subsidiary.

We do not hold any investments that were in a material unrealized loss position as of March 31, 2013.

**Note 3. Fair Value Measurement**

Fair value is defined as an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or a liability. As a basis for considering such assumptions, we are required to apply a three-tier value hierarchy, which prioritizes the inputs used in the valuation methodologies in measuring fair value. The three levels of the fair value hierarchy are:

*Level 1* Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.

*Level 2* Directly or indirectly observable inputs other than in Level 1, that include quoted prices for similar assets or liabilities in active markets or quoted prices for identical or similar assets or liabilities in markets that are not active.

*Level 3* Unobservable inputs which are supported by little or no market activity that reflects the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability.

The fair value hierarchy also requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. Assets measured at fair value are classified below based on the three fair value hierarchy tiers described above.

Our cash equivalents are classified as Level 1 because they are valued primarily using quoted market prices.

Our bonds payable, marketable securities, and liability for warrants issued in our 2008 and 2009 financing, are classified as Level 2 as they are valued using alternative pricing sources and models utilizing market observable inputs.

Our liability for warrants issued in our 2011 financing is classified as Level 3 as the liability is valued using a Monte Carlo simulation model. Some of the significant inputs used to calculate the fair value of warrant liability include our stock price on the valuation date, expected volatility of our common stock as traded on NASDAQ, and risk-free interest rates that are derived from the yield on U.S. Treasury debt securities, all of which are observable from active markets. However, the use of a Monte Carlo simulation model requires the input of additional subjective assumptions including management's assumptions regarding the likelihood of a re-pricing of these warrants pursuant to anti-dilution provisions and the progress of our R&D programs and its affect on potential future financings. The following table presents financial assets and liabilities measured at fair value as of March 31, 2013:

	Fair Value Measurement at Report Date Using			As of March 31, 2013
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Unobservable Inputs (Level 3)	
Financial assets:				
Cash equivalents:				
Money market funds	\$ 321,197	\$	\$	\$ 321,197
U.S. Treasury debt obligations	6,287,050			6,287,050
Marketable securities:				
Debt securities		9,817,509		9,817,509



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Total financial assets	\$ 6,608,247	\$ 9,817,509	\$	\$ 16,425,756
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	Fair Value Measurement at Report Date Using Quoted Prices in Active Markets for Identical Assets (Level 1)				Significant Other Observable Inputs (Level 2)	Unobservable Inputs (Level 3)	As of March 31, 2013
Financial liabilities:							
Bond obligation	\$		\$ 281,250		\$		\$ 281,250
Warrant liabilities			83,072		8,952,060		9,035,132
Total financial liabilities	\$		\$ 364,322		\$ 8,952,060		\$ 9,316,382

**Level 2 Reconciliation**

The following table presents a roll forward for financial assets and liabilities measured at fair value using significant other observable inputs (Level 2) for 2013:

	Level 2 Beginning Balance 12/31/12 \$	Net transfers (to) from Level 1 \$	Change included in earnings \$	Unrealized gain	Settled \$	Level 2 Ending Balance 03/31/13 \$
Marketable securities	13,900,678	(4,084,608)		1,439		9,817,509
Bond obligation	331,250				(50,000)	281,250
Warrant liabilities	107,968		(24,896)			83,072
Total	14,339,896	(4,084,608)	(24,896)	1,439	(50,000)	10,181,831

Transfers from Level 2 to Level 1 are the net of, (i) maturities of short term marketable securities into cash and cash equivalents and (ii) additional purchases of marketable securities.

**Level 3 Reconciliation**

The following table presents a roll forward for liabilities measured at fair value using significant unobservable inputs (Level 3) for 2013:

	Warrant Liabilities
Balance at December 31, 2012	\$ 9,157,397
Less fair value of warrants exercised	(418,841)
Add change in fair value of warrants	213,503
Balance at March 31, 2013	\$ 8,952,059

**Note 4. Goodwill and Other Intangible Assets**

On April 1, 2009, we acquired the operations of Stem Cell Sciences Plc (SCS) for an aggregate purchase price of approximately \$5,135,000. The acquired operations includes proprietary cell technologies relating to embryonic stem cells, induced pluripotent stem (iPS) cells, and tissue-derived (adult) stem cells; expertise and infrastructure for providing cell-based assays for drug discovery; a cell culture products business; and an intellectual property portfolio with claims relevant to cell processing, reprogramming and manipulation, as well as to gene targeting and insertion.

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The purchase price was allocated as follows:

	Allocated purchase Price	Estimated life of intangible assets in years
Net tangible assets	\$ 36,000	
Intangible assets:		
Customer relationships and developed technology	1,310,000	6 to 9
In-process research and development	1,340,000	N/A
Trade name	310,000	15
Goodwill	2,139,000	N/A
Total	\$ 5,135,000	

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In-process research and development assets relate to: 1) the acquisition of certain intellectual property rights not expected to expire until 2027 related to our program focused on developing genetically engineered rat models of human disease (our Transgenic Rat Program); and 2) the acquisition of certain technology related to the commercialization of our SC Proven cell culture products and the development and commercialization of cell-based assay platforms for use in drug discovery and development (our Assay Development Program).

At the time of valuation (April 2009), our Transgenic Rat Program was in its nascent stage and our Assay Development Program was expected to achieve proof of concept by 2012. Neither program was expected to begin generating revenue until 2011-2012. In December 2011, in part because of management's decision to focus on our therapeutic product development programs and not to allocate time and resources to the assays technology, we determined that we could not predict the future cash flows from the intangible IPR&D asset related to the Assay Development Program. Therefore, at December 31, 2011, we determined that the intangible asset was impaired and wrote off the approximately \$655,000 carrying value of the asset.

Trade name relates to the SC Proven trademark of our cell culture products which we expect to market for 15 years from the date of acquisition, based on which, we estimated a remaining useful life of 15 years from the valuation date.

The following table presents changes in goodwill:

Balance as of December 31, 2012	\$ 1,983,426
Foreign currency translation	(130,384)
<b>Balance as of March 31, 2013</b>	<b>\$ 1,853,042</b>

The components of our other intangible assets at March 31, 2013 are summarized below:

Other Intangible Asset Class	Cost	Additions	Impairment	Accumulated Amortization	Foreign Currency Translation	Net Carrying Amount	Weighted-Average Amortization Period
Customer relationships and developed technology	\$ 1,310,000	\$	\$	\$ (739,476)	\$ 103,454	\$ 673,978	8.0 years
In-process research and development	1,340,000		(654,961)	(270,687)	99,925	514,277	Indefinite
Trade name	310,000			(91,073)	20,904	239,831	15.0 years
Patents	979,612	64,000		(753,433)		290,179	16.0 years
<b>Total other intangible assets</b>	<b>\$ 3,939,612</b>	<b>\$ 64,000</b>	<b>\$ (654,961)</b>	<b>\$ (1,854,669)</b>	<b>\$ 224,283</b>	<b>\$ 1,718,265</b>	<b>12.2 years</b>

Amortization expense was approximately \$66,000 in the first quarter of 2013.

The expected future annual amortization expense for each of the next five years based on current balances of our intangible assets is approximately as follows:

<b>For the year ending December 31:</b>	
2013	\$ 276,000
2014	\$ 268,000
2015	\$ 268,000
2016	\$ 262,000
2017	\$ 240,000

**Note 5. Stock-Based Compensation**

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We currently grant stock-based compensation under two equity incentive plans approved by the Company's stockholders and one plan adopted in 2012 pursuant to NASDAQ Listing Rule 5635(c)(4) concerning inducement grants for new employees (our 2012 Commencement Incentive Plan). As of December 31, 2012, we had 593,199 shares available to grant under our two stockholder-approved plans, namely our 2001 Equity Incentive Plan and our 2006 Equity Incentive Plan. At our annual stockholders meeting held on June 12, 2007, our stockholders approved an amendment to our 2006 Equity Incentive Plan to provide for an annual increase in the number of shares of common stock available for issuance under the plan each January 1 (beginning January 1, 2008) equal to 4% of the outstanding common shares as of that date. The amendment further provided an aggregate limit of 3,000,000 shares issuable

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pursuant to incentive stock option awards under the plan. Under the two stockholder-approved plans we may grant incentive stock options, nonqualified stock options, stock appreciation rights, restricted stock, restricted stock units, 401(k) Plan employer match in form of shares and performance-based shares to our employees, directors and consultants, at prices determined by our Board of Directors. Incentive stock options may only be granted to employees under these plans with a grant price not less than the fair market value on the date of grant. Under our 2012 Commencement Inducement Plan, we may only award options, restricted stock units and other equity awards to newly hired employees and newly engaged directors, in each case as allowed by NASDAQ listing requirements.

Our stock-based compensation expense for the first quarter ended March 31 was as follows:

	Three months ended March 31,	
	2013	2012
Research and development expense	\$ 343,711	\$ 331,874
Selling, general and administrative expense	342,871	404,671
<b>Total employee stock-based compensation</b>	<b>\$ 686,582</b>	<b>\$ 736,545</b>
Effect on basic and diluted net loss per share	\$ (0.02)	\$ (0.03)

As of March 31, 2013, we had approximately \$1,875,000 of total unrecognized compensation expense related to unvested awards of stock options and restricted stock units granted under our various equity incentive plans that we expect to recognize over a weighted-average vesting period of 1.8 years.

*Stock Options*

Generally, stock options granted to employees have a maximum term of ten years, and vest over a four year period from the date of grant; 25% vest at the end of one year, and 75% vest monthly over the remaining three-year service period. We may grant options with different vesting terms from time to time. Upon employee termination of service, any unexercised vested option will be forfeited three months following termination or the expiration of the option, whichever is earlier. Unvested options are forfeited on termination.

A summary of our stock option activity for the three months ended March 31, 2013 is as follows:

	Number of options	Weighted-average exercise price (\$) per share
Balance at December 31, 2012	447,359	19.59
Granted		
Exercised		
Cancelled	(3,433)	4.40
<b>Outstanding options at March 31, 2013</b>	<b>443,926</b>	<b>19.70</b>

A summary of changes in unvested options for the three months ended March 31, 2013 is as follows:

	Number of options	Weighted-average exercise price (\$) per share	Weighted-average grant date fair value (\$) per option
Unvested options at December 31, 2012	64,503	10.86	8.67
Granted			

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Vested	(13,037)	11.86	9.54
Cancelled			
Unvested options at March 31, 2013	51,466	10.61	8.45

The estimated fair value of options vested was approximately \$124,000 in the three months ended March 31, 2013.

### *Restricted Stock Units*

We have granted restricted stock units (RSUs) to certain employees and members of the Board of Directors which entitle the holders to receive shares of our common stock upon vesting of the RSUs. The fair value of restricted stock units granted is based upon the market price of the underlying common stock as if it were vested and issued on the date of grant.

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A summary of our restricted stock units activity for the three months ended March 31, 2013 is as follows:

	Number of RSUs	Weighted-average grant date fair value (\$) per RSU
Outstanding at December 31, 2012	1,534,200	2.10
Granted(1)	65,200	1.64
Vested and exercised	(362,418)	1.06
Cancelled		
<b>Outstanding RSUs at March 31, 2013</b>	<b>1,236,982</b>	<b>2.38</b>

- (1) 10,000 of these restricted stock units vest and convert into shares of our common stock after one year from the date of grant. 55,200 of these restricted stock units will vest and convert into shares of our common stock over a four year period from the date of grant; one-fourth of the award will vest on each grant date anniversary following the grant.

*Stock Appreciation Rights*

In July 2006, we granted cash-settled Stock Appreciation Rights (SARs) to certain employees that give the holder the right, upon exercise, to the difference between the price per share of our common stock at the time of exercise and the exercise price of the SARs.

The SARs have a maximum term of ten years with an exercise price of \$20.00, which is equal to the market price of our common stock at the date of grant. The SARs vest 25% on the first anniversary of the grant date and 75% vest monthly over the remaining three-year service period. All of the outstanding SARs as of March 31, 2013 are fully vested. Compensation expense is based on the fair value of SARs which is calculated using the Black-Scholes option pricing model.

The stock-based compensation expense and liability are re-measured at each reporting date through the earlier of date of settlement or forfeiture of the SARs.

A summary of the changes in SARs for the three months ended March 31, 2013 is as follows:

	Number of SARs
Outstanding at December 31, 2012	110,593
Granted	
Exercised	
Forfeited and expired	
<b>Outstanding SARs at March 31, 2013</b>	<b>110,593</b>

SARs exercisable at March 31, 2013 110,593

For the three months ended March 31, 2013 and 2012, the re-measured liability and expense for the respective periods related to the SARs were not significant.

The compensation expense related to the SARs recognized for the three months ended March 31, 2013 may not be representative of compensation expense for future periods and its resulting effect on net loss and net loss per share attributable to common stockholders, due to changes in the fair value calculation which is dependent on the stock price, volatility, interest and forfeiture rates, additional grants and subsequent periods of vesting. We will continue to recognize compensation cost each period, which will be the change in fair value from the previous period through the earlier date of settlement or forfeiture of the SARs.

**Note 6. Wind-Down Expenses**



*Rhode Island*

In October 1999, we relocated to California from Rhode Island and established a wind-down reserve for the estimated lease payments and operating costs of the Rhode Island facilities. We periodically re-evaluate and adjust the reserve by considering various factors such as our lease payments through to the end of the lease, operating expenses, the current real estate market in Rhode Island, and estimated subtenant income based on actual and projected occupancy. We are no longer actively seeking additional subtenants due to the short time remaining on the lease period.

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The summary of the changes to our wind-down reserve related to this facility for 2013 and 2012 were as follows:

	January 1 to March 31, 2013	January 1 to December 31, 2012
Accrued wind-down reserve at beginning of period	\$ 854,000	\$ 1,683,000
Less actual expenses recorded against estimated reserve during the period	(372,000)	(1,185,000)
Additional expense recorded to revise estimated reserve at period-end	23,000	356,000
Revised reserve at period-end	505,000	854,000
Add deferred rent at period-end	124,000	249,000
Total accrued wind-down expenses at period-end, current	\$ 629,000	\$ 1,103,000

**Note 7. Commitments and Contingencies***Leases**Capital Leases*

We entered into direct financing transactions with the State of Rhode Island and received proceeds from the issuance of industrial revenue bonds totaling \$5,000,000 to finance the construction of our pilot manufacturing facility in Rhode Island. The related lease agreements are structured such that lease payments fully fund all semiannual interest payments and annual principal payments through maturity in August 2014. The interest rate for the remaining bond series is 9.5%. The bond contains certain restrictive covenants which limit, among other things, the payment of cash dividends and the sale of the related assets. The outstanding principal was approximately \$281,000 at March 31, 2013 and \$331,000 at December 31, 2012.

*Operating Leases*

We lease various real properties under operating leases that generally require us to pay taxes, insurance, maintenance, and minimum lease payments. Some of our leases have options to renew.

*Operating Leases - California*

In September 2010, we entered into a two-year sublease agreement with Caliper Life Sciences, Inc., for approximately 13,200 square feet in a facility located in Mountain View, California. In June 2012, the sublease term was extended to September 30, 2013. We will pay approximately \$1,081,000 in aggregate as rent over the term of the lease.

In December 2010, we entered into a commercial lease agreement with BMR-Gateway Boulevard LLC (BMR), as landlord, for approximately 43,000 square feet of office and research space at BMR's Pacific Research Center in Newark, California. The initial term of the lease is approximately eleven and one-half years. We will pay approximately \$17,869,000 in aggregate as rent over the term of the lease to BMR, which we recognize as operating lease expense on a straight-line basis. Deferred rent was approximately \$1,405,000 as of March 31, 2013, and approximately \$1,389,000 as of December 31, 2012. We had an option under the lease agreement, to lease up to an additional 30,000 square feet in the building, which expired unexercised on January 31, 2013.

In March 2013, we entered into a commercial lease agreement with Prologis, L.P. (Prologis), as landlord, for approximately 18,700 square feet of office and research space in Sunnyvale, California. The initial term of the lease is ten years from April 1, 2013, and we will pay approximately \$3,497,000 in aggregate rent over the term of the lease. As part of the lease, Prologis has agreed to provide us financial allowances to build initial tenant improvements, subject to customary terms and conditions relating to landlord-funded tenant improvements. The facility will house operations that support our clinical development activities.

*Operating Leases - Rhode Island*

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We entered into a fifteen-year lease agreement for a laboratory facility in Rhode Island in connection with a sale and leaseback arrangement in 1997. The lease term expires June 30, 2013. The lease contains escalating rent payments, which we recognize on a straight-line basis. At March 31, 2013, deferred rent expense was approximately \$124,000 for this facility and is included as part of the wind-down accrual on the accompanying Consolidated Balance Sheets.

**Table of Contents***Operating Leases United Kingdom*

In January 2011, we amended the existing lease agreements of our wholly-owned subsidiary, Stem Cell Sciences (U.K.) Ltd, effectively reducing our leased space from approximately 5,000 square feet to approximately 1,900 square feet of office and lab space. The lease by its terms was extended to September 30, 2013. We expect to pay approximately 61,000 GBP as rental payments for 2013. StemCells, Inc. is the guarantor of Stem Cell Sciences (U.K.) Ltd's obligations under the existing lease.

With the exception of the operating leases discussed above, we have not entered into any significant off balance sheet financial arrangements and have not established any special purpose entities. We have not guaranteed any debts or commitments of other entities or entered into any options on non-financial assets.

***Contingencies***

In July 2006, we filed suit against Neuralstem, Inc. in the Federal District Court for the District of Maryland, alleging that Neuralstem's activities violate claims in four of the patents we exclusively licensed from NeuroSpheres, specifically U.S. Patent No. 6,294,346 (claiming the use of human neural stem cells for drug screening), U.S. Patent No. 7,101,709 (claiming the use of human neural stem cells for screening biological agents), U.S. Patent No. 5,851,832 (claiming methods for proliferating human neural stem cells), and U.S. Patent No. 6,497,872 (claiming methods for transplanting human neural stem cells). In May 2008, we filed a second patent infringement suit against Neuralstem and its two founders, Karl Johe and Richard Garr. In this suit, which we filed in the Federal District Court for the Northern District of California, we allege that Neuralstem's activities infringe claims in two patents we exclusively license from NeuroSpheres, specifically U.S. Patent No. 7,361,505 (claiming composition of matter of human neural stem cells derived from any source material) and U.S. Patent No. 7,115,418 (claiming methods for proliferating human neural stem cells). In addition, we allege various state law causes of action against Neuralstem arising out of its repeated derogatory statements to the public about our patent portfolio. Also in May 2008, Neuralstem filed suit against us and NeuroSpheres in the Federal District Court for the District of Maryland seeking a declaratory judgment that the 505 and 418 patents are either invalid or are not infringed by Neuralstem and that Neuralstem has not violated California state law. In August 2008, the California court transferred our lawsuit against Neuralstem to Maryland for resolution on the merits. In July 2009, the Maryland District Court granted our motion to consolidate these two cases with the litigation we initiated against Neuralstem in 2006. Discovery is ongoing in these cases and we anticipate a trial date in 2014.

Effective 2008, as part of an indemnification agreement with NeuroSpheres, we are entitled to offset all litigation costs incurred in this patent infringement suit, against amounts that would otherwise be owed to NeuroSpheres under our exclusive license agreements with NeuroSpheres, such as annual maintenance fees, milestones and royalty payments. Under the terms of our license agreements, we are required to make annual payments of \$50,000 to NeuroSpheres, and we expect to make these annual payments through the remaining life of the patent which, at December 31, 2010, was approximately 14 years. We have therefore capitalized \$700,000 (14 years at \$50,000 per year) to offset litigation costs. The amount capitalized is not dependent on the achievement of any milestones or related to any other contingent payments which may become due under the arrangement. We will reduce this asset by \$50,000 per year in lieu of the cash payments due to NeuroSpheres. As the \$50,000 annual payments are fully creditable against royalties due to NeuroSpheres, we have classified the capitalized amount as prepaid royalties under Other assets, non-current on our accompanying Consolidated Balance Sheets. We have concluded that the estimated balance of \$600,000, as of March 31, 2013, is a fair estimate and realizable against future milestone and royalty payments to NeuroSpheres, and that litigation costs incurred above this amount will be expensed as incurred. Management will reevaluate this estimate on a quarterly basis based on actual costs and other relevant factors.

**Note 8. Warrant Liability**

We use various option pricing models, such as the Black-Scholes option pricing model and a Monte Carlo simulation model, to estimate fair value of warrants issued. In using these models, we make certain assumptions about risk-free interest rates, dividend yields, volatility, expected term of the warrants and other assumptions. Risk-free interest rates are derived from the yield on U.S. Treasury debt securities. Dividend yields are based on our historical dividend payments, which have been zero to date. Volatility is estimated from the historical volatility of our common stock as traded on NASDAQ. The expected term of the warrants is based on the time to expiration of the warrants from the date of measurement.

In November 2008, we sold 1,379,310 units to institutional investors at a price of \$14.50 per unit, for gross proceeds of \$20,000,000. The units, each of which consisted of one share of common stock and a warrant to purchase 0.75 shares of common stock at an exercise price of \$23.00 per share, were offered as a registered direct offering under a shelf registration statement previously filed with, and declared effective by, the SEC. We received total proceeds, net of offering expenses and placement agency fees, of approximately \$18,637,000. We recorded the fair value of the warrants to purchase 1,034,483 shares of our common stock as a liability. The fair value of the warrant liability is revalued at the end of each reporting period, with the change in fair value of the warrant liability recorded as a gain or loss in our condensed consolidated statements of operations. The fair value of the warrants will continue to be classified as a liability until such time as the warrants are exercised, expire or an amendment of the warrant agreement renders these warrants to be no longer classified as a liability.



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The assumptions used for the Black-Scholes option pricing model are as follows:

	To Calculate Fair Value of Warrant Liability at	
	March 31, 2013	December 31, 2012
Expected life (years)	1.1	1.4
Risk-free interest rate	0.2%	0.2%
Expected volatility	100.1%	108.2%
Expected dividend yield	0%	0%

	At March 31, 2013	At December 31, 2012	Change in Fair Value of Warrant Liability
Fair value of liability for warrants issued in 2008	\$ 14,752	\$ 44,628	\$ (29,876)

In November 2009, we sold 1,000,000 units to institutional investors at a price of \$12.50 per unit, for gross proceeds of \$12,500,000. The units, each of which consisted of one share of common stock and a warrant to purchase 0.40 shares of common stock at an exercise price of \$15.00 per share, were offered as a registered direct offering under a shelf registration statement previously filed with, and declared effective by, the SEC. We received total proceeds, net of offering expenses and placement agency fees, of approximately \$11,985,000. We recorded the fair value of the warrants to purchase 400,000 shares of our common stock as a liability. The fair value of the warrant liability is revalued at the end of each reporting period, with the change in fair value of the warrant liability recorded as a gain or loss in our condensed consolidated statements of operations. The fair value of the warrants will continue to be classified as a liability until such time as the warrants are exercised, expire or an amendment of the warrant agreement renders these warrants to be no longer classified as a liability.

The assumptions used for the Black-Scholes option pricing model are as follows:

	To Calculate Fair Value of Warrant Liability at	
	March 31, 2013	December 31, 2012
Expected life (years)	2.1	2.3
Risk-free interest rate	0.3%	0.3%
Expected volatility	98.6%	94.5%
Expected dividend yield	0%	0%

	At March 31, 2013	At December 31, 2012	Change in Fair Value of Warrant Liability
Fair value of liability for warrants issued in 2009	\$ 68,320	\$ 63,340	\$ 4,980

In December 2011, we raised gross proceeds of \$10,000,000 through a public offering of 8,000,000 units and 8,000,000 Series B Warrants. The combination of units and Series B Warrants were sold at a public offering price of \$1.25 per unit. Each Series B Warrant gave the holder the right to purchase one unit at an exercise price of \$1.25 per unit and was exercisable until May 2, 2012, the 90th trading day after the date of issuance. Each unit consists of one share of our common stock and one Series A Warrant. Each Series A Warrant gives the holder the right to purchase one share of our common stock at an initial exercise price of \$1.40 per share. The Series A Warrants are immediately exercisable upon issuance and will expire in December 2016. In 2012, an aggregate of 2,700,000 Series B Warrants were exercised. For the exercise of these warrants, we issued 2,700,000 shares of our common stock and 2,700,000 Series A Warrants. The remaining 5,300,000 Series B Warrants expired unexercised by their terms on May 2, 2012. In 2012, an aggregate of 2,198,571 Series A Warrants were exercised. For the exercise of these warrants, we issued 2,198,571 shares of our common stock. The shares were offered under our shelf registration statement previously filed with, and declared effective by, the SEC.

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In the first quarter of 2013, an aggregate of 334,534 Series A Warrants were exercised. For the exercise of these warrants, we issued 334,534 shares of our common stock and received gross proceeds of approximately \$468,000.

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The assumptions used for the Monte Carlo simulation model to value the Series A Warrants at March 31, 2013 are as follows:

Risk-free interest rate per year	0.5%
Expected volatility per year	81.6%
Expected dividend yield	0%
Expected life in years	3.7

The use of a Monte Carlo simulation model requires the input of additional subjective assumptions including the progress of our R&D programs and its affect on potential future financings.

The following table is a summary of the changes in fair value of warrant liability for the Series A Warrants for the three-month period ended March 31, 2013:

	Series A	
	Number of Warrants	Fair value \$
Balance at December 31, 2012	8,501,429	\$ 9,157,397
Less exercised	(334,534)	(418,841)
Changes in fair value		213,503
Balance at March 31, 2013	8,166,895	\$ 8,952,059

The following table is a summary of our outstanding warrants and fair value of our warrant liability as of March 31, 2013:

Warrants	Number Outstanding	Exercise Price (\$) per share	Fair value
Warrants issued in 2008	1,034,483	23.00	\$ 14,752
Warrants issued in 2009	400,000	15.00	68,320
Series A Warrants	8,166,895	1.40	8,952,059
Total	9,601,378		\$ 9,035,131

The fair value of the warrant liability is revalued at the end of each reporting period, with the change in fair value of the warrant liability recorded as a gain or loss in our condensed consolidated statements of operations. The fair value of the warrants will continue to be classified as a liability until such time as the warrants are exercised, expire or an amendment of the warrant agreement renders these warrants to be no longer classified as a liability.

**Note 9. Common Stock**

In June 2009, we entered into a sales agreement (2009 sales agreement) pursuant to which we had the option to sell up to \$30 million of our common stock, from time to time, in at-the-market offerings. Between June 2009 and November 2012, we sold common stock under the 2009 sales agreement worth approximately \$26.7 million. In December 2012, we amended the 2009 sales agreement (2012 amended sales agreement) to, among other things, raise the dollar amount of shares available to sell under the agreement back to \$30 million. The sales agent is paid compensation up to 3% of gross proceeds pursuant to the terms of the agreement. The sales agreement, as amended, has been filed with the SEC.

In the first quarter of 2013 we sold a total of 782,755 shares of our common stock at a price per share of \$2.06 for gross proceeds of approximately \$1,616,000. The shares were sold under the 2012 amended sales agreement. The shares were offered under our shelf registration statement previously filed with, and declared effective by, the SEC.



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In the first quarter of 2013, an aggregate of 334,534 Series A Warrants were exercised. For the exercise of these warrants, we issued 334,534 shares of our common stock and received gross proceeds of approximately \$468,000.

### Note 10. Accumulated Other Comprehensive Loss

The following table sets forth the changes in accumulated other comprehensive loss by component for the three months ended March 31, 2013:

	Unrealized Gain on Other Available-for-Sale Securities	Foreign Currency Translation	Total
Beginning balance	\$ (1,356)	\$ 194,533	\$ 193,177
Other comprehensive income (loss) current period	1,439	(234,104)	(232,665)
Ending balance	\$ 83	\$ (39,571)	\$ (39,488)

No amounts were reclassified from accumulated other comprehensive income (loss).

### Note 11. California Institute for Regenerative Medicine Loan

In April 2013, we entered into an agreement with the California Institute for Regenerative Medicine (CIRM) under which CIRM will provide approximately \$19.3 million to help fund preclinical development and IND-enabling activities of our HuCNS-SC cells for Alzheimer's disease (the CIRM Loan Agreement). The funding was awarded in September 2012 under CIRM's Disease Team Therapy Development Award program (RFA 10-05), and the goal of the research is to file an Investigational New Drug (IND)

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application with the U.S. Food and Drug Administration within four years. The funding is in the form of a forgivable loan, in accordance with mutually agreed upon terms and conditions and CIRM regulations, and is expected to be disbursed periodically by CIRM over the four-year project period subject to a number of preconditions, including the achievement of certain progress milestones and compliance with certain financial covenants. The loan is unsecured and the term of the loan is ten years, but may be extended under certain circumstances.

In March 2013, we elected not to borrow funds from CIRM under a separate award under RFA 10-05. This award, also for up to \$20 million in the form of a forgivable loan, was approved in July 2012 by the governing board of CIRM to help fund the study of HuCNS-SC cells as a potential treatment for cervical spinal cord injury.

**Note 12. Subsequent Events**

Subsequent to the end of the first quarter, we sold a total of 83,100 shares of our common stock at an average price per share of \$1.87 for gross proceeds of approximately \$155,000. The shares were sold under the 2012 amended sales agreement. The sales agent is paid compensation up to 3% of gross proceeds pursuant to the terms of the agreement. The shares were offered under our shelf registration statement previously filed with, and declared effective by, the SEC.

In April 2013, we received approximately \$9,900,000 net of fees, under a loan and security agreement with Silicon Valley Bank (SVB). The loan proceeds will be used for general corporate purposes. The loan has a three-year term and bears interest at an annual rate of 6%. For the first six months, payments will be interest only followed by repayment of principal and interest over a period of 30 months. There is also a final \$1,000,000 fee payment at the end of the term. In connection with the loan agreement, we issued to SVB a ten year warrant to acquire 293,531 shares of common stock at an exercise price of \$1.7034 per share.

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

This report contains forward looking statements within the meaning of Section 27A of the Securities Act and Section 21E of the Securities Exchange Act that involve substantial risks and uncertainties. Such statements include, without limitation, all statements as to expectation or belief and statements as to our future results of operations; the progress of our research, product development and clinical programs; the need for, and timing of, additional capital and capital expenditures; partnering prospects; costs of manufacture of products; the protection of, and the need for, additional intellectual property rights; effects of regulations; the need for additional facilities; and potential market opportunities. Our actual results may vary materially from those contained in such forward-looking statements because of risks to which we are subject, including the fact that additional trials will be required to confirm the safety and demonstrate the efficacy of our HuCNS-SC cells for the treatment of any disease or disorder; uncertainty as to whether the U.S. Food and Drug Administration (FDA), Swissmedic, or other regulatory authorities will permit us to proceed with clinical testing of proposed products despite the novel and unproven nature of our technologies; the risk that our clinical trials or studies could be substantially delayed beyond their expected dates or cause us to incur substantial unanticipated costs; uncertainties in our ability to obtain the capital resources needed to continue our current research and development operations and to conduct the research, preclinical development and clinical trials necessary for regulatory approvals; the uncertainty regarding our ability to obtain a corporate partner or partners, if needed, to support the development and commercialization of our potential cell-based therapeutics products; the uncertainty regarding the outcome of our clinical trials or studies we may conduct in the future; the uncertainty regarding the validity and enforceability of our issued patents; the risk that we may not be able to manufacture additional master and working cell banks when needed; the uncertainty whether any products that may be generated in our cell-based therapeutics programs will prove clinically safe and effective; the uncertainty whether we will achieve significant revenue from product sales or become profitable; uncertainties regarding our obligations with respect to our former facilities in Rhode Island; obsolescence of our technologies; competition from third parties; intellectual property rights of third parties; litigation risks; and other risks to which we are subject. All forward-looking statements attributable to us or to persons acting on our behalf are expressly qualified in their entirety by the cautionary statements and risk factors set forth in "Risk Factors" in Part I, Item 1A of our Form 10-K for the year ended December 31, 2012.

**Overview*****The Company***

We are engaged in researching, developing, and commercializing cell-based therapeutics and enabling tools and technologies for stem cell-based research and drug discovery and development. Our research and development (R&D) programs are primarily focused on identifying and developing potential cell-based therapeutics which can either restore or support organ function. In particular, since we relocated our corporate headquarters to California in 1999, our R&D efforts have been directed at refining our methods for identifying, isolating, culturing, and purifying the human neural stem cell and developing this cell as potential cell-based therapeutics for the central nervous system (CNS). Our HuCNS-SC<sup>®</sup> product candidate (purified human neural stem cells) is currently in clinical development for several indications – chronic spinal

cord injury, dry age-related macular degeneration (AMD) and

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Pelizeus-Merzbacher disease (PMD), which is a myelination disorder in the brain. In October 2012, we published in *Science Translational Medicine*, a peer-reviewed journal, the data from our four-patient Phase I clinical trial in PMD, which showed preliminary evidence of durable and progressive donor-derived myelination in all four patients. In addition, there were measurable gains in neurological function in three of the four patients, with the fourth patient clinically stable. We are conducting a Phase I/II clinical trial for the treatment of chronic spinal cord injury. This trial is being conducted in Switzerland under authorization from Swissmedic, and represents the first time that neural stem cells have been transplanted as a potential therapeutic agent for spinal cord injury. In February 2013, we announced that the first patient cohort, all of whom had complete spinal cord injuries, had completed the trial. In addition, data from this first cohort continued to demonstrate a favorable safety profile and showed that the considerable gains in sensory function observed at the six month assessment in two of the three patients compared to pre-transplant baselines had persisted at the 12 month assessment; the third patient remained stable. Also, in September 2012, the first patient with an incomplete spinal cord injury was enrolled and dosed with our HuCNS-SC cells. We are also conducting a Phase I/II clinical trial in dry AMD, and in April 2013, we added a second trial site for this trial. We previously completed a Phase I clinical trial in infantile and late infantile neuronal ceroid lipofuscinosis (NCL), and the data from that trial showed that our HuCNS-SC cells were well tolerated and non-tumorigenic, and that there was evidence of engraftment and long-term survival of the transplanted HuCNS-SC cells. In April 2013, we entered into an agreement with CIRM under which CIRM will provide approximately \$19.3 million as a forgivable loan, in accordance with mutually agreed upon terms and conditions and CIRM regulations. The CIRM loan will help fund preclinical development of our HuCNS-SC cells for Alzheimer's disease. For a brief description of our significant therapeutic research and development programs see Overview Research and Development Programs in the Business Section of Part I, Item 1 of our Form 10-K for the year ended December 31, 2012.

We are also engaged in developing and commercializing applications of our technologies to enable research, which we believe represent current and nearer-term commercial opportunities. Our portfolio of technologies includes cell technologies relating to embryonic stem cells, induced pluripotent stem (iPS) cells, and tissue-derived (adult) stem cells; expertise and infrastructure for providing cell-based assays for drug discovery; a cell culture products and antibody reagents business; and an intellectual property portfolio with claims relevant to cell processing, reprogramming and manipulation, as well as to gene targeting and insertion. Many of these enabling technologies were acquired in April 2009 as part of our acquisition of the operations of Stem Cell Sciences Plc (SCS).

We have not derived any revenue or cash flows from the sale or commercialization of any products except for license revenue for certain of our patented technologies and sales of products for use in stem cell research. As a result, we have incurred annual operating losses since inception and expect to incur substantial operating losses in the future. Therefore, we are dependent upon external financing, such as from equity and debt offerings, to finance our operations. Before we can derive revenue or cash inflows from the commercialization of any of our therapeutic product candidates, we will need to: (i) conduct substantial *in vitro* testing and characterization of our proprietary cell types, (ii) undertake preclinical and clinical testing for specific disease indications; (iii) develop, validate and scale-up manufacturing processes to produce these cell-based therapeutics, and (iv) obtain required regulatory approvals. These steps are risky, expensive and time consuming.

Overall, we expect our R&D expenses to be substantial and to increase for the foreseeable future as we continue the development and clinical investigation of our current and future product candidates. However, expenditures on R&D programs are subject to many uncertainties, including whether we develop our product candidates with a partner or independently. We cannot forecast with any degree of certainty which of our current product candidates will be subject to future collaboration, when such collaboration agreements will be secured, if at all, and to what degree such arrangements would affect our development plans and capital requirements. In addition, there are numerous factors associated with the successful commercialization of any of our cell-based therapeutics, including future trial design and regulatory requirements, many of which cannot be determined with accuracy at this time given the stage of our development and the novel nature of stem cell technologies. The regulatory pathways, both in the United States and internationally, are complex and fluid given the novel and, in general, clinically unproven nature of stem cell technologies. At this time, due to such uncertainties and inherent risks, we cannot estimate in a meaningful way the duration of, or the costs to complete, our R&D programs or whether, when or to what extent we will generate revenues or cash inflows from the commercialization and sale of any of our therapeutic product candidates. While we are currently focused on advancing each of our product development programs, our future R&D expenses will depend on the determinations we make as to the scientific and clinical prospects of each product candidate, as well as our ongoing assessment of the regulatory requirements and each product candidate's commercial potential.

Given the early stage of development of our therapeutic product candidates, any estimates of when we may be able to commercialize one or more of these products would not be meaningful. Moreover, any estimate of the time and investment required to develop potential products based upon our proprietary HuCNS-SC technologies will change depending on the ultimate approach or approaches we take to pursue them, the results of preclinical and clinical studies, and the content and timing of decisions made by the FDA, Swissmedic and other regulatory authorities. There can be no assurance that we will be able to develop any product successfully, or that we will be able to recover our development costs, whether upon commercialization of a developed product or otherwise. We cannot provide assurance that any of these programs will result in products that can be marketed or marketed profitably. If certain of our development-stage programs do not result in commercially viable products, our results of operations could be materially adversely affected.



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The research markets served by our tools and technologies products are highly competitive, complex and dynamic. Technological advances and scientific discoveries have accelerated the pace of change in biological research, and stem cell technologies have been evolving particularly fast. We compete mainly by focusing on specialty media and antibody reagent products and human cell lines where we believe our expertise, intellectual property and reputation give us competitive advantage. We believe that, in this particular market niche, our products and technologies offer customers specific advantages over those offered by our competitors. We compete by offering innovative, quality-controlled products, consistently made and designed to produce reproducible results. We continue to make investments in research and development, quality management, quality improvement, and product innovation. We cannot assure you that we will have sufficient resources to continue to make such investments. For the three month period ended March 31, 2013, we generated revenues from the sale of specialty cell culture products of approximately \$209,000. We can give no assurances that we will be able to continue to generate such revenues in the future.

### ***Significant Events***

In February 2013, the first patient cohort in our Phase I/II clinical trial of our proprietary HuCNS-SC cells for chronic spinal cord injury completed the trial. The data from this first cohort continued to demonstrate a favorable safety profile, and showed that the considerable gains in sensory function observed at the six month assessment in two of the three patients had persisted to the 12 month assessment. The third patient remained stable.

In March 2013, we acquired certain patents and patent applications from NsGene A/S, a Danish company. These patents and patent applications claim a purified population of GFAP+ Nestin+ precursor cells in which one or more of the cells are capable of differentiating into neurons.

In April 2013, we added the Byers Eye Institute at Stanford, located in Palo Alto, California, as a second site for our Phase I/II clinical trial of our proprietary HuCNS-SC cells in AMD.

In April 2013, we entered into an agreement with CIRM under which CIRM will provide approximately \$19.3 million to help fund preclinical development and IND-enabling activities of our HuCNS-SC cells for Alzheimer's disease. The funding, which will be in the form of a forgivable loan, was awarded under CIRM's Disease Team Therapy Development Award program (RFA 10-05) in September 2012. The goal of the research will be to file an Investigational New Drug (IND) application with the U.S. Food and Drug Administration within four years.

Also in April 2013, we closed a \$10 million loan from Silicon Valley Bank (SVB). The loan has a three-year term and the loan funds will be used for general corporate purposes.

### **Critical Accounting Policies and the Use of Estimates**

The accompanying discussion and analysis of our financial condition and results of operations are based on our condensed consolidated financial statements and the related disclosures, which have been prepared in accordance with U.S. GAAP. The preparation of these condensed consolidated financial statements requires management to make estimates, assumptions, and judgments that affect the reported amounts in our condensed consolidated financial statements and accompanying notes. These estimates form the basis for making judgments about