PACIFIC BIOSCIENCES OF CALIFORNIA, INC.
Form 10-Q
November 05, 2015

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2015

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 001-34899

Pacific Biosciences of California, Inc.

(Exact name of registrant as specified in its charter)

Delaware	16-1590339
(State or other jurisdiction of	(I.R.S. Employer

incorporation or organization)	Identification No.)
1380 Willow Road	
Menlo Park, CA 94025	94025
(Address of principal executive offices)	(Zip Code)

(650) 521-8000

(Registrant's telephone number, including area code)

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

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

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

Number of shares outstanding of the issuer's common stock as of October 31, 2015: 77,041,008

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PART I. FINANCIAL INFORMATION

Item 1.Financial Statements

PACIFIC BIOSCIENCES OF CALIFORNIA, INC.

Condensed Consolidated Balance Sheets

(Unaudited)

(in thousands except par value amounts)	September 30, 2015	December 31, 2014
Assets		
Current assets		
Cash and cash equivalents	$ 27,208	$ 36,449
Investments	31,701	64,899
Accounts receivable	4,164	3,406
Inventory	11,621	11,335
Prepaid expenses and other current assets	11,513	1,671
Total current assets	86,207	117,760
Property and equipment, net	7,855	6,601
Other long-term assets	5,715	162
Total assets	$ 99,777	$ 124,523
Liabilities and Stockholders' Equity		
Current liabilities		
Accounts payable	$ 6,097	$ 5,608
Accrued expenses	11,342	11,441
Deferred service revenue, current	6,303	6,121
Deferred contractual revenue, current	14,385	6,785
Other liabilities, current	627	1,534
Total current liabilities	38,754	31,489
Deferred service revenue, non-current	1,250	1,129
Deferred contractual revenue, non-current	1,347	19,735
Other liabilities, non-current	1,323	2,153
Notes payable	14,808	14,124
Financing derivative	925	944
Total liabilities	58,407	69,574
Commitments and contingencies		
Stockholders’ equity		

Preferred Stock, $0.001 par value:		
Authorized 50,000 shares; No shares issued or outstanding	—	—
Common Stock, $0.001 par value:		
Authorized 1,000,000 shares; Issued and outstanding 75,705 shares at September 30, 2015 and 73,927 shares at December 31, 2014	76	74
Additional paid-in capital	753,048	736,339
Accumulated other comprehensive income	6	9
Accumulated deficit	(711,760)	(681,473)
Total stockholders' equity	41,370	54,949
Total liabilities and stockholders' equity	$ 99,777	$ 124,523

See accompanying notes to the condensed consolidated financial statements.

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PACIFIC BIOSCIENCES OF CALIFORNIA, INC.

Condensed Consolidated Statements of Operations and Comprehensive Income (Loss)

(Unaudited)

	Three-Month Periods Ended September 30,		Nine-Month Periods Ended September 30,	
(in thousands, except per share amounts)	2015	2014	2015	2014
Revenue:				
Product revenue	$ 7,570	$ 6,762	$ 27,703	$ 22,376
Service and other revenue	2,751	2,165	8,010	6,226
Contractual revenue	3,596	11,696	20,788	15,088
Total revenue	13,917	20,623	56,501	43,690
Cost of Revenue:				
Cost of product revenue	5,119	5,608	23,289	19,048
Cost of service and other revenue	2,247	1,853	6,228	5,678
Total cost of revenue	7,366	7,461	29,517	24,726
Gross profit	6,551	13,162	26,984	18,964
Operating Expense:				
Research and development	16,162	11,693	45,688	35,899
Sales, general and administrative	10,818	9,882	32,411	28,025
Gain on lease amendments	(23,043)	—	(23,043)	—
Total operating expense	3,937	21,575	55,056	63,924
Operating income (loss)	2,614	(8,413)	(28,072)	(44,960)
Interest expense	(741)	(716)	(2,153)	(2,103)
Other expense, net	(52)	(34)	(62)	(122)
Net income (loss)	1,821	(9,163)	(30,287)	(47,185)
Other comprehensive income (loss):				
Unrealized gain (loss) on investments	(6)	(19)	(3)	9
Comprehensive income (loss)	$ 1,815	$ (9,182)	$ (30,290)	$ (47,176)
Net income (loss) per share:				
Basic	$ 0.02	$ (0.13)	$ (0.41)	$ (0.68)
Diluted	$ 0.02	$ (0.13)	$ (0.41)	$ (0.68)
Weighted average shares outstanding used in calculating net income (loss) per share				

Basic	75,205	70,740	74,699	69,716
Diluted	80,479	70,740	74,699	69,716

See accompanying notes to the condensed consolidated financial statements.

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PACIFIC BIOSCIENCES OF CALIFORNIA, INC.

Condensed Consolidated Statements of Cash Flows

(Unaudited)

	Nine-Month Periods Ended September 30,	
(in thousands)	2015	2014
Cash flows from operating activities		
Net loss	$ (30,287)	$ (47,185)
Adjustments to reconcile net loss to net cash used in operating activities		
Depreciation	2,694	3,311
Amortization of debt discount and financing costs	699	579
Stock-based compensation	9,813	6,944
Non-cash portion of gain on lease amendments	(3,043)	—
Other items	21	242
Changes in assets and liabilities		
Accounts receivable	(758)	376
Inventory	(1,990)	(1,348)
Prepaid expenses and other assets	(15,410)	85
Accounts payable	364	4,128
Accrued expenses	1,523	821
Deferred service revenue	303	1,661
Deferred contractual revenue	(10,788)	(5,088)
Other liabilities	(316)	(637)
Net cash used in operating activities	(47,175)	(36,111)
Cash flows from investing activities		
Purchase of property and equipment	(2,131)	(1,132)
Disposal of property and equipment	12	—
Purchase of investments	(43,715)	(97,468)
Sales of investments	8,317	—
Maturities of investments	68,553	119,673
Net cash provided by investing activities	31,036	21,073
Cash flows from financing activities		
Proceeds from issuance of common stock from equity plans	5,465	3,319
Proceeds from issuance of common stock from at-the-market equity offering, net of issuance costs	1,433	20,768
Net cash provided by financing activities	6,898	24,087
Net increase (decrease) in cash and cash equivalents	(9,241)	9,049
Cash and cash equivalents at beginning of period	36,449	26,362

Cash and cash equivalents at end of period	$ 27,208	$ 35,411
Supplemental disclosure of non-cash investing and financing activities		
Leased instruments that were transferred from inventory to property and equipment	1,704	—

See accompanying notes to the condensed consolidated financial statements.

PACIFIC BIOSCIENCES OF CALIFORNIA, INC.

Notes to Condensed Consolidated Financial Statements

(Unaudited)

NOTE 1. OVERVIEW

Pacific Biosciences of California, Inc. (“Pacific Biosciences”, the “Company”, “we”, “us”) has commercialized the PacBio RS II Sequencing System to help scientists solve genetically complex problems. Based on our novel Single Molecule, Real-Time (SMRT®) technology, our products enable: de novo genome assembly to finish genomes in order to more fully identify, annotate and decipher genomic structures; full-length transcript analysis to improve annotations in reference genomes, characterize alternatively spliced isoforms and find novel genes; targeted sequencing to more comprehensively characterize genetic variations; and DNA base modification identification to help characterize epigenetic regulation and DNA damage. Our technology combines very high consensus accuracy and long read lengths with the ability to detect real-time kinetic information.

In September 2015, we announced that we had launched a new nucleic acid sequencing platform, the Sequel™ System, which provides higher throughput, more scalability, a reduced footprint and lower sequencing project costs compared to the PacBio® RS II System, while maintaining the existing benefits of the company’s SMRT Technology.

The names “Pacific Biosciences,” “PacBio,” “SMRT,” “SMRTbell,” “Sequel” and our logo are our trademarks.

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

In the opinion of management, the accompanying unaudited Condensed Consolidated Financial Statements (“Financial Statements”) of Pacific Biosciences of California, Inc. have been prepared on a consistent basis with our December 31, 2014 audited Consolidated Financial Statements and include all adjustments, consisting of only normal recurring adjustments, necessary to fairly state the information set forth herein. Certain prior year amounts in the Financial Statements and notes thereto have been reclassified to conform to the current year presentation. The Financial Statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission (“SEC”) and, as permitted by such rules and regulations, omit certain information and footnote disclosures necessary to present the statements in accordance with U.S. generally accepted accounting principles (“GAAP”). These Financial Statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2014. The results of operations for the first nine-month period of 2015 are not necessarily indicative of the results to be expected for the entire year or any future periods.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires us to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes to the financial statements. Our estimates include, but are not limited to, the valuation of inventory, revenue valuation, the valuation of a financing derivative and long-term notes, the valuation and recognition of share-based compensation, the delivery period for collaboration agreements, the useful lives assigned to long-lived assets, and the computation provisions for income taxes. Actual results could differ materially from these estimates.

During the first quarter of 2015, we revised the estimated period over which the delivery of elements pursuant to the Development, Commercialization and License Agreement (the "Roche Agreement") with F. Hoffman-La Roche Ltd ("Roche") is expected to occur, due to an increased level of certainty regarding the development period. As a result, we are, on a prospective basis, recognizing the remaining deferred contractual revenue associated with the upfront payment received under the Roche Agreement over the revised estimated remaining development period. For the three- and nine-month periods ended September 30, 2015, this change in estimate increased contractual revenue by $1.9 million and $5.7 million, respectively, increased our basic net income per share for the three-month period ended September 30, 2015 by $0.03 per share, increased our diluted net income per share for the three-month period ended September 30, 2015 by $0.02 per share, and decreased our net loss per share for the nine-month period ended September 30, 2015 by $0.08 per share.

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Fair Value of Financial Instruments

Assets and liabilities measured at fair value on a recurring basis

The following table sets forth the fair value of our financial assets and liabilities measured on a recurring basis as of September 30, 2015 and December 31, 2014:

(in thousands)	September 30, 2015				December 31, 2014			
	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total
Assets								
Cash and cash equivalents:								
Cash and money market funds	$ 15,259	$ —	$ —	$ 15,259	$ 21,952	$ —	$ —	$ 21,952
Commercial paper	—	11,949	—	11,949	—	14,497	—	14,497
Total cash and cash equivalents	15,259	11,949	—	27,208	21,952	14,497	—	36,449
Investments:								
Commercial paper	—	14,234	—	14,234	—	43,653	—	43,653
Corporate debt securities	—	7,457	—	7,457	—	8,173	—	8,173
Asset backed securities	—	10,010	—	10,010	—	13,073	—	13,073
Total investments	—	31,701	—	31,701	—	64,899	—	64,899
Total assets measured at fair value	$ 15,259	$ 43,650	$ —	$ 58,909	$ 21,952	$ 79,396	$ —	$ 101,348
Liabilities								
Financing derivative	$ —	$ —	$ 925	$ 925	$ —	$ —	$ 944	$ 944

We classify our cash deposits and money market funds within Level 1 of the fair value hierarchy because they are valued using bank balances or quoted market prices. We classify our investments as Level 2 instruments based on market pricing and other observable inputs. We did not classify any of our investments within Level 3 of the fair value hierarchy.

During the nine-month periods ended September 30, 2015 and 2014, there were no impairments of our investments.

The estimated fair value of the Financing Derivative liability (as defined in Note 6. Notes Payable) was determined using Level 3 inputs, or significant unobservable inputs. Changes to the estimated fair value of the Financing Derivative are recorded in “Other income (expense), net” in the condensed consolidated statements of operations and comprehensive income (loss). The following table provides the changes in the estimated fair value of the Financial Derivative during the nine-month period ended September 30, 2015 (in thousands):

Financial Derivative	Amount
Balance as of December 31, 2014	$ 944
Gain on change in estimated fair value	(19)
Balance as of September 30, 2015	$ 925

During the nine-month period ended September 30, 2015 there were no transfers between Level 1, Level 2, or Level 3 assets or liabilities reported at fair value on a recurring basis and the valuation techniques used did not change compared to our established practice.

Financial assets and liabilities not measured at fair value on a recurring basis

The carrying amount of our accounts receivable, prepaid expenses, other current assets, accounts payable, accrued expenses and other liabilities, current, approximate fair value due to their short maturities. The carrying value of our other liabilities, non-current, approximates fair value due to the time to maturity and prevailing market rates.

We determined the estimated fair value of the Notes (as defined in Note 6. Notes Payable) using Level 3 inputs, or significant unobservable inputs. The estimated fair value of the Notes was determined by comparing the difference between the estimated fair value of the Notes with and without the Financing Derivative by calculating the respective present values from future cash flows using a weighted average market yield of 18.3% and 19.5% at September 30, 2015 and December 31, 2014, respectively.

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The estimated fair value and carrying value of the Notes are as follows (in thousands):

	September 30, 2015		December 31, 2014	
	Fair Value	Carrying Value	Fair Value	Carrying Value
Notes payable	$ 15,681	$ 14,808	$ 14,817	$ 14,124

Net Income (Loss) per Share

Basic net income (loss) per share and diluted net income (loss) per share are presented in conformity with ASC 260 Earnings per Share, for all periods presented. Basic net income (loss) per share is computed by dividing net income (loss) by the weighted average number of shares of common stock outstanding during the period. Diluted net income (loss) per share is computed using the weighted average number of shares of common stock outstanding and potential shares assuming the dilutive effect of outstanding stock options, warrants and common stock issuable pursuant to our employee stock purchase plan, or ESPP, using the treasury stock method.

The following table presents the calculation of weighted average shares of common stock used in the computations of basic and diluted net income (loss) per share amounts presented in the accompanying condensed consolidated statements of operations and comprehensive income (loss) (in thousands, except per share amounts):

	Three-Month Periods Ended September 30,		Nine-Month Periods Ended September 30,	
	2015	2014	2015	2014
Net income (loss)	$ 1,821	$ (9,163)	$ (30,287)	$ (47,185)
Basic				
Weighted average shares used in computing basic net income (loss) per share	75,205	70,740	74,699	69,716
Basic net income (loss) per share	$ 0.02	$ (0.13)	$ (0.41)	$ (0.68)
Diluted				
Weighted average shares used in computing basic net income (loss) per share	75,205	70,740	74,699	69,716
Add: weighted average stock options	2,733	—	—	—
Add: weighted average warrants	2,541	—	—	—
	80,479	70,740	74,699	69,716

Weighted average shares used in computing diluted net income (loss) per share				
Diluted net income (loss) per share	$ 0.02	$ (0.13)	$ (0.41)	$ (0.68)

The following outstanding common stock options and warrants to purchase common stock were excluded from the computation of diluted net loss per share for the periods presented because including them would have had an anti-dilutive effect (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Options to purchase common stock	11,959	16,651	18,469	16,651
Warrants to purchase common stock	—	5,500	5,500	5,500

Recent Accounting Pronouncements

On May 28, 2014, the Financial Accounting Standards Board (“FASB”) issued ASU No. 2014-09, Revenue from Contracts with Customers, requiring an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The updated standard will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective and permits the use of either the retrospective or cumulative effect transition method. In August 2015, the FASB issued ASU No. 2015-14, Revenue from Contracts with Customers: Deferral of the Effective Date, which deferred the effective date of the new revenue standard for periods beginning after December 15, 2016 to December 15, 2017, with early adoption permitted but not earlier than the original effective date. Accordingly, the updated standard is effective for us in the first quarter of 2018. We have not yet selected a transition method and we are currently evaluating the effect that the updated standard will have on our consolidated financial statements and related disclosures.

In April 2015, the FASB issued ASU 2015-03, Simplifying the Presentation of Debt Issuance Costs, which changes the presentation of debt issuance costs in financial statements. This ASU requires an entity to present such costs in the balance sheet as a direct deduction from the related debt liability rather than as an asset. Amortization of the costs will continue to be reported as interest expense. This ASU is effective for the Company's annual reporting periods beginning after December 15, 2015 and is effective for us in the first quarter of 2016. Early adoption is permitted. The new guidance will be applied retrospectively to each prior period presented. Early adoption is permitted for financial statements that have not been previously issued. ASU 2015-03 is not expected to have a material impact on our condensed consolidated financial statements and we will adopt it for the year ended December 31, 2015.

In July 2015, the FASB issued ASU 2015-11, Simplifying the Measurement of Inventory. ASU 2015-11 simplifies the subsequent measurement of inventory by replacing today's lower of cost or market test with a lower of cost and net realizable value test. The guidance applies only to inventories for which cost is determined by methods other than last-in first-out (LIFO) and the retail inventory method (RIM). Entities that use LIFO or RIM will continue to use existing impairment models (e.g., entities using LIFO would apply the lower of cost or market test). This ASU is effective for the Company's annual report periods beginning after December 15, 2016 and is effective for us in the first quarter of 2017. Early adoption is permitted as of the beginning of an interim or annual reporting period. The new guidance must be applied prospectively after the date of adoption. We are currently in the process of evaluating the impact of adopting this ASU on our financial statements and related disclosures.

NOTE 3. CONTRACTUAL REVENUE

During September 2013, we entered into a Development, Commercialization and License Agreement (the "Roche Agreement") with F. Hoffman-La Roche Ltd ("Roche"), pursuant to which we account for, and recognize as revenue, the up-front payment received thereunder using the proportional performance method over the periods in which the delivery of elements pursuant to the agreement occurs. We recognize revenue using a straight-line convention over the service periods of the deliverables as this method approximates our performance of services pursuant to the agreement. Out of the $35.0 million upfront cash payment received, quarterly amortization of $1.7 million has been recognized as contractual revenue from the fourth quarter of 2013 to the fourth quarter of 2014. Beginning in the three-month period ended March 31, 2015, we revised the estimated development period related to our contractual revenue amortization based on increasing certainty of the development time on a prospective approach. This change in estimate resulted in $1.9 million of additional contractual revenue being recognized per quarter and a total of $3.6 million as quarterly amortization.

We recognized a total of $3.6 million and $10.8 million of amortization related to the Roche Agreement for the three- and nine-month periods ended September 30, 2015, respectively. The additional contractual revenue due to the revision had a 100% margin and increased our net income for the three-month period ended September 30, 2015 by $1.9 million and decreased our net loss for the nine-month period ended September 30, 2015 by $5.7 million, increased our basic net income per share for three-month period ended September 30, 2015 by $0.03 per share, increased our diluted net income per share for the three-month period ended September 30, 2015 by $0.02 per share, and decreased our net loss per share for nine-month period ended September 30, 2015 by $0.08 per share. At September 30, 2015, going forward, on a prospective basis, we will recognize the remaining deferred contractual revenue of $15.7 million associated with upfront payment received under the Roche Agreement over the revised estimated remaining delivery period.

In addition to the deliverables above, the Roche Agreement provides for additional payments totaling up to $40.0 million upon the achievement of certain development milestones. Consideration from development milestones is recognized in the period in which a milestone is achieved only if the milestone is considered substantive in its entirety. During August 2014, we achieved the first such development milestone and we recognized the related $10.0 million as contractual revenue for the quarter ended September 30, 2014. During April 2015, we achieved the second development milestone and we recognized the related $10.0 million as contractual revenue for the quarter ended June 30, 2015.

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NOTE 4. CASH, CASH EQUIVALENTS AND INVESTMENTS

The following tables summarize our cash, cash equivalents and investments as of September 30, 2015 and December 31, 2014 (in thousands):

	September 30, 2015			
	Amortized Cost	Gross unrealized gains	Gross unrealized losses	Fair Value
Cash and cash equivalents:				
Cash and money market funds	$ 15,259	$ —	$ —	$ 15,259
Commercial paper	11,948	1	—	11,949
Total cash and cash equivalents	27,207	1	—	27,208
Investments:				
Commercial paper	14,231	3	—	14,234
Corporate debt securities	7,454	3	—	7,457
Asset backed securities	10,011	—	(1)	10,010
Total investments	31,696	6	(1)	31,701
Total cash, cash equivalents and investments	$ 58,903	$ 7	$ (1)	$ 58,909

	December 31, 2014			
	Amortized Cost	Gross unrealized gains	Gross unrealized losses	Fair Value
Cash and cash equivalents:				