

SAFEGUARD SCIENTIFICS INC

Form 10-Q

November 03, 2006

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**SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549**

**FORM 10-Q  
Quarterly Report Pursuant to Section 13 or 15(d)  
of the Securities Exchange Act of 1934  
For the Quarter Ended September 30, 2006**

**Commission File Number 1-5620  
SAFEGUARD SCIENTIFICS, INC.  
(Exact name of registrant as specified in its charter)**

**Pennsylvania  
(State or other jurisdiction of  
incorporation or organization)**

**23-1609753  
(I.R.S. Employer  
Identification Number)**

**Building 800  
435 Devon Park Drive, Wayne, PA  
(Address of principal executive offices)**

**19087  
(Zip Code)**

**(610) 293-0600**

**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 and 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 is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

Yes  No

**Number of shares outstanding as of October 30, 2006**

**Common Stock 120,155,036**

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QUARTERLY REPORT ON FORM 10-Q  
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**SAFEGUARD SCIENTIFICS, INC.  
CONSOLIDATED BALANCE SHEETS**

	<b>September 30, 2006</b>	<b>December 31, 2005</b>
	<b>(in thousands except per share data)</b>	
	<b>(unaudited)</b>	
<b>ASSETS</b>		
Current Assets		
Cash and cash equivalents	\$ 48,937	\$ 124,916
Restricted cash	275	1,098
Marketable securities	29,416	31,770
Trading securities	2,106	
Restricted marketable securities	3,813	3,805
Accounts receivable, less allowances (\$1,889 - 2006; \$1,720- 2005)	42,718	41,006
Prepaid expenses and other current assets	6,039	5,498
Current assets of discontinued operations	15,446	12,263
Total current assets	148,750	220,356
Property and equipment, net	44,193	37,739
Ownership interests in and advances to companies	49,585	17,897
Long-term marketable securities	928	3,311
Long-term restricted marketable securities	5,720	9,457
Intangible assets, net	17,079	15,312
Goodwill	82,455	77,972
Note receivable related party	414	
Other	4,501	5,563
Non-current assets of discontinued operations	22,837	28,695
Total Assets	\$ 376,462	\$ 416,302
 <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Current Liabilities		
Current portion of credit line borrowings	\$ 24,364	\$ 13,023
Current maturities of long-term debt	3,950	3,374
Current portion of convertible senior debentures		5,000
Accounts payable	8,880	10,358
Accrued compensation and benefits	14,138	12,310
Accrued expenses and other current liabilities	11,097	14,567
Deferred revenue	4,978	3,465
Current liabilities of discontinued operations	8,372	12,718
Total current liabilities	75,779	74,815
Long-term debt	5,693	5,170
Other long-term liabilities	15,398	14,013

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Convertible senior debentures	129,000	145,000
Deferred taxes	889	895
Minority interest	6,193	10,478
Non-current liabilities of discontinued operations	709	956
Commitments and contingencies		
Redeemable stock-based compensation	1,966	
Shareholders' Equity		
Preferred stock, \$0.10 par value; 1,000 shares authorized		
Common stock, \$0.10 par value; 500,000 shares authorized; 120,155 and 119,935 shares issued and outstanding in 2006 and 2005	12,016	11,993
Additional paid-in capital	750,349	747,953
Accumulated deficit	(622,382)	(597,088)
Accumulated other comprehensive income	852	3,166
Treasury stock, at cost (2 shares-2005)		(6)
Unamortized deferred compensation		(1,043)
Total shareholders' equity	140,835	164,975
Total Liabilities and Shareholders' Equity	\$ 376,462	\$ 416,302

See Notes to Consolidated Financial Statements.

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**SAFEGUARD SCIENTIFICS, INC.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
	(in thousands, except per share data) (unaudited)			
Revenue				
Product sales	\$ 2,033	\$ 898	\$ 7,086	\$ 3,241
Service sales	48,575	33,135	137,632	99,902
 Total revenue	 50,608	 34,033	 144,718	 103,143
 Operating Expenses				
Cost of sales product	1,340	127	4,916	478
Cost of sales service	34,489	25,497	99,581	74,686
Selling, general and administrative	24,599	18,834	73,424	53,318
Research and development	1,660	921	5,032	2,567
Amortization of intangibles	700	611	2,645	1,832
 Total operating expenses	 62,788	 45,990	 185,598	 132,881
 Operating loss	 (12,180)	 (11,957)	 (40,880)	 (29,738)
Other income, net	3,077	966	4,971	2,216
Impairment related party				(260)
Interest income	1,399	1,363	4,518	3,614
Interest expense	(1,777)	(1,659)	(5,054)	(4,699)
Equity loss	(1,910)	(599)	(2,180)	(6,006)
Minority interest	1,789	1,849	5,681	4,700
 Net loss from continuing operations before income taxes	 (9,602)	 (10,037)	 (32,944)	 (30,173)
Income tax (expense) benefit	(83)	(38)	1,140	2
 Net loss from continuing operations	 (9,685)	 (10,075)	 (31,804)	 (30,171)
Net income (loss) from discontinued operations	78	(565)	6,510	(4,241)
 Net Loss	 \$ (9,607)	 \$ (10,640)	 \$ (25,294)	 \$ (34,412)
 Basic Income (Loss) Per Share:				
Net loss from continuing operations	\$ (0.08)	\$ (0.08)	\$ (0.26)	\$ (0.25)
Net income (loss) from discontinued operations		(0.01)	0.05	(0.03)
 Net Loss Per Share	 \$ (0.08)	 \$ (0.09)	 \$ (0.21)	 \$ (0.28)
 Diluted Income (Loss) Per Share:				

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Net loss from continuing operations	\$ (0.08)	\$ (0.08)	\$ (0.26)	\$ (0.25)
Net income (loss) from discontinued operations		(0.01)	0.05	(0.04)
Net Loss Per Share	\$ (0.08)	\$ (0.09)	\$ (0.21)	\$ (0.29)
Shares Used in Computing Basic and Diluted Income (Loss) Per Share	121,541	120,898	121,441	120,776

See Notes to Consolidated Financial Statements.

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**SAFEGUARD SCIENTIFICS, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

	Nine Months Ended September 30,	
	2006	2005
	(in thousands) (unaudited)	
<b>Cash Flows from Operating Activities</b>		
Net cash used in operating activities of continuing operations	\$ (25,948)	\$ (15,443)
Net cash provided by operating activities of discontinued operations	2,468	202
Net cash used in operating activities	(23,480)	(15,241)
<b>Cash Flows from Investing Activities</b>		
Proceeds from sale of available-for-sale and trading securities	348	241
Proceeds from sales of and distributions from companies and funds	1,530	5,035
Advances to companies		(2,185)
Acquisitions of ownership interests in companies, funds and subsidiaries, net of cash acquired	(40,887)	(9,367)
Increase in restricted cash and marketable securities	(62,016)	(54,113)
Decrease in restricted cash and marketable securities	64,370	36,219
Capital expenditures	(14,078)	(7,393)
Proceeds from sale of property and equipment	415	4,212
Capitalized software costs	(171)	(104)
Proceeds from sale of discontinued operations	6,154	
Other, net	(484)	566
Cash flows from investing activities of discontinued operations	(59)	(266)
Net cash used in investing activities	(44,878)	(27,155)
<b>Cash Flows from Financing Activities</b>		
Repurchase of convertible senior debentures	(16,215)	
Borrowings on revolving credit facilities	102,911	69,635
Repayments on revolving credit facilities	(91,546)	(68,372)
Borrowings of term debt	4,679	4,978
Repayments of term debt	(3,577)	(6,001)
Increase (decrease) in restricted cash	(275)	508
Issuance of Company common stock, net	356	
Issuance of subsidiary common stock, net	50	194
Purchase of subsidiary common stock, net		(611)
Offering costs on issuance of subsidiary common stock	(70)	
Cash flows from financing activities of discontinued operations	(1,360)	506
Net cash (used in) provided by financing activities	(5,047)	837



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<b>Net Decrease in Cash and Cash Equivalents</b>	(73,405)	(41,559)
Changes in Cash and Cash Equivalents from Mantas included in discontinued operations	(2,574)	(986)
	(75,979)	(42,545)
Cash and Cash Equivalents at beginning of period	124,916	143,398
<b>Cash and Cash Equivalents at end of period</b>	<b>\$ 48,937</b>	<b>\$ 100,853</b>

See Notes to Consolidated Financial Statements.

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**SAFEGUARD SCIENTIFICS, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2006**

**1. GENERAL**

The accompanying unaudited interim Consolidated Financial Statements of Safeguard Scientifics, Inc. (the Company) were prepared in accordance with accounting principles generally accepted in the United States of America and the interim financial statements rules and regulations of the SEC. In the opinion of management, these statements include all adjustments (consisting only of normal recurring adjustments) necessary for a fair presentation of the Consolidated Financial Statements. The interim operating results are not necessarily indicative of the results for a full year or for any interim period. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations relating to interim financial statements. The Consolidated Financial Statements included in this Form 10-Q should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations included elsewhere in this Form 10-Q and with the Company's Consolidated Financial Statements and Notes thereto included in the Company's 2005 Annual Report on Form 10-K.

**2. BASIS OF PRESENTATION**

The Consolidated Financial Statements include the accounts of the Company and all subsidiaries in which it directly or indirectly owns more than 50% of the outstanding voting securities.

The Company's Consolidated Statements of Operations and Consolidated Statements of Cash Flows include the following subsidiaries:

<b>Three Months Ended September 30,</b>	
<b>2006</b>	<b>2005</b>
Acsis, Inc. ( Acsis ) Alliance Consulting Group Associates, Inc. ( Alliance Consulting ) Clarient, Inc. ( Clarient ) Laureate Pharma, Inc. ( Laureate Pharma ) Pacific Title and Art Studio, Inc. ( Pacific Title )	Alliance Consulting Clarient Laureate Pharma Pacific Title

<b>Nine Months Ended September 30,</b>	
<b>2006</b>	<b>2005</b>
Acsis Alliance Consulting Clarient Laureate Pharma Pacific Title	Alliance Consulting Clarient Laureate Pharma Pacific Title

The Company's Consolidated Balance Sheets include the following majority-owned subsidiaries:

<b>September 30, 2006</b>	<b>December 31, 2005</b>
Acsis Alliance Consulting Clarient Laureate Pharma Pacific Title	Acsis Alliance Consulting Clarient Laureate Pharma Pacific Title



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**SAFEGUARD SCIENTIFICS, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**SEPTEMBER 30, 2006**

Alliance Consulting operates on a 52 or 53-week fiscal year, ending on the Saturday closest to the end of the fiscal period. The Company and all other subsidiaries operate on a calendar year. Alliance Consulting's third quarter ended on September 30, 2006 and October 1, 2005, each a period of 13 weeks and year-to-date a period of 39 weeks.

See Note 3 for discontinued operations treatment of Mantas and components of Alliance Consulting and Laureate Pharma.

**3. DISCONTINUED OPERATIONS*****Mantas***

In October 2006, the Company completed the merger of Mantas into a wholly-owned US subsidiary of i-flex® Solutions (See Note 18). As of September 30, 2006, Mantas' assets and liabilities have been classified as held for sale and its results of operations and cash flows are presented as discontinued operations for the three and nine months ended September 30, 2006. All prior periods presented have been reclassified to conform to this presentation. Mantas sold its telecommunications business and certain related assets and liabilities in the first quarter of 2006 for \$2.1 million in cash. As a result of the sale, Mantas recorded a gain of \$1.9 million in the first quarter of 2006.

***Laureate Pharma Totowa Operations***

In December 2005, Laureate Pharma sold its Totowa operations for \$16.0 million in cash. Laureate Pharma recognized a \$7.7 million gain on the transaction. The Totowa operations are reported in discontinued operations in 2005.

***Alliance Consulting Southwest Region***

Alliance Consulting completed the sale of its Southwest region on May 1, 2006 for proceeds of \$4.5 million, including cash of \$3.0 million and stock of the acquiror of \$1.5 million which was subsequently sold. As a result of the sale, Alliance Consulting recorded a gain of \$1.6 million in the second quarter of 2006. Alliance Consulting's Southwest region is reported in discontinued operations for all periods presented.

Results of all discontinued operations were as follows:

	<b>Three Months ended</b>		<b>Nine Months ended September</b>	
	<b>September 30,</b>		<b>30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	<b>(in thousands)</b>			
	<b>(unaudited)</b>			
Revenue	\$ 7,784	\$ 12,004	\$ 29,476	\$ 33,748
Operating expenses	(7,895)	(12,566)	(26,487)	(37,925)
Other	39	1	84	(31)
Net income (loss) before income taxes	(72)	(561)	3,073	(4,208)
Income tax expense	(106)	(4)	(228)	(33)
Net income (loss) from operations	(178)	(565)	2,845	(4,241)
Gain on disposal	256		3,665	
Income (loss) from discontinued operations, net of income taxes	\$ 78	\$ (565)	\$ 6,510	\$ (4,241)

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**SAFEGUARD SCIENTIFICS, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**SEPTEMBER 30, 2006**

The assets and liabilities of the discontinued operations were as follows:

	<b>September 30, 2006</b>	<b>December 31, 2005</b>
	<b>(in thousands)</b>	
	<b>(unaudited)</b>	
Cash	\$ 5,197	\$ 2,637
Restricted Cash	100	250
Accounts receivable, less allowances	9,569	8,752
Other current assets	580	624
<b>Total current assets</b>	<b>15,446</b>	<b>12,263</b>
Property and equipment, net	1,229	1,954
Intangibles		306
Goodwill	19,454	22,867
Other assets	2,154	3,568
<b>Total non-current assets</b>	<b>22,837</b>	<b>28,695</b>
<b>Total Assets</b>	<b>\$ 38,283</b>	<b>\$ 40,958</b>
Current debt	\$	\$ 1,506
Accounts payable	1,169	1,022
Accrued expenses	4,025	4,474
Deferred revenue	3,178	5,716
<b>Total current liabilities</b>	<b>8,372</b>	<b>12,718</b>
Other long-term liabilities	709	956
<b>Total liabilities</b>	<b>\$ 9,081</b>	<b>\$ 13,674</b>
<b>Carrying value</b>	<b>\$ 29,202</b>	<b>\$ 27,284</b>

**4. MARKETABLE SECURITIES**

Marketable securities include the following:

	<b>Current</b>		<b>Long-term</b>	
	<b>September 30, 2006</b>	<b>December 31, 2005</b>	<b>September 30, 2006</b>	<b>December 31, 2005</b>
	<b>(in thousands)</b>			

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	(unaudited)		(unaudited)	
Held-to-maturity:				
Certificates of deposit	\$ 500	\$ 12,289	\$	\$
U.S. Treasury securities		2,845		
Mortgage and asset-backed securities		2,457		
Commercial paper	28,916	14,179		
	29,416	31,770		
Restricted U.S. Treasury securities.	3,813	3,805	5,720	9,457
	33,229	35,575	5,720	9,457
Available-for-sale:				
Equity securities			928	3,311
Trading securities:				
Equity securities	2,106			
	\$ 35,335	\$ 35,575	\$ 6,648	\$ 12,768

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**SAFEGUARD SCIENTIFICS, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**SEPTEMBER 30, 2006**

As of September 30, 2006, the contractual maturities of securities were as follows:

	<b>Years to Maturity (in thousands) (unaudited)</b>			<b>Total</b>
	<b>Less Than One Year</b>	<b>One to Five Years</b>	<b>No Single Maturity Date</b>	
Held-to-maturity	\$ 33,229	\$ 5,720	\$	\$ 38,949
Available-for-sale			928	928
Trading	2,106			2,106
	\$ 35,335	\$ 5,720	\$ 928	\$ 41,983

As of September 30, 2006 and December 31, 2005, the Company's investment in available-for-sale securities had generated, on a cumulative basis, unrealized gains of \$0.9 million and \$3.3 million, respectively, which are reflected in Accumulated Other Comprehensive Income on the Consolidated Balance Sheets. For the three and nine months ended September 30, 2006, the Company recorded unrealized losses of \$0.6 million and \$0.2 million, respectively, associated with the Company's investment in trading securities, which are reflected in Other Income, Net in the Consolidated Statements of Operations.

**5. GOODWILL AND OTHER INTANGIBLE ASSETS**

The following is a summary of changes in the carrying amount of goodwill by segment:

	<b>Alliance Consulting</b>	<b>Clarient</b>	<b>Acsis</b>	<b>Total</b>
	<b>(in thousands) (unaudited)</b>			
Balance at December 31, 2005	\$ 51,782	\$ 14,259	\$ 11,931	\$ 77,972
Additions	4,364	516		4,880
Purchase price adjustments			(397)	(397)
Balance at September 30, 2006	\$ 56,146	\$ 14,775	\$ 11,534	\$ 82,455

See Note 15, regarding current year goodwill activity.

Intangible assets with definite useful lives are amortized over their respective estimated useful lives to their estimated residual values. The following table provides a summary of the Company's intangible assets with definite and indefinite useful lives:

	<b>September 30, 2006</b>			<b>Net</b>
	<b>Amortization Period</b>	<b>Gross Carrying Value</b>	<b>Accumulated Amortization</b>	
		<b>(In thousands) (unaudited)</b>		
Customer-related		\$ 10,089	\$ 2,438	\$ 7,651

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	5 10			
	years			
Technology-related	3 10	9,879	6,181	3,698
Process-related	years	1,363	871	492
	3 years			
	10 20			
Tradenames	years	1,352	51	1,301
Covenant not-to-compete	1 year	470	390	80
	10 15			
Other	years	1,290		1,290
		24,443	9,931	14,512
Tradenames	Indefinite	2,567		2,567
Total		\$ 27,010	\$ 9,931	\$ 17,079



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**SAFEGUARD SCIENTIFICS, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**SEPTEMBER 30, 2006**

		<b>December 31, 2005</b>		
	<b>Amortization Period</b>	<b>Gross Carrying Value</b>	<b>Accumulated Amortization</b>	<b>Net</b>
		<b>(In thousands)</b>		
Customer-related	7 - 10 years	\$ 8,991	\$ 1,626	\$ 7,365
Technology-related	3 - 10 years	7,993	5,094	2,899
Process-related	3 years	1,363	530	833
Tradenames	20 years	1,222	5	1,217
Covenant not-to-compete	1 year	470	39	431
		20,039	7,294	12,745
Tradenames	Indefinite	2,567		2,567
<b>Total</b>		<b>\$ 22,606</b>	<b>\$ 7,294</b>	<b>\$ 15,312</b>

Amortization expense related to intangible assets was \$0.7 million and \$2.6 million for the three and nine months ended September 30, 2006, respectively, and \$0.6 million and \$1.8 million for the three and nine months ended September 30, 2005, respectively. The following table provides estimated future amortization expense related to intangible assets:

	<b>Total (In thousands) (unaudited)</b>
Remainder of 2006	\$ 764
2007	2,675
2008	2,257
2009	1,797
2010 and thereafter	7,019
	<b>\$ 14,512</b>

**6. RECENT ACCOUNTING PRONOUNCEMENTS**

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements ( SFAS No. 157 ). SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company does not expect the adoption of SFAS No. 157 to have a material impact on its financial statements.

In June 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes ( FIN 48 ). FIN 48 defines the threshold for recognizing the benefits of tax return positions in the financial statements as more-likely-than-not to be sustained by the taxing authority. FIN 48 also includes guidance concerning accounting for

income tax uncertainties in interim periods and increases the level of disclosures associated with any recorded income tax uncertainties. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company does not believe adoption of FIN 48 will have a material effect on its consolidated financial position, results of operations or cash flows.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), Share-Based Payment ( SFAS No. 123(R) ). SFAS No. 123(R) requires companies to measure all employee stock-based compensation awards using a fair value method and record such expense in its consolidated financial statements. In addition, the adoption of SFAS No. 123(R) requires additional accounting and disclosure related to the income tax and cash flow effects resulting from share-based payment arrangements. The Company adopted SFAS No. 123(R) on January 1, 2006 using the modified prospective method. See Note 10.

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**SAFEGUARD SCIENTIFICS, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**SEPTEMBER 30, 2006**

**7. COMPREHENSIVE INCOME (LOSS)**

Comprehensive income (loss) is the change in equity of a business enterprise from transactions and other events and circumstances from non-owner sources. Excluding net income (loss), the Company's sources of comprehensive income (loss) are from net unrealized appreciation (depreciation) on its holdings classified as available-for-sale and foreign currency translation adjustments.

The following summarizes the components of comprehensive loss:

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	<b>(in thousands)</b>			
	<b>(unaudited)</b>			
Net loss from continuing operations	\$ (9,685)	\$ (10,075)	\$ (31,804)	\$ (30,171)
Other comprehensive income (loss):				
Foreign currency translation adjustments	(18)	6	69	(49)
Unrealized holding losses in available-for-sale securities	(201)	(978)	(2,383)	(8,051)
Other comprehensive loss from continuing operations	(219)	(972)	(2,314)	(8,100)
Comprehensive loss from continuing operations	(9,904)	(11,047)	(34,118)	(38,271)
Income (loss) from discontinued operations	78	(565)	6,510	(4,241)
Comprehensive loss	\$ (9,826)	\$ (11,612)	\$ (27,608)	\$ (42,512)

**8. LONG-TERM DEBT AND CREDIT ARRANGEMENTS**

Consolidated long-term debt consists of the following:

	<b>September</b>	<b>December</b>
	<b>30,</b>	<b>31</b>
	<b>2006</b>	<b>2005</b>
	<b>(in thousands)</b>	
	<b>(unaudited)</b>	
Subsidiary credit line borrowings (guaranteed by the Company)	\$ 23,364	\$ 13,023
Subsidiary credit line borrowings (not guaranteed by the Company)	1,000	
Subsidiary term loans (guaranteed by the Company)	3,250	4,000
	27,614	17,023
Other term loans	2,148	849
Capital lease obligations	4,245	3,695
	34,007	21,567
Less current maturities	(28,314)	(16,397)
Total long-term debt, less current portion	\$ 5,693	\$ 5,170

In May 2006, the Company renewed its revolving credit facility that provides for borrowings and issuances of letters of credit and guarantees of up to \$55 million. In addition, a subsidiary increased their facility by \$3 million. Borrowing availability under the facility is reduced by the amounts outstanding for the Company's borrowings and letters of credit and amounts guaranteed under partner company facilities maintained with that same lender. This credit facility bears interest at the prime rate (8.25% at September 30, 2006) for outstanding borrowings. The credit facility is subject to an unused commitment fee of 0.0125%, which is subject to reduction based on deposits maintained at the bank. The facility requires cash collateral equal to one times the Company's borrowings and letters of credit and amounts borrowed by partner companies under the guaranteed portion of the partner company facilities maintained at the same bank. The credit facility matures in May 2007.

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**SAFEGUARD SCIENTIFICS, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**SEPTEMBER 30, 2006**

Availability under the Company's revolving credit facility at September 30, 2006 is as follows:

	<b>Revolving Credit</b>	<b>Letters of Credit (in thousands) (unaudited)</b>	<b>Total</b>
Size of facility	\$ 48,664	\$ 6,336	\$ 55,000
Subsidiary facilities at same bank (a)	(28,000)		(28,000)
Outstanding letter of credit (b)		(6,336)	(6,336)
Amount available at September 30, 2006	\$ 20,664	\$	\$ 20,664

(a) The Company's ability to borrow under its credit facility is limited by the amounts outstanding for the Company's borrowings and letters of credit and amounts guaranteed under partner company facilities maintained at the same bank. Of the total facilities, \$26.6 million is outstanding under these facilities at September 30, 2006 and is included as debt on the Consolidated Balance Sheet.

(b) In connection with the sale of CompuCom, the

Company  
provided to the  
landlord of  
CompuCom's  
Dallas  
headquarters, a  
letter of credit,  
which will  
expire on  
March 19, 2019,  
in an amount  
equal to  
\$6.3 million.

As a result of the sale of the Company's holdings in Mantas in October 2006, the Company's guarantee related to the Mantas facility was released in September 2006, thereby increasing the Company's availability under its credit facility by \$3.5 million.

All subsidiary facilities expire in February 2007 with the exception of Acsis' facility, which expires in August 2008.

Borrowings are secured by substantially all of the assets of the respective subsidiaries. These obligations bear interest at variable rates ranging between the prime rate minus 0.5% and the prime rate plus 1.0%. These facilities contain financial and non-financial covenants.

In September 2006, Clariant entered into a \$5 million senior secured revolving credit agreement. Borrowing availability under the agreement is based on the level of their qualified accounts receivable, less certain reserves. The agreement has a two-year term and bears interest at variable rates based on the lower of LIBOR plus 3.25% or the prime rate plus 0.5%. As of September 30, 2006, Clariant borrowed \$1.0 million and had approximately \$2.0 million available under this facility.

Debt as of September 30, 2006 bears interest at fixed rates ranging between 4.62% and 20.33% and variable rates indexed to the prime rate plus 1.75%. Debt as of December 31, 2005 bore interest at fixed rates ranging between 4.0% and 22.0% and variable rates indexed to the prime rate plus 1.75%.

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**SAFEGUARD SCIENTIFICS, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**SEPTEMBER 30, 2006**

The Company's debt matures as follows:

	<b>Total (In thousands) (unaudited)</b>
Remainder of 2006	\$ 5,466
2007	23,720
2008	3,057
2009	1,758
2010 and thereafter	6
<b>Total debt</b>	<b>\$ 34,007</b>

**9. CONVERTIBLE SENIOR DEBENTURES**

In February 2004, the Company completed the sale of \$150 million of 2.625% convertible senior debentures with a stated maturity of March 15, 2024. Interest on the 2024 Debentures is payable semi-annually. At the debenture holders option, the 2024 Debentures are convertible into our common stock through March 14, 2024, subject to certain conditions. The conversion rate of the debentures at September 30, 2006 was \$7.2174 of principal amount per share. The closing price of the Company's common stock at September 30, 2006 was \$1.96. The 2024 Debenture holders may require repurchase of the debentures on March 21, 2011, March 20, 2014 or March 20, 2019 at a repurchase price equal to 100% of their respective face amount plus accrued and unpaid interest. The Debenture holders may also require repurchase of the debentures upon certain events, including sale of all or substantially all of our common stock or assets, liquidation, dissolution or a change in control. Subject to certain conditions, the Company may redeem all or some of the 2024 Debentures commencing March 20, 2009. During the first and third quarters of 2006, the Company repurchased \$5 million and \$16 million of the face value of the 2024 Debentures for \$3.8 and \$12.6 million in cash, respectively. In connection with the repurchase, during the third quarter the Company recorded \$0.3 million of expense related to the acceleration of deferred debt issuance costs associated with the 2024 Debentures, resulting in a net gain of \$3.2 million, which is included in Other Income, Net in the Consolidated Statements of Operations for the three months ended September 30, 2006. For the nine months ended September 30, 2006, the Company recorded \$0.5 million of expense related to the acceleration of deferred debt issuance costs associated with the 2024 Debentures, resulting in a net gain of \$4.3 million, which is included in Other Income, Net in the Consolidated Statements of Operations. At September 30, 2006, the market value of the \$129 million of outstanding 2024 Debentures was approximately \$98.5 million based on quoted market prices.

As required by the terms of the 2024 Debentures, after completing the sale of CompuCom in October 2004, the Company escrowed \$16.7 million for interest payments through March 15, 2009 on the 2024 Debentures. A total of \$9.5 million is included in Restricted Marketable Securities on the Consolidated Balance Sheet at September 30, 2006, of which \$3.8 million is classified as a current asset.

**10. STOCK-BASED COMPENSATION**

On January 1, 2006, the Company adopted SFAS No. 123 (revised 2004), Share-Based Payment (SFAS No. 123(R)). SFAS No. 123(R) requires companies to measure all employee stock-based compensation awards using a fair value method and record such expense in its consolidated financial statements. The Company adopted SFAS No. 123(R) using the modified prospective method. Accordingly, prior period amounts have not been restated. Under this application, the Company is required to record compensation expense for all awards granted after the date of adoption and for the unvested portion of previously granted awards that remain outstanding at the date of adoption.





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**SAFEGUARD SCIENTIFICS, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**SEPTEMBER 30, 2006**

**Equity Compensation Plans**

The Company has three equity compensation plans: the 1999 Equity Compensation Plan, with 9.0 million shares authorized for issuance; the 2001 Associates Equity Compensation Plan with 5.4 million shares authorized for issuance; and the 2004 Equity Compensation Plan, with 6.0 million shares authorized for issuance. Employees and consultants are eligible for grants of stock options, restricted stock awards, stock appreciation rights, stock units, performance units and other stock-based awards under each of these plans; directors and executive officers are eligible for grants only under the 1999 and 2004 Equity Compensation Plans. During 2005, 6,000,000 options also were awarded outside of existing plans as inducement awards in accordance with New York Stock Exchange rules.

To the extent allowable, all grants are incentive stock options. Options granted under the plans are at prices equal to the fair market value at the date of grant. Upon exercise of stock options, the Company issues shares first from treasury stock, if available, then from authorized but unissued shares. At September 30, 2006, the Company had reserved 23.7 million shares of common stock for possible future issuance under its equity compensation plans. Several subsidiaries also maintain separate equity compensation plans for their employees, directors and advisors.

**Classification of Stock-Based Compensation Expense**

Stock-based compensation expense is recognized in the Consolidated Statements of Operations as follows:

	<b>Three Months Ended September 30, 2006</b>	<b>Nine Months Ended September 30, 2006</b>
		<b>(in thousands) (unaudited)</b>
Cost of sales – product	\$	\$ 3
Cost of sales – service	21	61
Selling, general and administrative	1,348	4,974
Research and development	34	88
	<b>\$ 1,403</b>	<b>\$ 5,126</b>

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**SAFEGUARD SCIENTIFICS, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**SEPTEMBER 30, 2006**

Prior to adopting SFAS No. 123(R), the Company accounted for stock-based compensation in accordance with APB Opinion No. 25, Accounting for Stock Issued to Employees. Had compensation cost been recognized consistent with SFAS No. 123, Accounting for Stock-Based Compensation, the Company's consolidated net loss from continuing operations and discontinued operations and loss per share from continuing operations and from discontinued operations would have been as follows:

		<b>Three Months Ended September 30, 2005</b>	<b>Nine Months Ended September 30, 2005</b>
		<b>(in thousands, except per share data) (unaudited)</b>	
Consolidated net loss from continuing operations	As reported	\$ (10,075)	\$ (30,171)
Add: Stock-based compensation expense included in net loss, net of minority interest	As reported	607	1,645
Deduct: Total stock based employee compensation expense from continuing operations determined under fair value based method for all awards, net of related tax effects		(1,819)	(5,216)
Consolidated net loss from continuing operations	Pro forma	(11,287)	(33,742)
Net loss from discontinued operations	As reported	(565)	(4,241)
Deduct: Total stock based employee compensation expense from discontinued operations determined under fair value based method for all awards, net of related tax effects		(96)	(307)
	Pro forma	\$ (11,948)	\$ (38,290)
Basic Loss Per Share:			
Net loss from continuing operations	As reported	\$ (0.08)	\$ (0.25)
Net loss from discontinued operations	As reported	(0.01)	(0.03)
		\$ (0.09)	\$ (0.28)
Net loss from continuing operations		\$ (0.09)	\$ (0.28)

Net loss from discontinued operations	Pro forma Pro forma	(0.01)		(0.03)
		\$ (0.10)	\$	(0.31)
Diluted Loss Per Share:				
Net loss from continuing operations	As reported	\$ (0.08)	\$	(0.25)
Net loss from discontinued operations	As reported	(0.01)		(0.04)
		\$ (0.09)	\$	(0.29)
Net loss from continuing operations	Pro forma	\$ (0.09)	\$	(0.28)
Net loss from discontinued operations	Pro forma	(0.01)		(0.04)
		\$ (0.10)	\$	(0.32)

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**SAFEGUARD SCIENTIFICS, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**SEPTEMBER 30, 2006**

**The Company**

The fair value of the Company's stock-based awards to employees during the three and nine months ended September 30, 2006 was estimated at the date of grant using the Black-Scholes option-pricing model. The risk-free rate is based on the U.S. Treasury yield curve in effect at the end of the quarter in which the grant occurred. The expected life of stock options granted was estimated using the historical exercise behavior of employees. Expected volatility was based on historical volatility for a period equal to the stock option's expected life.

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	<b>(unaudited)</b>			
<b>Service-Based Awards</b>				
Dividend yield	0%	0%	0%	0%
Expected volatility	70%	85%	72%	85%
Average expected option life	5 years	5 years	5 years	5 years
Risk-free interest rate	4.4%	4.5%	4.7%	4.5%
<b>Market-Based Awards</b>				
Dividend yield	0%	0%	0%	0%
Expected volatility	62%	67%	65%	67%
Average expected option life	5 7	5 7 years	4 7 years	5 7 years
Risk-free interest rate	4.8%	4.3%	4.9%	4.3%

The weighted-average grant date fair value of options issued by the Company during the three and nine months ended September 30, 2006 was \$1.17 per share and \$1.34 per share, respectively. The weighted-average grant date fair value of options issued by the Company during the three and nine months ended September 30, 2005 was \$0.94 per share and \$0.93 per share, respectively.

The Company granted 0.5 million and 1.2 million market-based stock option awards to employees during the three and nine months ended September 30, 2006, respectively, and 6.0 million market-based stock option awards during the three months ended September 30, 2005. The awards entitle participants to vest in a number of options determined by achievement of certain target market capitalization increases (measured by reference to stock price increases on a specified number of outstanding shares) over an eight-year period. The requisite service periods for the market-based awards are based on our estimate of the dates on which the market conditions will be met as determined using a Monte Carlo simulation model. Compensation expense is recognized over the requisite service periods using the straight-line method, but is accelerated if market capitalization targets are achieved earlier than estimated. Based on the achievement of market capitalization targets, 0.6 million and 1.7 million shares vested during the three and nine months ended September 30, 2006, respectively. The Company recorded \$0.3 million and \$1.7 million of compensation expense related to the market-based awards in the three and nine months ended September 30, 2006, respectively. The maximum number of unvested shares at September 30, 2006 attainable under these grants is 8.0 million shares.

All other outstanding options are service-based awards that generally vest over four years after the date of grant and expire eight years after the date of grant. Compensation expense is recognized over the requisite service period using the straight-line method. The requisite service period for service-based awards is the period over which the award vests. The Company recorded \$0.3 million and \$1.1 million of compensation expense related to these awards during the three and nine months ended September 30, 2006.

During the nine months ended September 30, 2006, the Company granted twenty-one thousand stock options to members of its advisory boards, which comprise non-employees. Such awards vest over one year, are equity classified and are marked-to-market each period.

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**SAFEGUARD SCIENTIFICS, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**SEPTEMBER 30, 2006**

Option activity of the Company is summarized below:

	Shares (In thousands) (unaudited)	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (In years)	Aggregate Intrinsic Value (In thousands)
Outstanding at December 31, 2005	18,971	\$ 2.20		
Options granted	1,786	2.12		
Options exercised	(222)	1.60		
Options canceled/forfeited	(755)	3.62		
Outstanding at September 30, 2006	19,780	2.14	6.0	\$ 6,573
Options exercisable at September 30, 2006	8,390	2.87	4.6	1,761
Options vested and expected to vest at September 30, 2006	13,714	2.40	5.5	3,816
Shares available for future grant	2,450			

The total intrinsic value of options exercised in the nine months ended September 30, 2006 was \$0.1 million.

At September 30, 2006, total unrecognized compensation cost related to non-vested stock options granted under the plans for service-based awards was \$2.9 million. That cost is expected to be recognized over a weighted-average period of 2.5 years.

At September 30, 2006, total unrecognized compensation cost related to non-vested stock options granted under the plans for market-based awards was \$4.2 million. That cost is expected to be recognized over a weighted-average period of 4.7 years but would be accelerated if market capitalization targets are achieved earlier than estimated.

Total compensation expense for restricted stock issuances was approximately \$0.1 million and \$0.3 million for the three and nine months ended September 30, 2005. No unamortized compensation expense related to restricted stock issuances remains at September 30, 2006.

The Company has previously issued deferred stock units to certain employees. The Company issued deferred stock units during the three and nine months ended September 30, 2006 and 2005, to directors who elected to defer all or a portion of directors' fees earned. Deferred stock units issued to directors in lieu of directors' fees are 100% vested at grant; matching deferred stock units equal to 25% of directors' fees deferred vest one year following grant. Deferred stock units are payable in stock on a one-for-one basis. Payments in respect of the deferred stock units are generally distributable following termination of employment or service, death, permanent disability or retirement. Total compensation expense for deferred stock units was approximately \$0.1 and \$0.2 million for the three and nine months ended September 30, 2006, respectively, and \$0.2 million and \$0.6 million for the three and nine months ended September 30, 2005, respectively. Unamortized compensation expense related to deferred stock units at September 30, 2006 is \$0.3 million.

Deferred stock unit activity is summarized below:

**Weighted  
Average**

	<b>Shares (In thousands) (unaudited)</b>	<b>Grant Date Fair Value</b>
Unvested at December 31, 2005	196	\$ 3.21
Granted	31	2.09
Vested	(112)	2.40
Forfeited	(44)	4.41
Unvested at September 30, 2006	71	3.28

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**SAFEGUARD SCIENTIFICS, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**SEPTEMBER 30, 2006**

The total fair value of deferred stock units vested during the three and nine months ended September 30, 2006 was \$0.1 million and \$0.2 million, respectively.

**Consolidated Subsidiaries**

The fair value of the Company's subsidiaries' stock-based awards issued to employees during the three and nine months ended September 30, 2006 and 2005 was estimated at the date of grant using the Black-Scholes option-pricing model. The risk-free rate is based on the U.S. Treasury yield curve in effect at the end of the quarter in which the grant occurred. The expected life of stock options granted was estimated using the historical exercise behavior of employees. The expected life of stock options granted for subsidiaries that do not have sufficient historical exercise behavior of employees was calculated using the simplified method of determining expected term as provided in Staff Accounting Bulletin No. 107, Share-Based Payment (SAB 107). Expected volatility for publicly-held subsidiaries was based on historical volatility for a period equal to the stock option's expected life. Expected volatility for privately-held subsidiaries is based on the average historical volatility of comparable companies for a period equal to the stock option's expected life. The fair value of the underlying stock of privately-held subsidiaries on the date of grant was determined based on a number of valuation methods, including discounted cash flows and revenue and acquisition multiples.

	Three Months Ended September		Nine Months Ended September	
	2006	2005	2006	2005
			(unaudited)	
Dividend yield	0%	0%	0%	0%
Expected volatility	38% - 92%	70% - 99%	38% - 92%	70% - 103%
Average expected option life	5 - 8 years	4 - 5 years	5 - 8 years	4 - 5 years
Risk-free interest rate	4.5% - 5.3%	4.5%	4.5% - 5.3%	3.9% - 4.5%

Stock options granted by subsidiaries generally are service-based awards that vest four years after the date of grant and expire 7 to 10 years after the date of grant. Compensation expense is recognized over the requisite service period using the straight-line method. The requisite service period is the period over which the award vests. The Company's consolidated subsidiaries recorded \$0.7 million and \$2.1 million of compensation expense related to these awards during the three and nine months ended September 30, 2006, respectively.

At September 30, 2006, total unrecognized compensation cost related to non-vested stock options granted under the consolidated subsidiaries' plans was \$4.6 million. That cost is expected to be recognized over a weighted-average period of 2.9 years.

During the nine months ended September 30, 2006, certain subsidiaries granted stock options to advisory boards, which comprise of non-employees. Such awards vest over four years, are equity classified and are marked-to-market each period.

Certain employees of our subsidiaries have the right to require the respective subsidiary to purchase shares of common stock of the subsidiary received by the employee pursuant to the exercise of options or the conversion of deferred stock units. The employee must hold the shares for at least six months prior to exercising this right. The required purchase price is 75% to 100% of the fair market value at the time the right is exercised. These options and deferred stock units qualify for equity-classification under SFAS No. 123(R). In accordance with EITF Issue No. D-98, however, these instruments are classified outside of permanent equity on the Consolidated Balance Sheet as Redeemable Stock-Based Compensation at their current redemption amount based on the number of options and deferred stock units vested as of September 30, 2006.



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**SAFEGUARD SCIENTIFICS, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**SEPTEMBER 30, 2006**

**11. INCOME TAXES**

The Company's consolidated net income tax expense recorded for the three months ended September 30, 2006, was \$0.1 million and the income tax benefit recorded for the nine months ended September 30, 2006 was \$1.1 million. The Company recognized tax expense of \$0.1 million in the three months ended September 30, 2006 related to the Company's share of net state tax expenses recorded by subsidiaries. The Company recognized a \$1.3 million tax benefit in the nine months ended September 30, 2006 related to uncertain tax positions for which the statute of limitations expired during the period in the applicable tax jurisdictions. The Company has recorded a valuation allowance to reduce its net deferred tax asset to an amount that is more likely than not to be realized in future years. Accordingly, the net operating loss benefit that would have been recognized in 2006 was offset by a valuation allowance.

**12. NET LOSS PER SHARE**

The calculations of net loss per share were:

	<b>Three Months Ended</b>		<b>Nine Months Ended September</b>	
	<b>September 30,</b>		<b>30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	<b>(In thousands except per share data)</b>			
	<b>(unaudited)</b>			
Basic:				
Net loss from continuing operations	\$ (9,685)	\$ (10,075)	\$ (31,804)	\$ (30,171)
Net income (loss) from discontinued operations	78	(565)	6,510	(4,241)
Net loss	\$ (9,607)	\$ (10,640)	\$ (25,294)	\$ (34,412)
Average common shares outstanding	121,541	120,898	121,441	120,776
Net loss from continuing operations	\$ (0.08)	\$ (0.08)	\$ (0.26)	\$ (0.25)
Net income (loss) from discontinued operations		(0.01)	0.05	(0.03)
Net loss per share	\$ (0.08)	\$ (0.09)	\$ (0.21)	\$ (0.28)
Diluted:				
Net loss from continuing operations principle	\$ (9,685)	\$ (10,075)	\$ (31,804)	\$ (30,171)
Effect of holdings	(53)	(25)	(102)	(173)
Net income (loss) from discontinued operations	78	(565)	6,510	(4,241)
Net loss	\$ (9,660)	\$ (10,665)	\$ (25,396)	\$ (34,585)
Average common shares outstanding	121,541	120,898	121,441	120,776
Loss per share from continuing operations	\$ (0.08)	\$ (0.08)	\$ (0.26)	\$ (0.25)

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Net income (loss) from discontinued operations	(0.01)	0.05	(0.04)	
Diluted loss per share	\$ (0.08)	\$ (0.09)	\$ (0.21)	\$ (0.29)

Basic and diluted average common shares outstanding for purposes of computing net income (loss) per share includes outstanding common shares and vested deferred stock units (DSU s).

If a consolidated or equity method partner company has dilutive stock options, unvested restricted stock, DSU s, warrants or securities outstanding, diluted net loss per share is computed by first deducting from net loss the income attributable to the potential exercise of the dilutive securities of the partner company. This impact is shown as an adjustment to net loss for purposes of calculating diluted net loss per share.

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**SAFEGUARD SCIENTIFICS, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**SEPTEMBER 30, 2006**

The following potential shares of common stock and their effects on income were excluded from the diluted net loss per share calculation because their effect would be anti-dilutive:

At September 30, 2006 and 2005, options to purchase 19.8 million and 16.1 million shares of common stock, respectively, at prices ranging from \$1.03 to \$45.47 per share, were excluded from the 2006 and 2005 calculations, respectively.

At September 30, 2006 and 2005, unvested deferred stock units convertible into 0.1 million and 0.4 million shares, respectively, were excluded from the calculations.

At September 30, 2006 and 2005, a total of 19.0 million and 20.8 million shares related to the Company's 2024 Debentures (See Note 9) representing the weighted average effect of assumed conversion of the 2024 Debentures were excluded from the calculation.

**13. PARENT COMPANY FINANCIAL INFORMATION**

Parent company financial information is provided to present the financial position and results of operations of the Company as if the consolidated subsidiaries (see Note 2) were accounted for under the equity method of accounting for all periods presented during which the Company owned its interest in these companies.

**Parent Company Balance Sheets**

	<b>September 30, 2006</b>	<b>December 31, 2005</b>
	<b>(in thousands)</b>	
	<b>(unaudited)</b>	
Assets		
Cash and cash equivalents	\$ 38,044	\$ 108,300
Restricted cash		1,098
Marketable securities	29,416	31,770
Trading securities	2,106	
Restricted marketable securities	3,813	3,805
Other current assets	958	1,704
Asset held-for-sale	29,202	24,242
Total current assets	103,539	170,919
Ownership interests in and advances to companies	177,035	150,891
Long-term marketable securities	928	3,311
Long-term restricted marketable securities	5,720	9,457
Note receivable related party	414	
Other	3,596	5,109
Total Assets	\$ 291,232	\$ 339,687
Liabilities and Shareholders' Equity		
Current convertible senior debentures	\$	\$ 5,000
Current liabilities	9,312	13,625
Total current liabilities	9,312	18,625
Long-term liabilities	10,119	11,087

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Convertible senior debentures	129,000		145,000
Shareholders' equity	142,801		164,975
Total Liabilities and Shareholders' Equity	\$ 291,232	\$	339,687

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**SAFEGUARD SCIENTIFICS, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**SEPTEMBER 30, 2006**

**Parent Company Statements of Operations**

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	<b>(in thousands)</b>			
	<b>(unaudited)</b>			
Operating expenses	\$ (5,050)	\$ (4,886)	\$ (15,994)	\$ (13,174)
Other income, net	3,081	981	4,958	1,891
Impairment related party				(260)
Interest income	1,309	1,346	4,346	3,546
Interest expense	(1,150)	(1,235)	(3,554)	(3,682)
Equity loss	(7,875)	(6,281)	(22,844)	(18,492)
Net loss from continuing operations before income taxes	(9,685)	(10,075)	(33,088)	(30,171)
Income tax benefit			1,284	
Equity income (loss) attributable to discontinued operations	78	(565)	6,510	(4,241)
Net Loss	\$ (9,607)	\$ (10,640)	\$ (25,294)	\$ (34,412)

**Parent Company Statements of Cash Flows**

	<b>Nine Months Ended September</b>	
	<b>30,</b>	
	<b>2006</b>	<b>2005</b>
	<b>(in thousands)</b>	
	<b>(unaudited)</b>	
Net cash used in operating activities	\$ (12,326)	\$ (14,876)
<b>Cash Flows from Investing Activities</b>		
Proceeds from sales of available-for-sale and trading securities		241
Proceeds from sales of and distributions from companies	672	5,035
Advances to companies		(2,185)
Acquisitions of ownership interests in companies, funds and subsidiaries, net of cash acquired	(46,887)	(9,367)
Advances to related party	(415)	717
Increase in restricted cash and marketable securities	(62,016)	(54,113)
Decrease in restricted cash and marketable securities	64,370	36,219
Proceeds from sale of property and equipment		4,160
Capital expenditures	(93)	(37)
Other, net	1,200	
Net cash used in investing activities	(43,169)	(19,330)

**Cash Flows from Financing Activities**

Repurchase of convertible senior debentures	(16,215)	
Decrease in restricted cash	1,098	
Issuance of Company common stock, net	356	
Net cash used in financing activities	(14,761)	

<b>Net Decrease in Cash and Cash Equivalents</b>	(70,256)	(34,206)
Cash and Cash Equivalents at beginning of period	108,300	128,262
<b>Cash and Cash Equivalents at end of period</b>	\$ 38,044	\$ 94,056

Parent Company cash and cash equivalents exclude marketable securities, which consists of longer-term securities, including commercial paper and certificates of deposit.

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**SAFEGUARD SCIENTIFICS, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**SEPTEMBER 30, 2006**

**14. OPERATING SEGMENTS**

Management evaluates segment performance based on segment revenue, operating income (loss) and income (loss) before income taxes, which reflects the portion of income (loss) allocated to minority shareholders.

Other Items includes certain corporate expenses, which are not identifiable to the operations of the Company's operating business segments. Other Items primarily consists of general and administrative expenses related to corporate operations, including employee compensation, insurance and professional fees including legal, finance and consulting. Other Items also includes interest income, interest expense and income taxes, which are reviewed by management independent of segment results.

The following tables reflect the Company's consolidated operating data by reportable segment. Each segment includes the results of the respective consolidated company and records the Company's share of income or losses for entities accounted for under the equity method. Segment results also include impairment charges, gains or losses related to the disposition of the partner companies and the mark to market of trading securities. All significant intersegment activity has been eliminated in consolidation. Accordingly, segment results reported by the Company exclude the effect of transactions between the Company and its subsidiaries and among the Company's subsidiaries.

Revenue is attributed to geographic areas based on where the services are performed or the customer's shipped to location. A majority of the Company's revenue is generated in the United States.

As of September 30, 2006 and December 31, 2005, the Company's assets were primarily located in the United States.

The following represents the segment data from continuing operations:

**Three Months Ended September 30, 2006**  
**(in thousands)**  
**(unaudited)**

	Acsis	Alliance Consulting	Clarient	Laureate Pharma	Pacific Title	Other Companies	Total Segments	Other Items	Total Continuing Operations
Revenues	\$ 4,156	\$27,527	\$ 9,122	\$ 2,218	\$ 7,585	\$	\$ 50,608	\$	\$ 50,608
Operating income (loss)	\$ (2,528)	\$ 752	\$ (3,638)	\$ (2,735)	\$ 1,019	\$	\$ (7,130)	\$ (5,050)	\$ (12,180)
Net income (loss)	\$ (2,358)	\$ 560	\$ (2,188)	\$ (2,916)	\$ 1,020	\$ (2,145)	\$ (8,027)	\$ (1,658)	\$ (9,685)
<b>Segment Assets</b>									
September 30, 2006	\$28,885	\$85,583	\$44,597	\$24,194	\$20,340	\$52,619	\$256,218	\$ 81,961	\$338,179
December 31, 2005	\$30,993	\$80,959	\$40,599	\$21,479	\$18,864	\$21,208	\$214,102	\$161,242	\$375,344

**Three Months Ended September 30, 2005**  
**(in thousands)**  
**(unaudited)**

	Alliance Consulting	Clarient	Laureate Pharma	Pacific Title	Other Companies	Total Segments	Other Items	Total Continuing Operations
Revenues	\$20,472	\$ 4,906	\$ 1,135	\$7,520	\$	\$34,033	\$	\$ 34,033
	\$ (421)	\$ (4,480)	\$ (3,017)	\$ 616	\$	\$ (7,302)	\$ (4,655)	\$ (11,957)

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Operating  
income (loss)  
Net income  
(loss)

\$ (631)	\$(2,709)	\$(3,129)	\$ 594	\$305	\$(5,570)	\$(4,505)	\$(10,075)
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**SAFEGUARD SCIENTIFICS, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**SEPTEMBER 30, 2006**

**Nine Months Ended September 30, 2006**

(in thousands)  
(unaudited)

	Acsis	Alliance Consulting	Clariant	Laureate Pharma	Pacific Title	Other Companies	Total Segments	Other Items	Total Continuing Operations
Revenues	\$ 13,141	\$ 78,607	\$ 23,368	\$ 6,864	\$ 22,738	\$	\$ 144,718	\$	\$ 144,718
Operating Income (loss)	\$ (6,656)	\$ (198)	\$ (12,527)	\$ (7,457)	\$ 1,952	\$	\$ (24,886)	\$ (15,994)	\$ (40,880)
Net Income (loss)	\$ (6,263)	\$ (754)	\$ (7,574)	\$ (7,880)	\$ 1,951	\$ (1,795)	\$ (22,315)	\$ (9,489)	\$ (31,804)

**Nine Months Ended September 30, 2005**

(in thousands)  
(unaudited)

	Alliance Consulting	Clariant	Laureate Pharma	Pacific Title	Other Companies	Total Segments	Other Items	Total Continuing Operations
Revenues	\$ 58,578	\$ 14,122	\$ 6,151	\$ 24,292	\$	\$ 103,143	\$	\$ 103,143
Operating income (loss)	\$ (1,065)	\$ (11,922)	\$ (7,408)	\$ 3,831	\$	\$ (16,564)	\$ (13,174)	\$ (29,738)
Net income (loss)	\$ (1,626)	\$ (7,241)	\$ (7,663)	\$ 4,042	\$ (5,201)	\$ (17,689)	\$ (12,482)	\$ (30,171)
<b>Other Items</b>								

**Three Months  
Ended September  
30,**

**2006**

**2005**

**Nine Months Ended September  
30,**

**2006**

**2005**

(in thousands)  
(unaudited)

Corporate operations	\$ (1,575)	\$ (4,467)	\$ (10,629)	\$ (12,484)
Income tax benefit (expense)	(83)	(38)	1,140	2
	\$ (1,658)	\$ (4,505)	\$ (9,489)	\$ (12,482)

**15. BUSINESS COMBINATIONS****Acquisitions by the Company 2006**

In September 2006, the Company acquired additional common shares of Clariant for \$3.0 million in cash to fund Clariant's acquisition of Trestle Holdings, Inc. ( Trestle ). As a result of the funding, the Company's ownership in Clariant increased to 60%. The Company allocated purchase price of \$1.5 million to working capital, \$0.8 million to intangibles, with an estimated useful life of 5 years, \$0.2 million to fixed assets with estimated depreciable lives of 3 years and \$0.5 million to goodwill.

In September 2006, the Company acquired 24% of NuPathe, Inc. for \$3 million in cash. NuPathe develops therapeutics in conjunction with novel transdermal delivery technologies. The Company accounts for its holdings in NuPathe under the equity method. The Company allocated \$1.2 million of the purchase price to NuPathe's in-process-research and development resulting in a charge, which is reflected in equity loss in the Consolidated Statement of Operations for the three and nine months ended September 30, 2006.

In August 2006, the Company acquired 47% of Portico Systems for \$6 million in cash. Portico is a leading software solutions provider for regional and national health plans looking to optimize provider network operations and streamline business processes. The Company accounts for its holdings in Portico under the equity method. The Company has not yet completed the allocation of its purchase price.

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**SAFEGUARD SCIENTIFICS, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**SEPTEMBER 30, 2006**

In August 2006, the Company acquired 36% of Rubicor Medical, Inc. for \$20 million in cash. Rubicor develops and distributes technologically advanced, disposable, minimally-invasive breast biopsy devices. The Company accounts for its holdings in Rubicor under the equity method. The Company allocated \$0.7 million of the purchase price to Rubicor's in-process-research and development resulting in a charge, which is reflected in equity loss in the Consolidated Statement of Operations for the three and nine months ended September 30, 2006.

In June 2006, the Company acquired additional common shares of Acsis for an aggregate purchase price of \$6 million in cash at the same per share value as the December 2005 acquisition. Taking into account our existing ownership, the result of the June 2006 incremental equity purchase was an increase in ownership in Acsis of 1.2% to 95%. The capital provided is expected to be used by Acsis to support their long-term growth strategy.

**Acquisitions by the Company 2005**

In December 2005, the Company acquired 94% of Acsis, Inc. for approximately \$26 million in cash plus options with a fair market value of \$1.7 million. Acsis provides enterprise data collection solutions to global manufacturers. The Acsis transaction was accounted for as a purchase and, accordingly, the Consolidated Financial Statements reflect the operations of Acsis from the acquisition date.

In November 2005, Clariant entered into a securities purchase agreement with a limited number of accredited investors pursuant to which Clariant issued shares of common stock and warrants to purchase additional shares of common stock for an aggregate purchase price of \$15 million. Of the total placement of \$15 million, the Company funded \$9 million to Clariant. The Company participated in the private placement to support Clariant's diagnostic services business line expansion as well as to maintain the Company's controlling interest.

In April and June 2005, the Company acquired additional shares of Pacific Title from minority shareholders for a total of \$1.3 million, increasing its ownership in Pacific Title from 93% to 100%. Of the total purchase price, \$1.2 million was allocated to working capital and \$0.1 million was allocated to property and equipment.

The following table summarizes the estimated fair values of assets acquired and liabilities assumed:

	Acsis	Clariant
	(In thousands)	
	(unaudited)	
Working Capital	\$ 4,241	\$ 8,372
Property and equipment	1,263	210
Intangible assets	8,366	209
Acquired In-Process Research and Development	1,974	209
Goodwill	11,558	
Total Purchase Price	\$ 27,402	\$ 9,000

The intangible assets of Acsis consist of a covenant not-to-compete with a one year life, developed technology with a three year life, customer-related intangibles with a 10 year life, and a tradename with a 20 year life. Property and equipment are being depreciated over their weighted average lives (3 years to 5 years). The acquired in-process research and development costs were charged to earnings in 2005. The purchase price allocation for Acsis is preliminary.

**Acquisitions by Subsidiaries 2006**

In September 2006, Clariant completed the purchase of substantially all of the assets of Trestle Holdings, Inc. (Trestle) for approximately \$2.8 million in cash and the assumption of approximately \$0.2 million of liabilities.

In July 2006, Alliance Consulting completed the acquisition of Fusion Technologies for \$5.4 million in cash.

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**SAFEGUARD SCIENTIFICS, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**SEPTEMBER 30, 2006**

The companies have not completed the allocations of purchase price for the acquisitions listed above. Therefore, the allocations of the purchase prices could be adjusted once the valuations of assets acquired and liabilities assumed are completed. The following table summarizes the estimated fair values of assets acquired and liabilities assumed:

	<b>Alliance Consulting</b>	<b>Clariant</b>
	<b>(In thousands)</b>	
	<b>(unaudited)</b>	
Working Capital	\$ (112)	\$ (34)
Property and equipment	443	76
Intangible assets	730	2,750
Goodwill	4,364	516
<b>Total Purchase Price</b>	<b>\$ 5,425</b>	<b>\$ 3,308</b>

The intangible assets acquired by Alliance Consulting consist of customer lists with a seven year life and property and equipment which are being depreciated over their weighted average lives (3 to 5 years). The intangible assets acquired by Clariant consist of developed technology with a 7 to 10 year life, tradename with a 10 year life and other which consists of customer relationships and service with 10 to 15 year lives. Property and equipment of Clariant are being depreciated over their weighted average lives (3 years).

The following unaudited pro forma financial information presents the combined results of operations of the Company as if the acquisitions had occurred as of the beginning of the periods presented, after giving effect to certain adjustments, including amortization of intangibles with definite useful lives. The pro forma results of operations are not indicative of the actual results that would have occurred had the acquisitions been completed at the beginning of the period presented and are not intended to be a projection of future results.

	<b>Three Months Ended September 30, 2005</b>	<b>Nine Months Ended September 30, 2005</b>
	<b>(In thousands except per share data)</b>	
	<b>(unaudited)</b>	
Total revenue	\$ 45,345	\$ 134,211
Net loss	\$ (10,800)	\$ (33,013)
Basic and diluted loss per share	\$ (0.09)	\$ (0.26)

**16. RELATED PARTY TRANSACTIONS**

In May 2001, the Company entered into a \$26.5 million loan agreement with Warren V. Musser, the former Chairman and Chief Executive Officer of the Company. The proceeds of the loan were used to repay margin loans guaranteed by the Company in October 2000.

Through September 30, 2006, the Company has recognized net impairment charges against the loan of \$15.4 million to the estimated value of the collateral that the Company held at each respective date. The Company's carrying value of the loan at September 30, 2006 is \$0.4 million. The Company will continue to evaluate the value of the collateral compared to the carrying value of the note on a quarterly basis.



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**SAFEGUARD SCIENTIFICS, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**SEPTEMBER 30, 2006**

**17. COMMITMENTS AND CONTINGENCIES**

The Company, and its partner companies, are involved in various claims and legal actions arising in the ordinary course of business. While in the current opinion of management, the ultimate disposition of these matters will not have a material adverse effect on the Company's consolidated financial position or results of operations, no assurance can be given as to the outcome of these lawsuits, and one or more adverse rulings could have a material adverse effect on the Company's consolidated financial position and results of operations, or that of our partner companies.

In connection with its ownership interests in certain affiliates, the Company has the following outstanding guarantees:

	<b>Amount</b>	<b>Debt Included on Consolidated Balance Sheet at September 30, 2006 (in millions) (unaudited)</b>
Consolidated companies guarantees – credit facilities	\$ 28.0	\$ 26.6
Other consolidated company guarantees – operating leases	4.7	
Non-consolidated company guarantees	3.8	
<b>Total</b>	<b>\$ 36.5</b>	<b>\$ 26.6</b>

Additionally, we have committed capital of approximately \$6.5 million, including a conditional commitment to provide a partner company with additional funding and commitments made in prior years to various private equity funds. These commitments will be funded over the next several years, including approximately \$5.0 million which is expected to be funded during the next twelve months.

Under certain circumstances, the Company may be required to return a portion or all the distributions it received as a general partner of certain private equity funds (the "clawback"). Assuming the private equity funds in which the Company was a general partner were liquidated or dissolved on September 30, 2006 and assuming for these purposes the only distributions from the funds were equal to the carrying value of the funds on the September 30, 2006 financial statements, the maximum clawback the Company would be required to return for its general partner interest is approximately \$8 million. The Company estimates its liability to be approximately \$6 million. This amount is reflected in "Other Long-Term Liabilities" on the Consolidated Balance Sheet at September 30, 2006.

The Company's ownership in the general partner of the funds which have potential clawback liabilities range from 19-30%. The clawback liability is joint and several, such that the Company may be required to fund the clawback for other general partners should they default. The funds have taken several steps to reduce the potential liabilities should other general partners default, including withholding all general partner distributions in escrow and adding rights of set-off among certain funds. The Company believes its liability due to the default of other general partners is remote.

The Company has employment agreements with certain executive officers that provide for severance payments to the executive officer in the event the officer is terminated without cause or an officer terminates their employment for good reason.

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**SAFEGUARD SCIENTIFICS, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**SEPTEMBER 30, 2006**

**18. SUBSEQUENT EVENTS**

*Sale of Mantas*

On October 2, 2006, the Company completed the sale of its interest in Mantas through a merger of Mantas into a wholly owned US subsidiary of i-flex® Solutions ( i-flex ), for net cash proceeds of approximately \$113 million including \$19 million to be held in escrow. The Company expects to record a net gain of approximately \$83 million in the fourth quarter of 2006 which will be reported in discontinued operations.

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**Table of Contents****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**  
**Cautionary Note concerning Forward-Looking Statements**

This report contains forward-looking statements that are based on current expectations, estimates, forecasts and projections about us, the industries in which we operate and other matters, as well as management's beliefs and assumptions and other statements regarding matters that are not historical facts. These statements include, in particular, statements about our plans, strategies and prospects. For example, when we use words such as projects, expects, anticipates, intends, plans, believes, seeks, estimates, should, would, could, will, may, variations of such words or other words that convey uncertainty of future events or outcomes, we are making forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Our forward-looking statements are subject to risks and uncertainties. Factors that could cause actual results to differ materially, include, among others, managing rapidly changing technologies, limited access to capital, competition, the ability to attract and retain qualified employees, the ability to execute our strategy, the uncertainty of the future performance of our partner companies, acquisitions and dispositions of companies, the inability to manage growth, compliance with government regulation and legal liabilities, additional financing requirements, labor disputes and the effect of economic conditions in the business sectors in which our partner companies operate, all of which are discussed below under the heading Factors that May Affect Future Results in Item 1A in Safeguard's Annual Report on Form 10-K and updated, as applicable, in Item 1A Risk Factors below. Many of these factors are beyond our ability to predict or control. In addition, as a result of these and other factors, our past financial performance should not be relied on as an indication of future performance.

All forward-looking statements attributable to us, or to persons acting on our behalf, are expressly qualified in their entirety by this cautionary statement. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, except as required by law.

In light of these risks and uncertainties, the forward-looking events and circumstances discussed in this report might not occur.

**Overview**

Safeguard's charter is to build value in revenue-stage information technology and life sciences businesses. We provide growth capital as well as a range of strategic, operational and management resources to our partner companies. Safeguard participates in expansion financings, carve-outs, management buy-outs, recapitalizations, industry consolidations and early-stage financings. Our vision is to be the preferred catalyst for creating great information technology and life sciences companies.

We strive to create long-term value for our shareholders through building value in our partner companies. We help our partner companies in their efforts to increase market penetration, grow revenue and improve cash flow in order to create long-term value. We concentrate on companies that operate in two categories:

*Information Technology* including companies focused on providing software, technology-enabled services and information technology services for analytics and business intelligence, enterprise applications and infrastructure; and

*Life Sciences* including companies focused on therapeutics and treatments, pharmaceutical services, drug formulation and delivery techniques, diagnostics and devices.

**Principles of Accounting for Ownership Interests in Partner Companies**

The various interests that we acquire in our partner companies and private equity funds are accounted for under three methods: consolidation, equity or cost. The applicable accounting method is generally determined based on our influence over the entity, primarily determined based on our voting interest in the entity.

*Consolidation Method.* Partner companies in which we directly or indirectly own more than 50% of the outstanding voting securities are accounted for under the consolidation method of accounting. Participation of other partner company shareholders in the income or losses of our consolidated partner companies is reflected as Minority Interest in the Consolidated Statements of Operations. Minority interest adjusts our consolidated operating results to reflect only our share of the earnings or losses of the consolidated partner company. However, if there is no minority interest balance remaining on the



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Consolidated Balance Sheets related to the respective partner company, we record 100% of the consolidated partner company's losses; we record 100% of subsequent earnings of the partner company to the extent of such previously recognized losses in excess of our proportionate share.

*Equity Method.* The partner companies whose results are not consolidated, but over whom we exercise significant influence, are accounted for under the equity method of accounting. We also account for our interests in some private equity funds under the equity method of accounting, based on our respective general and limited partner interests. Under the equity method of accounting, our share of the income or loss of the company is reflected in Equity Income (Loss) in the Consolidated Statements of Operations. We report our share of the results of the equity method partner companies on a quarter lag.

When the carrying value of our holding in an equity method partner company is reduced to zero, no further losses are recorded in our Consolidated Statements of Operations unless we have outstanding guarantee obligations or have committed additional funding to the equity method company. When the equity method partner company subsequently reports income, we will not record our share of such income until it equals the amount of our share of losses not previously recognized.

*Cost Method.* Partner companies not consolidated or accounted for under the equity method are accounted for under the cost method of accounting. Under the cost method, our share of the income or losses of such entities is not included in our Consolidated Statements of Operations. However, the effect of the change in market value of cost method holdings classified as trading securities is reflected in Other Income (Loss), Net in the Consolidated Statements of Operations.

**Critical Accounting Policies and Estimates**

Accounting policies, methods and estimates are an integral part of consolidated financial statements prepared by management and are based upon management's current judgments. These judgments are normally based on knowledge and experience with regard to past and current events and assumptions about future events. Certain accounting policies, methods and estimates are particularly important because of their significance to the financial statements and because of the possibility that future events affecting them may differ from management's current judgments.

On an ongoing basis, we evaluate our estimates. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. There can be no assurance that actual results will not differ from those estimates.

While there are a number of accounting policies, methods and estimates affecting our financial statements, areas that are particularly significant include the following:

Revenue recognition

Recoverability of goodwill

Recoverability of long-lived assets

Recoverability of ownership interests in and advances to companies

Income taxes

Allowance for doubtful accounts

Commitments and contingencies

Stock-based compensation

**Revenue Recognition**

During the three and nine months of 2006 and 2005, our revenue from continuing operations was attributable to Acsis, Inc. ( Acsis ) (2006 only), Alliance Consulting Group Associates, Inc. ( Alliance Consulting ), Clariant, Inc. ( Clariant ), Laureate Pharma, Inc. ( Laureate Pharma ) and Pacific Title and Art Studio, Inc. ( Pacific Title ).

Acsis recognizes revenue from software licenses, related consulting services, hardware and post-contract customer support (PCS). Revenue from software license agreements are recognized upon delivery, provided that all of the following conditions are met: a non-cancelable license agreement has been signed; the software or hardware has been delivered; no significant production, modification or customization of the software is required; the fee is fixed or determinable; and collection of the resulting receivable is deemed probable. In software arrangements that include rights to software products, hardware products, PCS, and/or other services, Acsis allocates the total arrangement fee among each deliverable based on vendor-specific objective evidence using the residual method. Revenue from PCS agreements is recognized ratably over the

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term of the maintenance period, generally one year. Consulting and training services provided by Acsis that are not considered essential to the functionality of the software products are recognized as the respective services are performed.

Alliance Consulting generates revenue primarily from consulting services. Alliance Consulting generally recognizes revenue when persuasive evidence of an arrangement exists, services are performed, the service fee is fixed or determinable and collectibility is probable. Revenue from services is recognized as services are performed. Alliance Consulting also performs certain services under fixed-price service contracts related to discrete projects. Alliance Consulting recognizes revenue from these contracts using the percentage-of-completion method, primarily based on the actual labor hours incurred to date compared to the estimated total hours of the project. Any losses expected to be incurred on jobs in process are charged to income in the period such losses become known. Changes in estimates of total costs could result in changes in the amount of revenue recognized.

Clariant generates revenue from diagnostic services, system sales and fee-per-use charges. Clariant recognizes revenue for diagnostic services at the time of completion of services at amounts equal to the contractual rates allowed from third parties, including Medicare, insurance companies and, to a small degree, private patients. These expected amounts are based both on Medicare allowable rates and Clariant's collection experience with other third party payors.

Clariant recognizes revenue for fee-per-use agreements based on the greater of actual usage fees or the minimum monthly rental fee. Under this pricing model, Clariant owns or retains a substantial risk of ownership of most of the ACIS® instruments that are engaged in service and, accordingly, all related depreciation and maintenance and service costs are expensed as incurred. For those instruments that are sold, Clariant recognizes and defers revenue using the residual method pursuant to the requirements of Statement of Position No. 97-2, Software Revenue Recognition (SOP 97-2), as amended by Statement of Position No. 98-9, Modification of SOP 97-2, Software Revenue Recognition with Respect to Certain Arrangements. At the outset of the arrangement with the customer, Clariant defers revenue for the fair value of its undelivered elements (e.g., maintenance) and recognizes revenue for the remainder of the arrangement fee attributable to the elements initially delivered in the arrangement (e.g., software license and related instrument) when the basic criteria in SOP 97-2 have been met. Maintenance revenue is recognized ratably over the term of the maintenance contract, typically twelve months. Clariant does not recognize revenue on sales of assets subject to an operating lease where they retain a substantial risk of ownership.

Clariant recognizes revenue on system sales in accordance with Staff Accounting Bulletin No. 101, as amended by Staff Accounting Bulletin No. 104, when all criteria for revenue recognition have been met. Such criteria includes, but is not limited to: existence of persuasive evidence of an arrangement; fixed or determinable product pricing; satisfaction of the terms of the arrangement including passing title and risk of loss to their customer upon shipment; and reasonable assurance of collection from their customer in accordance with the terms of the arrangement. For system sales delivered under the Dako distribution and development agreement, Clariant recognizes revenue when those ACIS® instruments have been delivered and accepted by an end-user customer. Revenue for certain systems sold for Dako's use as training and demonstration units is recorded when the units are delivered and accepted by Dako. Systems sold under a leasing arrangement are accounted for as sales-type leases pursuant to SFAS No. 13, Accounting for Leases, if applicable. Clariant recognizes the net effect of these transactions as a sale because of the bargain purchase option granted to the lessee. Clariant recognizes revenue from research and development agreements over the contract performance period, starting with the contract's commencement. Upfront payments are generally deferred and recognized on a straight-line basis over the estimated performance periods. Milestone payments are recognized as revenue when they are earned and collectible, but not prior to the removal of any contingencies for each individual milestone.

Laureate Pharma's revenue is primarily derived from contract manufacturing work, process development services, and formulation and filling. Laureate Pharma enters into revenue arrangements with multiple deliverables in order to meet its customers' needs. Multiple element revenue agreements are evaluated under Emerging Issues Task Force (EITF) Issue Number 00-21, Revenue Arrangements with Multiple Deliverables, to determine whether the delivered item has value to the customer on a stand-alone basis and whether objective and reliable evidence of the fair value of the undelivered item exists. Deliverables in an arrangement that do not meet the separation criteria in EITF 00-21 are treated as one unit of accounting for purposes of revenue recognition. Revenue is generally recognized upon the

performance of services. Certain services are performed under fixed price contracts. Revenue from these contracts are recognized on a percentage of completion basis. When current cost estimates indicate a loss is expected to be incurred, the entire loss is recorded in the period in which it is identified. Changes in estimates of total costs could result in changes in the amount of revenue recognized.

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Pacific Title's revenue is primarily derived from providing archival and post-production services to the motion picture and television industry. Pacific Title recognizes revenue generally upon the performance of services. Pacific Title performs certain services under fixed-price contracts. Revenue from these contracts is recognized on a percentage-of-completion basis based on costs incurred to total estimated costs to be incurred. Changes in the estimates of total cost could result in changes in the amount of revenue recognized. Any anticipated losses on contracts are expensed when identified.

***Recoverability of Goodwill***

We conduct a review for impairment of goodwill annually on December 1<sup>st</sup>. Additionally, on an interim basis, we assess the impairment of goodwill whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors that we consider important which could trigger an impairment review include significant underperformance relative to historical or expected future operating results, significant changes in the manner or use of the acquired assets or the strategy for the overall business, divestiture of all or part of the business, significant negative industry or economic trends or a decline in a company's stock price for a sustained period.

We test for impairment at a level referred to as a reporting unit (same as or one level below an operating segment as defined in SFAS No. 131, "Disclosures About Segments of an Enterprise and Related Information"). If we determine that the fair value of a reporting unit is less than its carrying value, we assess whether goodwill of the reporting unit is impaired. To determine fair value, we use a number of valuation methods including quoted market prices, discounted cash flows and revenue and acquisition multiples. Depending on the complexity of the valuation and the significance of the carrying value of the goodwill to the Consolidated Financial Statements, we may engage an outside valuation firm to assist us in determining fair value. As an overall check on the reasonableness of the fair values attributed to our reporting units, we compare and contrast the aggregate fair values for all reporting units with our average total market capitalization for a reasonable period of time.

The carrying value of goodwill at September 30, 2006 was \$82 million.

We operate in industries which are rapidly evolving and extremely competitive. It is reasonably possible that our accounting estimates with respect to the ultimate recoverability of the carrying value of goodwill could change in the near term and that the effect of such changes on our Consolidated Financial Statements could be material. While we believe that the current recorded carrying values of our companies are not impaired, there can be no assurance that a significant write-down or write-off will not be required in the future.

***Recoverability of Long-Lived Assets***

We test long-lived assets, including property and equipment and amortizable intangible assets, for recoverability whenever events or changes in circumstances indicate that we may not be able to recover the asset's carrying amount. When events or changes in circumstances indicate an impairment may exist, we evaluate the recoverability by determining whether the undiscounted cash flows expected to result from the use and eventual disposition of that asset cover the carrying value at the evaluation date. If the undiscounted cash flows are not sufficient to recover the carrying value, we measure any impairment loss as the excess of the carrying amount of the asset over its fair value.

The carrying value of net intangible assets at September 30, 2006 was \$17 million. The carrying value of net property and equipment at September 30, 2006 was \$44 million.

***Recoverability of Ownership Interests In and Advances to Companies***

On a continuous basis (but no less frequently than at the end of each quarterly period) we evaluate the carrying value of our equity and cost method partner companies for possible impairment based on achievement of business plan objectives and milestones, the fair value of each company relative to its carrying value, the financial condition and prospects of the company and other relevant factors. We then determine whether there has been an other than temporary decline in the carrying value of our ownership interest in the company. Impairment to be recognized is measured by the amount by which the carrying value of the assets exceeds the fair value of the assets.

The fair value of privately held companies is generally determined based on the value at which independent third parties have invested or have committed to invest in these companies or based on other valuation methods including discounted cash flows, valuation of comparable public companies and the valuation of acquisitions of similar companies. The



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fair value of our ownership interests in private equity funds is generally determined based on the value of our pro rata portion of the funds' net assets and estimated future proceeds from sales of investments provided by the funds managers.

The new carrying value of a company is not written-up if circumstances suggest the value of the company has subsequently recovered.

We operate in industries which are rapidly evolving and extremely competitive. It is reasonably possible that our accounting estimates with respect to the ultimate recoverability of the carrying value of ownership interests in and advances to partner companies, including goodwill, could change in the near term and that the effect of such changes on our Consolidated Financial Statements could be material. While we believe that the current recorded carrying values of our equity and cost method partner companies are not impaired, there can be no assurance that our future results will confirm this assessment or that a significant write-down or write-off of the carrying value will not be required in the future.

***Income Taxes***

We are required to estimate income taxes in each of the jurisdictions in which we operate. This process involves estimating our actual current tax exposure together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within our Consolidated Balance Sheet. We must assess the likelihood that the deferred tax assets will be recovered from future taxable income and to the extent that we believe recovery is not likely, we must establish a valuation allowance. To the extent we establish a valuation allowance in a period, we must include an expense within the tax provision in the Consolidated Statements of Operations. We have recorded a valuation allowance to reduce our deferred tax assets to an amount that is more likely than not to be realized in future years. If we determine in the future that it is more likely than not that the net deferred tax assets would be realized, then the previously established valuation allowance would be reversed.

***Allowance for Doubtful Accounts***

The allowance for doubtful accounts is an estimate prepared by management based on identification of the collectibility of specific accounts and the overall condition of the receivable portfolios. When evaluating the adequacy of the allowance for doubtful accounts, we specifically analyze trade receivables, historical bad debts, customer credits, customer concentrations, customer credit-worthiness, current economic trends and changes in customer payment terms. If the financial condition of customers or vendors were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required. Likewise, should we determine that we would be able to realize more of our receivables in the future than previously estimated, an adjustment to the allowance would increase income in the period such determination was made. The allowance for doubtful accounts is reviewed on a quarterly basis and adjustments are recorded as deemed necessary.

***Commitments and Contingencies***

From time to time, we are a defendant or plaintiff in various legal actions which arise in the normal course of business. Additionally, we have received distributions as both a general partner and a limited partner from certain private equity funds. Under certain circumstances, we may be required to return a portion or all the distributions we received as a general partner to the fund for a further distribution to the fund's limited partners (the "clawback"). We are also a guarantor of various third-party obligations and commitments, and are subject to the possibility of various loss contingencies arising in the ordinary course of business. We are required to assess the likelihood of any adverse outcomes to these matters as well as potential ranges of probable losses. A determination of the amount of provision required for these commitments and contingencies, if any, which would be charged to earnings, is made after careful analysis of each matter. The provision may change in the future due to new developments or changes in circumstances. Changes in the provision could increase or decrease our earnings in the period the changes are made.

***Stock-based Compensation***

As permitted by SFAS No. 123, Accounting for Stock-Based Compensation, prior to January 1, 2006, we accounted for employee stock-based compensation in accordance with Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees. Accordingly, no compensation expense was recorded for stock options issued to employees at fair market value.





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On January 1, 2006, we adopted SFAS No. 123 (revised 2004), Share-Based Payment ( SFAS No. 123(R) ). SFAS No. 123(R) requires companies to measure all employee stock-based compensation awards using a fair value method and record such expense in its consolidated financial statements. We adopted SFAS No. 123(R) using the modified prospective method. Accordingly, prior period amounts have not been restated. Under this application, we are required to record compensation expense for all awards granted after the date of adoption and for the unvested portion of previously granted awards that remain outstanding at the date of adoption.

We estimate the grant date fair value of stock options using the Black-Scholes option-pricing model which requires the input of highly subjective assumptions. These assumptions include estimating the expected term of the award and the estimated volatility of our stock price over the expected term. Changes in these assumptions and in the estimated forfeitures of stock option awards can materially affect the amount of stock-based compensation recognized in the Consolidated Statements of Operations. In addition, the requisite service periods for market-based stock option awards are based on our estimate of the dates on which the market conditions will be met as determined using a Monte Carlo simulation model. Changes in the derived requisite service period or achievement of market capitalization targets earlier than estimated can materially affect the amount of stock-based compensation recognized in the Consolidated Statements of Operations.

**Results of Operations**

Management evaluates segment performance based on segment revenue, operating income (loss) and income (loss) before income taxes, which reflects the portion of income (loss) allocated to minority shareholders.

Other items include certain expenses which are not identifiable to the operations of the Company's operating business segments. Other items primarily consist of general and administrative expenses related to our corporate operations, including employee compensation, insurance and professional fees, including legal, finance and consulting. Other items also includes interest income, interest expense and income taxes, which are reviewed by management independent of segment results.

The following tables reflect our consolidated operating data by reportable segment. Each segment includes the results of our consolidated companies and records our share of income or losses for entities accounted for under the equity method. Segment results also include impairment charges, gains or losses related to the disposition of the companies and the mark to market of trading securities. All significant intersegment activity has been eliminated in consolidation. Accordingly, segment results reported by us exclude the effect of transactions between us and our subsidiaries and among our subsidiaries.

The Company's operating results including net income (loss) before income taxes by segment are as follows:

	<b>Three Months Ended</b>		<b>Nine Months Ended September</b>	
	<b>September 30,</b>		<b>30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	<b>(In thousands)</b>			
Acis	\$ (2,358)	\$ n/a	\$ (6,263)	\$ n/a
Alliance Consulting Alliance	560	(631)	(754)	(1,626)
Clariant	(2,188)	(2,709)	(7,574)	(7,241)
Laureate	(2,916)	(3,129)	(7,880)	(7,663)
Pacific Title	1,020	594	1,951	4,042
Other companies	(2,145)	305	(1,795)	(5,201)
<b>Total segments</b>	<b>(8,027)</b>	<b>(5,570)</b>	<b>(22,315)</b>	<b>(17,689)</b>
Other items				
Corporate operations	(1,575)	(4,467)	(10,629)	(12,484)
Income tax benefit (expense)	(83)	(38)	1,140	2
<b>Total other items</b>	<b>(1,658)</b>	<b>(4,505)</b>	<b>(9,489)</b>	<b>(12,482)</b>

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Net loss from continuing operations	(9,685)	(10,075)	(31,804)	(30,171)
Net income (loss) from discontinued operations	78	(565)	6,510	(4,241)
Net Loss	\$ (9,607)	\$ (10,640)	\$ (25,294)	\$ (34,412)

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Included in the above is stock-based compensation expense, which for the three and nine months ended September 30, 2006 reflects the adoption of SFAS No. 123(R) as follows:

	<b>Stock-Based Compensation</b>			
	<b>Three Months</b>		<b>Nine Months Ended September</b>	
	<b>Ended September</b>		<b>30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	<b>(In thousands)</b>			
Acsis	\$ 76	n/a	\$ 139	n/a
Alliance Consulting	251	\$ 82	779	\$ 247
Clariant	332	94	984	239
Laureate Pharma	42		123	
Pacific Title		139	139	416
Total segment results	701	315	2,164	902
Other items	702	292	2,962	743
	\$ 1,403	\$ 607	\$ 5,126	\$ 1,645

There is intense competition in the markets in which these companies operate, and we expect competition to intensify in the future. Additionally, the markets in which these companies operate are characterized by rapidly changing technology, evolving industry standards, frequent introduction of new products and services, shifting distribution channels, evolving government regulation, frequently changing intellectual property landscapes and changing customer demands. Their future success depends on each company's ability to execute its business plan and to adapt to its respective rapidly changing markets.

**Acsis**

We acquired 94% of Acsis in December 2005. As a result there is no comparative financial information for the prior year periods.

	<b>Three</b>	<b>Nine Months Ended</b>
	<b>Months</b>	
	<b>Ended</b>	<b>September 30,</b>
	<b>September</b>	<b>September 30,</b>
	<b>30,</b>	<b>2006</b>
	<b>2006</b>	<b>2006</b>
	<b>(In thousands)</b>	
Revenue	\$ 4,156	\$ 13,141
Operating expenses		
Cost of sales	2,755	9,249
Selling, general and administrative	2,930	7,708
Research and development	616	1,697
Amortization of intangibles	383	1,143
Total operating expenses	6,684	19,797
Operating loss	(2,528)	(6,656)

Interest, net	59	69
Minority interest	111	324
Net loss before income taxes	\$ (2,358)	\$ (6,263)

Acsis is a leading provider of software and service solutions that assist manufacturing companies in improving efficiencies throughout the entire supply-chain. Its solutions enable manufacturers to automate plant floor/warehouse operations and take advantage of emerging automated-ID technologies, including radio frequency identification ( RFID ) and barcode.

Acsis draws from a variety of technologies and service offerings to create a solution that matches the client's business, budget and IT environment. Solutions range from value-added services for implementing SAPConsole, to the next generation of shop floor process automation and data collection using their Data-Link enterprise solution suite and Line Manager, a scalable appliance plug and play solution designed to automate warehouse and manufacturing operations. If requested, Acsis will provide all necessary hardware, consulting services and software to deliver a turnkey data-collection / supply chain solution.

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Acsis competition generally comes from large, diversified software or consulting businesses or niche providers with a variety of individual solutions for barcode, RFID or other data collection systems. Acsis differentiates itself by providing a single, integrated platform which can be used across the entire enterprise / supply chain to increase efficiencies and reduce operational costs.

Acsis recognizes revenue from software licenses, related consulting services, hardware and PCS. Revenue from software license agreements is recognized upon delivery, provided that all of the following conditions are met: a non-cancelable license agreement has been signed; the software or hardware has been delivered and there is vendor-specific objective evidence (VSOE) of fair value of any undelivered elements; no significant production, modification or customization of the software is required; the fee is fixed or determinable; and collection of the resulting receivable is deemed probable. Revenue from PCS agreements is recognized ratably over the term of the maintenance period, generally one-year. Consulting and training services provided by Acsis that are not considered essential to the functionality of the software products are recognized as the respective services are performed.

In June 2006, Safeguard acquired additional common shares of Acsis for an aggregate purchase price of \$6 million in cash increasing our ownership by 1.2% to 95%. We funded Acsis to support its long-term growth strategy.

At September 30, 2006, we owned a 95% voting interest in Acsis.

*Revenue.*

*Quarter September 30, 2006 vs. June 30, 2006.* Revenue decreased \$0.4 million, or 9.3%, in the third quarter of 2006 as compared to the second quarter of 2006. The decline was primarily due to a \$0.7 million decrease in hardware sales, partially offset by an increase in consulting revenue. During the quarter, Acsis signed four new license agreements. Hardware sales fluctuate significantly from period to period given the timing of customer orders. Acsis expects revenue to increase modestly for the remainder of the year although license revenue is generally recognized upon delivery, which may cause variability in the timing of revenue.

*Operating Expenses.*

*Quarter September 30, 2006 vs. June 30, 2006.* Operating expenses increased \$0.2 million, or 3.3%, in the third quarter of 2006 as compared to the second quarter of 2006. Gross margins increased to 34% for the third quarter of 2006, up from 30% in the second quarter of 2006. The increase is due to the increased utilization of the consulting staff. Selling, general and administrative expense increased for the third quarter of 2006 as compared to the second quarter of 2006 due to severance costs associated with the termination of two employees.

Research and development expense increased slightly for the third quarter as compared to the second quarter of 2006. Acsis released three new products in June 2006. Acsis expects research and development costs to increase in future periods as it continues to develop new products.

Acsis anticipates that its net loss in the fourth quarter of 2006 will be consistent with the third quarter of 2006. Acsis anticipates the addition of management resources and new sales and product initiatives during 2006 to assist in growth. As a result of these strategies, Acsis expects continued losses in 2007.

**Table of Contents****Alliance Consulting**

Alliance Consulting operates on a 52 or 53-week fiscal year, ending on the Saturday closest to the end of the fiscal period. Alliance Consulting's third quarter ended on September 30, 2006 and October 1, 2005, each a period of 13 weeks, and year-to-date a period of 39 weeks. The financial information presented below does not include the results of operations of Alliance Consulting's Southwest region business, which is included in discontinued operations for all periods presented. Alliance Consulting completed the sale of that business during the second quarter of 2006, which resulted in a net gain of \$1.6 million. For the nine months ended September 30, 2006, the Southwest region business generated \$3.1 million of revenue and net income of \$1.6 million including the gain on the sale of the business. For the three and nine months ended October 1, 2005, the Southwest region business generated revenue of \$2.8 million and \$8.0 million, respectively, with net income of \$0.3 million and \$0.5 million, respectively.

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	<b>(In thousands)</b>			
Revenue	\$ 27,527	\$ 20,472	\$ 78,607	\$ 58,578
Operating expenses				
Cost of sales	18,863	14,250	55,508	40,596
Selling, general and administrative	7,649	6,399	22,547	18,324
Amortization of intangibles	263	244	750	723
Total operating expenses	26,775	20,893	78,805	59,643
Operating income (loss)	752	(421)	(198)	(1,065)
Other income (loss), net	34	(15)	53	(37)
Interest, net	(219)	(195)	(602)	(530)
Minority interest	(7)		(7)	6
Net income (loss) before income taxes	\$ 560	\$ (631)	\$ (754)	\$ (1,626)

Alliance Consulting is a leading national business intelligence consultancy providing services primarily to clients in the Fortune 2000 market in the pharmaceutical, financial services and manufacturing industries. Alliance Consulting specializes in information management, which is comprised of a full range of business intelligence solutions from data acquisition and warehousing to master data management, analytics and reporting; and application services, which includes software development, integration, testing and application support delivered through a high quality and cost-effective hybrid global delivery model. Alliance Consulting has developed a strategy focused on enabling business intelligence through the application of deep domain experience and custom-tailored project teams to deliver software solutions and consulting services.

Alliance Consulting recognizes revenue upon the performance of services. Contracts for such services are typically for one year or less. Alliance Consulting performs certain services under fixed-price contracts related to discrete projects. Alliance Consulting recognizes revenue from these contracts using the percentage-of-completion method based on the percentage of labor hours incurred to date compared to the estimated total hours of the project. Losses expected to be incurred on jobs in process are charged to income in the period such losses become known.

While global economic conditions continue to cause companies to be cautious about increasing their use of consulting and IT services, Alliance Consulting continues to see growing demand for its services. Alliance Consulting continues to experience pricing pressures from its competitors as well as from clients facing pressure to control costs. In addition, the growing use of offshore resources to provide lower-cost service delivery capabilities within the

industry continues to place pressure on pricing and revenue. Alliance Consulting expects to continue to focus on maintaining and growing its blue chip client base and providing high quality solutions and services to its clients.

In July 2006, Alliance Consulting completed the purchase of specific assets and assumed certain liabilities of Fusion Technologies, Inc., a provider of strategic information technology solutions to rapidly growing organizations within the United States. This purchase further enhances Alliance Consulting's offshore capabilities to its new and existing clients.

At September 30, 2006, we owned 99% of Alliance.

**Table of Contents***Revenue.*

*Quarter 2006 vs. 2005.* Revenue, including reimbursement of expenses, increased \$7.1 million, or 34.5% in 2006 as compared to the prior year period. The Fusion acquisition contributed approximately \$3.5 million in revenue. The remaining increase was due to the growth in existing accounts as well as the development of new key accounts; plus the expansion of Alliance Consulting's Outsourcing, Master Data Management and Global Delivery services. In Outsourcing engagements, Alliance Consulting assumes responsibility for managing a client's business applications with the goal of improving reliability and performance of those applications while reducing costs. Master Data Management includes business intelligence and data management as well as corporate performance management. Global Delivery is Alliance Consulting's high quality, lower-priced offshore delivery and support service. Revenue from these services was \$7.3 million for the third quarter of 2006 as compared to \$6.9 million for the third quarter of 2005.

Alliance Consulting's top ten customers accounted for approximately 56% of total revenue in 2006 and approximately 60% of total revenue in 2005. The same two customers each represented more than 10% of total revenue for the three months ended September 30, 2006 and October 1, 2005.

Alliance Consulting will continue to leverage its Outsourcing, Master Data Management and Global Delivery capabilities to facilitate growth in all of its vertical market sectors. Clients continue to award projects in multiple phases resulting in extended sales cycles and gaps between phases. In addition, Alliance Consulting is continuing to target mid-market pharmaceutical companies which they believe have higher potential for growth in IT spending as opposed to the large pharmaceutical manufacturers. Alliance Consulting must also compete against larger IT services companies with greater resources and more developed offshore delivery organizations. Alliance expects revenue to be affected by general economic uncertainty, increase in overall pricing pressures within the industry, discounts required for long-term engagements and risk associated with large contracts. As a result of these factors, Alliance expects revenue for the remainder of 2006 to be consistent with the third quarter.

*Year-to-date 2006 vs. 2005.* Revenue, including reimbursement of expenses, increased \$20.0 million, or 34.5% in 2006 as compared to the prior year period. This increase was due to growth in existing accounts, the development of new key accounts, the expansion of Alliance Consulting's Outsourcing, Master Data Management and Global Delivery services and the Fusion acquisition. Revenue from these strategic services was \$23.9 million in 2006 as compared to \$12.1 million in 2005.

Alliance Consulting's top ten customers accounted for approximately 56% of total revenue in 2006 and approximately 59% of total revenue in 2005. Two customers each represented more than 10% of total revenue for 2006; while one of these customers represented more than 10% of total revenue for 2005.

*Cost of Sales.*

*Quarter 2006 vs. 2005.* Cost of sales increased \$4.6 million, or 32.4% in 2006 as compared to the prior year period. This increase was primarily a result of growth in revenues. Gross margin improved from 30.4% in 2005 to 31.5% in 2006 primarily due to the Fusion acquisition.

Alliance Consulting expects gross margins to continue to be affected by general economic uncertainty, increases in overall pricing pressures within the industry, discounts required for longer-term engagements, increased employee and contractor costs resulting from greater competition within the talent pool due to declining unemployment levels, wage inflation in India as the demand for those resources increases, resource availability and ability to retain key resources and efficiency in project management.

*Year-to-date 2006 vs. 2005.* Cost of sales increased \$14.9 million, or 36.7% in 2006 as compared to the prior year period. This increase was primarily a result of growth in revenues. Gross margin declined from 30.7% in 2005 to 29.4% in 2006 primarily due to an increase in reimbursable expenses and higher staffing costs due to additional full-time employees, partially offset by the impact of the Fusion acquisition.



**Table of Contents***Selling, General and Administrative.*

*Quarter 2006 vs. 2005.* Selling, general and administrative expenses increased \$1.3 million, or 19.5% in 2006 as compared to the prior year period. Selling, general and administrative expenses were 27.8% of revenue in 2006 as compared to 31.3% of revenue in 2005. The dollar increase was primarily due to \$1.0 million from the acquired Fusion business and \$0.1 million incremental stock-based compensation costs due to the adoption of SFAS No. 123(R).

Selling, general and administrative costs are expected to increase as Alliance Consulting's business continues to grow. As a percentage of revenue, however, costs are expected to decrease as certain costs are not expected to recur. Alliance Consulting also expects to continue realizing benefits from cost savings initiatives and realignment of support and sales positions.

*Year-to-date 2006 vs. 2005.* Selling, general and administrative expenses increased \$4.2 million, or 23.0% in 2006 as compared to the prior year period. Selling, general and administrative expenses were 28.7% of revenue in 2006 as compared to 31.3% of revenue in 2005. The increase in dollars was primarily \$1.0 million from Fusion, an increase in variable compensation due to growth in revenues of approximately \$1.1 million, a restructuring charge of \$0.5 million taken to consolidate multiple facilities within the same market, incremental stock-based compensation charges of approximately \$0.5 million due to the adoption of SFAS No. 123(R), and incremental travel costs associated with the growth in revenues. The decrease as a percentage of revenue is due to the company's fixed costs and benefits from cost savings initiatives. Alliance Consulting expects selling, general and administrative expenses to be stable in dollars and percentage of revenue for the remainder of 2006.

*Interest, Net.*

*Quarter 2006 vs. 2005.* Interest expense remained relatively flat in 2006 as compared to 2005, as a result of higher interest rates partially offset by lower outstanding debt balances in 2006.

*Year-to-date 2006 vs. 2005.* Interest expense increased slightly as compared to the prior year period due to an increase in interest rates.

*Net Income (Loss) Before Income Taxes.*

*Quarter 2006 vs. 2005.* Net income of \$0.6 million in the third quarter of 2006 improved compared to net loss of \$0.6 million in 2005 primarily due to the Fusion acquisition, the increase in revenues and cost savings from prior period restructuring initiatives.

*Year-to-date 2006 vs. 2005.* Net loss decreased \$0.9 million due to the growth in revenues and the Fusion acquisition partially offset by the decline in gross margins, restructuring expenses and incremental stock-based compensation expense due to the adoption of SFAS No. 123(R).

**Clariant**

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
	(In thousands)			
Revenue	\$ 9,122	\$ 4,906	\$ 23,368	\$ 14,122
Operating expenses				
Cost of sales	4,978	2,904	12,537	8,088
Selling, general and administrative	6,684	5,194	19,271	14,280
Research and development	1,044	921	3,335	2,567
Amortization of intangibles	54	367	752	1,109
Total operating expenses	12,760	9,386	35,895	26,044

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Operating loss	(3,638)	(4,480)	(12,527)	(11,922)
Other loss	(39)		(39)	
Interest, net	(196)	(78)	(372)	(128)
Minority interest	1,685	1,849	5,364	4,809
Net loss before income taxes	\$ (2,188)	\$ (2,709)	\$ (7,574)	\$ (7,241)

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Clariant is a comprehensive cancer diagnostics company providing cellular assessment and cancer characterization to community pathologists, academic researchers, university hospitals and biopharmaceutical companies. Clariant addresses these customers' needs through applications of its proprietary bright field microscopy technology. Its Automated Cellular Imaging System (ACIS®) instrument is a premiere digital cellular imaging solution that provides precise, reproducible results required by targeted cancer therapies and drug discovery efforts. Clariant leverages ACIS® to provide a broad range of oncology testing services (for community pathologists focused on cancer diagnosis and prognosis) and biopharmaceutical services (in support of companies and researchers developing new cancer therapies).

Clariant generates revenue from diagnostic services, system sales and fee-per-use charges. Clariant recognizes revenue for fee-per-use agreements based on the greater of actual usage fees or the minimum monthly rental fee. Revenue on system sales is recognized upon acceptance by the customer subsequent to a testing and evaluation period. For system sales delivered under the Dako distribution and development agreement, Clariant recognizes revenue when those ACIS® instruments have been delivered and accepted by an end-user customer. Revenue for diagnostic services is recognized at the time of completion of services at amounts equal to contractual rates from third parties including Medicare, insurance companies and to a small degree, private patients. The expected amount is based on both Medicare allowable rates and Clariant's collection experience with other third party payors.

The decision to provide in-house laboratory services was made in 2004 to give Clariant an opportunity to capture a significant service-related revenue stream over the much broader and expanding cancer diagnostic testing marketplace while also optimizing the level of service and accuracy provided to remote pathology customers. Clariant believes that they are positioned to participate in this growth because of their proprietary analysis capabilities, depth of experience of the staff in their diagnostic laboratory, relationships with the pharmaceutical companies, and demonstrated ability to develop unique assays to support new diagnostic tests.

Clariant operates primarily in two businesses: 1) the services group which delivers critical oncology testing services to community pathologists, biopharmaceutical companies and other researchers; and 2) the technology group which is engaged in the development, manufacture and marketing of an automated cellular imaging system that is designed to assist physicians in making critical medical decisions.

In September 2006, Clariant completed their acquisition of Trestle Holdings, Inc. ( Trestle ) and Trestle Acquisition Corp. (a wholly-owned subsidiary of Trestle). The purchase strategically positions Clariant as a leading provider in the anatomical pathology market integrating image analysis, high-speed scanning capabilities and virtual microscopy into one offering. Complementing Clariant's current proprietary ACIS® with Trestle's technology enables Clariant to cover virtually all of the pathology samples needing anatomical laboratory analysis.

In September 2006, Safeguard acquired additional common shares of Clariant for \$3.0 million increasing our ownership to 60%. Clariant used the proceeds to support their acquisition of Trestle Holdings, Inc. ( Trestle ).

As of September 30, 2006, we owned a 60% voting interest in Clariant.

*Revenue.*

*Quarter 2006 vs. 2005.* Revenue increased \$4.2 million, or 85.9%, in 2006 as compared to 2005. Revenue from Clariant's services group increased 162% or \$4.9 million from \$3.0 million in 2005 to \$7.9 million in 2006. This increase resulted from the execution of Clariant's marketing and sales strategy to increase Clariant's sales to additional new customers and to enter into new managed care contracts. This increase was also driven in part by increasing the number of available tests being performed that include immunohistochemistry, flow cytometry, and florescent in-situ hybridization ( FISH ).

Partially offsetting the increase in revenues from the services group is a decline of \$0.7 million in the technology group. The change is primarily the result of a decrease in instrument systems revenue from \$0.9 million for the third quarter 2005 to \$0.6 million for the third quarter 2006 and a decline in per click revenue of \$0.4 million from \$1.0 million to \$0.6 million in the comparable three month period.

*Year-to-date 2006 vs. 2005.* Revenue increased \$9.2 million, or 65.5%, in 2006 as compared to 2005. Revenue from Clariant's services group increased 162% or \$12.2 million from \$7.6 million in 2005 to \$19.8 million in 2006. The increase resulted from the execution of Clariant marketing and sales strategy to increase Clariant's sales to additional new customers



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and to enter into new managed care contracts. This increase was also driven in part by increasing the number of available tests being performed that include immunohistochemistry, flow cytometry, and FISH. Clariant anticipates that diagnostic services revenues will continue to increase throughout the remainder of 2006 as a result of increased revenue from existing customers, with additional penetration of new customers (including managed care providers) by Clariant's sales force and their offering of a more comprehensive suite of advanced cancer diagnostic tests.

Partially offsetting the increase in revenues from the services group is a decline of \$3.1 million in the technology group. The change was primarily the result of a decrease in instrument systems revenue from \$3.3 million in 2005 to \$1.3 million in 2006, a decrease of 61%, and a decline in per click revenue of \$1.5 million from \$3.3 million to \$1.8 million in the comparable nine month period, a decrease of 45%. The decline was partially offset by an increase in development revenue in the third quarter of 2006 of \$0.4 million compared to no development revenue in the same period of 2005. Clariant expects technology group revenue will increase for the remainder of 2006 as a result of the sale of systems through the Dako distribution agreement, particularly from development fees earned through milestone payments under the Dako development agreement and the planned launch of ACIS® III in the fourth quarter of 2006.

*Cost of Sales.*

*Quarter 2006 vs. 2005.* Cost of sales increased \$2.1 million, or 71.4%, in 2006 as compared to 2005. Cost of revenue for the services group in 2006 was \$4.4 million compared to \$2.3 million in 2005. Gross margin for Clariant's services group in 2006 was 45%, compared to 23% in 2005. The improvement in gross margin in the second quarter of 2006 was attributable to achieving economies of scale in Clariant's diagnostics laboratory operations.

Cost of sales in the technology group remained constant. Gross margins for Clariant's technology group were 53% in 2006 compared to 70% in 2005. This decrease in gross margin was a result of lower than expected sales volume combined with the anticipated lower per system sales price as Clariant moved to their distributor sales arrangement with Dako.

*Year-to-date 2006 vs. 2005.* Cost of sales increased \$4.4 million, or 55.0%, in 2006 as compared to 2005. Cost of revenue for the services group in 2006 was \$11.1 million compared to \$6.2 million in 2005, an increase of 79%. Gross margin for Clariant's services group for 2006 was 44%, compared to 18% in 2005. The increase in gross margin in 2006 was attributable to achieving economies of scale in Clariant's diagnostics laboratory operations. Clariant anticipates similar gross margin results throughout 2006.

Partially offsetting the increase in cost of sales in the services group was a \$0.4 million decline in cost of sales in the technology group. Gross margins for Clariant's technology group were 61% in 2006 and 72% in 2005. Clariant attributes the decrease in gross margin to a result of lower than expected sales volume combined with anticipated lower per system sales price as they moved to their distributor sales agreement with Dako.

*Selling, General and Administrative.*

*Quarter 2006 vs. 2005.* Selling, general and administrative expenses increased \$1.5 million, or 28.7%, in 2006 as compared to 2005. Expenses related to both selling, general and administrative and diagnostic services administration are included in this category. Selling, general and administrative expenses for 2006 increased approximately \$0.7 million, or 19%, to \$4.4 million compared to \$3.7 million for the comparable period in 2005. As a percent of revenues, these costs declined from 76% in 2005 to 48% in 2006. The increase in expenses in the current quarter was primarily due to increases in rent expense related to Clariant's new facility, increases in selling expenses to support the growing diagnostics services business and the implementation of SFAS No. 123(R).

Also contributing to the overall increase in selling, general and administrative expenses was diagnostic services administration expenses which were \$2.3 million in 2006 compared to \$1.6 million in 2005, an increase of 46%. The increase was primarily due to higher collection costs due to the increase in services group revenues.

*Year-to-date 2006 vs. 2005.* Selling, general and administrative expenses increased \$5.0 million, or 35.0%, in 2006 as compared to 2005. Expenses related to both selling, general and administrative and diagnostic services administration are included in this category. Selling, general and administrative expenses for 2006 increased approximately \$3.0 million, or 30% to \$12.8 million compared to \$9.8 million for the comparable period in 2005. As a percent of revenues, these costs decreased from 70% in 2005 to 55% in 2006. The increase in expenses in 2006 was primarily due to increases in rent expense related to Clariant's new facility, increases in selling expenses to support the growing

diagnostics services business, higher stock-based

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compensation expense due to the implementation of SFAS No. 123(R) and relocation and recruiting expenses. Clariant expects sales expenses to support their growing diagnostics services business will continue to grow throughout the remainder of 2006, and expect general and administrative expenses to decline as a percentage of revenues as their infrastructure costs stabilize.

Also contributing to the overall increase in selling, general and administrative expenses was diagnostic services administration expenses which were \$6.4 million in 2006 compared to \$4.5 million in 2005. The increase was primarily due to higher collection costs due to an increase in services group revenue for the period, and the addition of medical and administrative staff to support this rapidly growing segment of Clariant's business. These costs are expected to continue to increase for the remainder of 2006, relative to the prior period, because of higher collection costs on an anticipated, continued increase in services group revenue.

*Research and Development.*

*Quarter 2006 vs. 2005.* Research and development expenses increased \$0.1 million, or 13.4%, in 2006 as compared to 2005. This increase was primarily attributable to personnel and consultants supporting the development activity under Clariant's agreement with Dako. While development expenses are higher, Clariant earns development fees under the terms of its distribution and development agreement with Dako which are recognized in revenue. These development activities, which are intended to produce features that could expand the volume of clinical tests supported by ACIS® and increase the utility of the ACIS® as a tool for researchers, are important to increasing clinical system test volume, expanding the number of clinical system placements and increasing research systems sales.

*Year-to-date 2006 vs. 2005.* Research and development expenses increased \$0.8 million, or 29.9%, in 2006 as compared to 2005. This increase was primarily attributable to personnel and consultants supporting the development activity under Clariant's agreement with Dako. While development expenses are higher, Clariant earns development fees under the terms of our distribution and development agreement with Dako which are recognized in revenue. These development activities, which are intended to produce features that could expand the volume of clinical tests supported by ACIS® and increase the utility of the ACIS® as a tool for researchers, are important to increasing clinical system test volume, expanding the number of clinical system placements and increasing research systems sales. Clariant expects development expenses to continue at similar levels until completion of ACIS III®, which it expects to launch in the fourth quarter of 2006.

*Net Loss Before Income Taxes.*

*Quarter 2006 vs. 2005.* Net loss declined \$0.5 million, or 19.2%, in 2006 as compared to 2005. The improvement is related to increases in revenue and improved gross margin in the services group, partially offset by increases in selling, general and administrative expenses and research and development expenses.

*Year-to-date 2006 vs. 2005.* Net loss increased \$0.3 million, or 4.6%, in 2006 as compared to 2005. The increase is primarily attributable to higher selling, general and administrative expenses and research and development expenses, partially offset by improved gross margin in the services group in 2006.

**Table of Contents****Laureate Pharma**

The financial information presented below does not include the results of operations of the Totowa facility, which was sold in December 2005 and are included in discontinued operations in 2005. For the three and nine months ended September 30, 2005, the Totowa operation generated revenue of \$1.0 million and \$2.4 million and a net loss of \$0.5 million and \$2.0 million, respectively.

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	<b>(In thousands)</b>			
Revenue	\$ 2,218	\$ 1,135	\$ 6,864	\$ 6,151
Operating expenses				
Cost of sales	3,795	3,121	10,712	10,581
Selling, general and administrative	1,158	1,031	3,609	2,978
Total operating expenses	4,953	4,152	14,321	13,559
Operating loss	(2,735)	(3,017)	(7,457)	(7,408)
Interest, net	(181)	(112)	(423)	(255)
Net loss before income taxes	\$ (2,916)	\$ (3,129)	\$ (7,880)	\$ (7,663)

Laureate Pharma is a life sciences company dedicated to providing critical services to facilitate biopharmaceutical product development and manufacturing. Laureate Pharma seeks to become a leader in the biopharmaceutical industry by delivering superior development and manufacturing services to its customers.

Laureate Pharma's broad range of services includes: bioprocessing, quality control and quality assurance. Laureate Pharma provides process development and manufacturing services on a contract basis to biopharmaceutical companies. Laureate Pharma operates a facility in Princeton, New Jersey.

Laureate Pharma's customers generally include small to mid-sized biotechnology and pharmaceutical companies seeking outsourced bioprocessing manufacturing and development services. Laureate Pharma's customers are often dependent on the availability of funding to pursue drugs that are in early stages of clinical trials, and thus have high failure rates. Losses of one or more customers can result in significant swings in profitability from quarter to quarter and year to year. Although there has been a trend among biopharmaceutical companies to outsource drug production functions, this trend may not continue. Many of Laureate Pharma's contracts are short term in duration. As a result, Laureate Pharma must seek to replace these short-term contracts with new contracts to sustain its revenue.

Laureate Pharma's revenue is generated by the sale of contract manufacturing services to support the development and commercialization of pharmaceutical products. Revenue is generally recognized upon the performance of services. Certain services are performed under fixed-price contracts. Revenue from these contracts is recognized on a percentage of completion basis based on costs incurred to total estimated costs to be incurred. Any anticipated losses on contracts are expensed when identified.

Laureate Pharma has recently begun an expansion of its biopharmaceutical manufacturing facility to increase capacity and broaden its service offerings.

As of September 30, 2006, we owned a 100% voting interest in Laureate Pharma.

*Revenue.*

*Quarter 2006 vs. 2005.* Revenue increased \$1.1 million, or 95.4%, in 2006 as compared to 2005. The increase in revenue is primarily related to new client contracts signed in 2006. Laureate signed five new contracts and received



five purchase orders to begin work on new contracts during the third quarter.

*Year-to-date 2006 vs. 2005.* Revenue increased \$0.7 million, or 11.6%, in 2006 as compared to 2005. The increase in revenue is primarily related to new client contracts. With new contracts signed in 2006 and additional purchase orders received, Laureate Pharma expects a significant increase in revenues for the fourth quarter of 2006.

**Table of Contents***Cost of Sales.*

*Quarter 2006 vs. 2005.* Cost of sales increased \$0.7 million, or 21.6%, in 2006 as compared to 2005. The increase is primarily related to increased staffing and related facility expenses to support future revenue growth.

*Year-to-date 2006 vs. 2005.* Cost of sales increased \$0.1 million, or 1.2%, in 2006 as compared to 2005. The increase is related to materials and associated costs to support increased revenues. Laureate expects costs of sales to continue to increase for the remainder of 2006 relative to the expected increase in revenues in the fourth quarter of 2006 and margins are expected to improve as Laureate reaches scale.

*Selling, General and Administrative.*

*Quarter 2006 vs. 2005.* Selling, general and administrative expenses increased \$0.1 million, or 12.3%, in 2006 as compared to 2005. The increase is primarily related to increased staffing.

*Year-to-date 2006 vs. 2005.* Selling, general and administrative expenses increased \$0.6 million, or 21.2%, in 2006 as compared to 2005. The increase is related to increased staffing of \$0.4 million, marketing expenses of \$0.1 million and stock-based compensation of \$0.1 million. Selling, general and administrative expense is expected to remain relatively constant for the remainder of 2006 except for variable compensation related to increased sales.

*Net Loss Before Income Taxes.*

*Quarter 2006 vs. 2005.* Net loss decreased \$0.2 million, or 6.8%, in 2006 as compared to 2005. The improvement is primarily attributable to higher revenue in 2006, partially offset by increased selling, general and administrative expenses.

*Year-to-date 2006 vs. 2005.* Net loss increased \$0.2 million, or 2.8%, in 2006 as compared to 2005. The increase is primarily related to higher revenue in 2006, partially offset by increased manufacturing costs, higher selling, general and administrative expense and higher interest expense on increased borrowing.

**Pacific Title**

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	<b>(In thousands)</b>			
Revenue	\$ 7,585	\$ 7,520	\$ 22,738	\$ 24,292
Operating expenses				
Cost of sales	5,438	5,349	16,491	15,899
Selling, general and administrative	1,128	1,555	4,295	4,562
Total operating expenses	6,566	6,904	20,786	20,461
Operating income	1,019	616	1,952	3,831
Other income (loss), net	1		(1)	362
Interest, net		(22)		(36)
Minority interest				(115)
Net income before income taxes	\$ 1,020	\$ 594	\$ 1,951	\$ 4,042

Pacific Title is a leading provider of a broad range of digital and photo-chemical services for post-production and archival applications in the Hollywood motion picture and television industry. Pacific Title provides a complete array of state-of-the art digital post-production capabilities both for new releases and restoration of film libraries, leading the transformation from optical, analog image reproduction and processing with digital image processing technologies, which we believe is more cost-effective and flexible. In 2005, Pacific Title introduced a digital YCM

process, which is a proprietary method of archiving films, involving the transfer of the film to three color film reels: (yellow, cyan and magenta), which can be stored for more than 100 years.

Pacific Title recognizes revenue on a percentage of completion basis based on costs incurred to total estimated costs to be incurred. Any anticipated losses on contracts are expensed when identified.

As of September 30, 2006, we owned a 100% voting interest in Pacific Title.

**Table of Contents***Revenue.*

*Quarter 2006 vs. 2005.* Revenue increased \$0.1 million, or 0.9% in 2006 as compared to 2005. The increase was attributable to increased revenues of \$0.8 million from two newer lines of business, partially offset by a decline in trailer revenue of \$0.6 million.

*Year-to-date 2006 vs. 2005.* Revenue decreased to \$1.6 million, or 6.4% in 2006 as compared to 2005. The decline is primarily attributable to a decline in trailer revenue, visual effects and scanning and recording (aggregate decline \$4.4 million.) Offsetting the declines were increased revenues from two newer lines of business, digital intermediate and YCM of 3.2 million. Revenue for the remainder of the year is expected to be consistent with the first three quarters.

*Cost of Sales.*

*Quarter 2006 vs. 2005.* Cost of Sales increased \$0.1 million, or 1.7% in 2006 as compared to 2005. The increase is primarily related to increases in film and outside lab expenses for the digital intermediate and YCM archiving of \$0.2 million and \$0.1 million, respectively, partially offset by the \$0.2 million decline in employee costs due to staff reductions.

*Year-to-date 2006 vs. 2005.* Cost of Sales increased \$0.6 million, or 3.7% in 2006 as compared to 2005. The increase is attributable to an increase in employee costs of \$0.7 million, and an increase of \$0.3 million in other operating costs. Also, increased film and lab services expense of \$0.3 million is due to increased digital intermediate and YCM archiving revenue. Partially offsetting the increase were declines in equipment leasing expenses of \$0.4 million and taxes and licenses expenses of \$0.2 million, primarily related to a successful appeal of property taxes assessed in 2005.

*Selling, General and Administrative.*

*Quarter 2006 vs. 2005.* Selling, general and administrative expense decreased \$0.4 million, or 27.5% in 2006 as compared to 2005. The decrease is attributable to a reduction of accrued management incentive bonuses, and lower amortization expense from deferred stock units (DSU s) in 2005 with no expense in the current quarter. Partially offsetting the decline was an increase in salaries and benefits of \$0.1 million due to increased staffing, higher commissions and benefit expenses.

*Year-to-date 2006 vs. 2005.* Selling General and Administrative expenses decreased by \$0.3 million, or 5.9% in 2006 as compared to 2005. Reduced management incentive bonuses and lower DSU amortization expense accounted for \$0.2 million and \$0.3 million, respectively. Selling, general and administrative expenses are expected to remain constant for the remainder of the year.

*Net Income.*

*Quarter 2006 vs. 2005.* Net income increased \$0.4 million, or 71.7% in 2006 as compared to 2005 due to the increases in revenue and decreases in administrative expenses.

*Year-to-date 2006 vs. 2005.* Net income decreased \$2.1 million, or 51.7% in 2006 as compared to 2005 due to the decreases in revenue and increased cost of sales, partially offset by the decrease in administrative expenses.

**Other Companies**

	<b>Three Months</b>		<b>Nine Months Ended September</b>	
	<b>Ended September</b>		<b>30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	<b>(In thousands)</b>			
Other income (loss), net	\$ (235)	\$ 926	\$ 385	\$ 825
Equity loss	(1,910)	(621)	(2,180)	(6,026)
Net income (loss) before income taxes	\$ (2,145)	\$ 305	\$ (1,795)	\$ (5,201)

**Table of Contents***Other Income, Net*

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	<b>(In thousands)</b>			
Gain on sale of companies and funds, net	\$	\$ 1,031	\$ 1,181	\$ 1,313
Loss on trading securities	(235)	(11)	(767)	(229)
Impairment charges		(125)		(325)
Other		31	(29)	66
	\$ (235)	\$ 926	\$ 385	\$ 825

Gain on sale of companies and funds of \$1.2 million for the nine months ended September 30, 2006 primarily relates to the sale of a cost method investment whose carrying value was zero. Gain on sale of companies and funds of \$1.0 million and \$1.3 million for the three and nine months ended September 30, 2005 reflects a gain on distribution of stock from a private equity fund.

Loss on trading securities in 2006 primarily reflects the adjustment to fair value of our holdings in Traffic.com, which are classified as trading securities following their initial public offering in January 2006. Loss on trading securities in 2005 reflects the adjustment to fair value of our holdings in Arbinet-thexchange.

*Equity Income (Loss).* Equity income (loss) fluctuates with the number of partner companies and funds accounted for under the equity method, our voting ownership percentage in these partner companies and funds and the net results of operations of these partner companies. We recognize our share of losses to the extent we have cost basis in the equity investee or we have outstanding commitments or guarantees. Certain amounts recorded to reflect our share of the income or losses of our partner companies accounted for under the equity method are based on estimates and on unaudited results of operations of those companies and may require adjustments in the future when audits of these entities are made final. We report our share of the results of the equity method partner companies on a quarter lag.

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	<b>(In thousands)</b>			
Share of equity method companies results of operations	\$ (1,823)	\$ (868)	\$ (1,823)	\$ (2,205)
Share of private equity funds results of operations	(87)	247	(357)	(3,821)
	\$ (1,910)	\$ (621)	\$ (2,180)	\$ (6,026)

During the third quarter of 2006, we acquired interests in three new partner companies accounted for under the equity method, NuPathe, Portico Systems and Rubicor Medical. Included in equity loss for the three and nine months ended September 30, 2006, was expenses of \$1.8 million associated with acquired in-process research and development related to our acquisitions of Rubicor Medical and NuPathe. New holdings in revenue stage companies are expected to lead to larger equity losses until those companies reach scale and achieve profitability.

During 2005, we restructured our ownership interest in four private equity funds from a general partner to a special limited partner interest. As a result of the change, we have virtually no influence over these funds; therefore, effective April 1, 2005, we began accounting for these funds on the cost method. In December 2005, we sold most of our holdings in certain private equity funds. These private equity funds accounted for \$1.5 million of equity loss in the nine months ended September 30, 2005, respectively. We expect that equity loss related to our holdings in private

equity funds will be lower for the remainder of 2006 as compared to the comparable period of 2005 as a result of the sales of a majority of our holdings in the private equity funds in 2005, as well as the possible sale of our remaining holdings in private equity funds.

**Table of Contents****Corporate Operations**

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
	(In thousands)			
General and administrative costs, net	\$ (4,348)	\$ (4,363)	\$ (13,032)	\$ (12,430)
Stock-based compensation	(702)	(292)	(2,962)	(744)
Interest income	1,309	1,346	4,346	3,546
Interest expense	(1,150)	(1,235)	(3,554)	(3,682)
Impairment related party				(260)
Other	3,316	77	4,573	1,086
	\$ (1,575)	\$ (4,467)	\$ (10,629)	\$ (12,484)

*General and Administrative Costs, Net.* Our general and administrative expenses consist primarily of employee compensation, insurance, professional fees such as legal, accounting and consulting, and travel-related costs. General and administrative costs remained constant for the three months ended September 30, 2006 as compared to 2005 and increased \$0.6 million for the nine months ended September 30, 2006 as compared to 2005. The increase relates to a \$1.1 million increase in employee costs due to new hires to support Safeguard's long-term strategy, partially offset by a \$0.7 million decline in insurance expense.

We expect full year corporate general and administrative expenses to continue to be slightly higher in 2006 as compared to the prior year.

*Stock-Based Compensation.* Stock-based compensation consists primarily of expense related to stock option grants and grants of restricted stock and deferred stock units to our employees. The increases of \$0.4 million and \$2.2 million for the three and nine months ended September 30, 2006, respectively as compared to the prior year periods are primarily attributable to the adoption of SFAS No. 123(R) on January 1, 2006. Prior to the adoption of SFAS 123(R) the Company recognized expense related to restricted stock and deferred stock units but not stock options. Stock-based compensation expense in the three and nine months ended September 30, 2006 includes \$0.3 million and \$1.7 million related to market-based awards and \$0.3 million and \$1.1 million related to service-based awards, respectively. Stock based compensation expense related to corporate operations is included in Selling, general and administrative in the Consolidated Statements of Operations.

*Interest Income.* Interest income includes all interest earned on available cash balances as well as any interest income associated with any outstanding notes receivable to Safeguard. Interest income remained constant for the three months ended September 30, 2006. Interest income increased \$0.8 million for the nine months ended September 30, 2006 as compared to 2005. The net interest is attributable to higher interest rates partially offset by lower invested cash balances in 2006 as compared to 2005.

*Interest Expense.* Interest expense is primarily related to our 2.625% convertible senior debentures with a stated maturity of 2024. Interest expense did not change significantly for the three and nine months of 2006 as compared to 2005.

*Impairment Related Party.* In May 2001, we entered into a loan agreement with Mr. Musser, our former CEO. We recorded impairment charges of \$0.3 million for the nine months ended September 30, 2005 to write down the note to the estimated value of the collateral that we held at that time.

*Other.* Included in the three months ended September 30, 2006 is a net gain of \$3.2 million on the repurchase of \$16 million of face value of the 2024 Debentures. Included in the nine months ended September 30, 2006 is a net gain of \$4.3 million on the repurchase of \$21 million of face value of the 2024 Debentures. Included in this category in 2005 is \$0.9 million related to the sale of certain property.

**Income Tax (Expense) Benefit**

Our consolidated net income tax expense recorded for the three months ended September 30, 2006, was \$0.1 million and the income tax benefit recorded for the nine months ended September 30, 2006 was \$1.1 million. We recognized tax expense of \$0.1 million in the three months ended September 30, 2006 related to our share of net state tax expenses recorded by subsidiaries. We recognized a \$1.3 million tax benefit in the nine months ended September 30, 2006 related to uncertain tax positions for which the statute of limitations expired during the period in the applicable tax jurisdictions. We have recorded a valuation allowance to reduce our net deferred tax asset to an amount that is more likely than not to be realized in



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future years. Accordingly, the net operating loss benefit that would have been recognized in 2006 was offset by a valuation allowance.

**Liquidity and Capital Resources****Parent Company**

We fund our operations with cash on hand as well as proceeds from sales of and distributions from partner companies, private equity funds and trading securities. In prior periods we have also used sales of available-for-sale securities, sales of our equity and issuance of debt as sources of liquidity. Our ability to generate liquidity from sales of partner companies, sales of available-for-sale securities and from equity and debt issuances has been adversely affected from time to time by the decline in the U.S. capital markets and other factors.

As of September 30, 2006, at the parent company level, we had \$38.0 million of cash and cash equivalents and \$29.4 million of marketable securities for a total of \$67.4 million. In addition to the amounts above, we have \$9.5 million of marketable securities in escrow associated with our interest payments due on the 2024 Debentures through March 2009 and our consolidated subsidiaries had cash and cash equivalents of \$11.2 million.

Proceeds from sales of and distributions from companies and funds were \$1.5 million for the nine months ended September 30, 2006 and \$4.5 million and \$5.0 million, respectively, for the three and nine months ended September 30, 2005.

In May 2006, we renewed our revolving credit facility that provides for borrowings, issuances of letters of credit and guarantees of up to \$55 million. Borrowing availability under the facility is reduced by the amounts outstanding for Safeguard borrowings and letters of credit and amounts guaranteed under partner company facilities maintained with that same lender. This credit facility matures in May 2007 and bears interest at the prime rate (8.25% at September 30, 2006) for outstanding borrowings. The credit facility is subject to an unused commitment fee of 0.0125%, which is subject to reduction based on deposits maintained at the bank. The facility requires cash collateral equal to one times Safeguard borrowings and letters of credit and amounts borrowed by partner companies under the guaranteed portion of the partner company facilities maintained at the same bank. This facility provides us flexibility to implement our strategy and support our companies.

Availability under our revolving credit facility at September 30, 2006 is as follows (in thousands):

	<b>Revolving Credit</b>	<b>Letters of Credit</b>	<b>Total</b>
Size of facility	\$ 48,664	\$ 6,336	\$ 55,000
Subsidiary facilities at same bank (a)	(28,000)		(28,000)
Outstanding letter of credit (b)		(6,336)	(6,336)
Amount Available at September 30, 2006	\$ 20,664	\$	\$ 20,644

(a) Our ability to borrow under our credit facility is limited by the amounts outstanding for Safeguard borrowings and letters of credit and amounts guaranteed under partner

company facilities maintained at the same bank. Of the total facilities, \$26.6 million is outstanding under these facilities at September 30, 2006 and included as debt on the Consolidated Balance Sheet.

- (b) In connection with the sale of CompuCom, we provided to the landlord of CompuCom's Dallas headquarters lease, a letter of credit, which will expire on March 19, 2019, in an amount equal to \$6.3 million.

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Additionally, we have committed capital of approximately \$6.5 million, including a conditional commitment to a partner company for additional funding of \$3.0 million and commitments made in prior years to various private equity funds. These commitments will be funded over the next several years, including approximately \$5.0 million which is expected to be funded in the next twelve months. We do not intend to commit new investments in additional private equity funds and may seek to reduce our current ownership interests in, and our existing commitments to the funds in which we hold interests.

The transactions we enter into in pursuit of our strategy could increase or decrease our liquidity at any point in time. As we seek to acquire interests in information technology and life sciences companies or provide additional funding to existing partner companies, we may be required to expend our cash or incur debt, which will decrease our liquidity. Conversely, as we dispose of our interests in companies from time-to-time we may receive proceeds from such sales which could increase our liquidity. From time-to-time, we are engaged in discussions concerning acquisitions and dispositions which, if consummated, could impact our liquidity, perhaps significantly.

In May 2001, we entered into a loan agreement with Mr. Musser, our former Chairman and Chief Executive Officer. To date we have recognized net impairment charges against the loan of \$15.4 million, to the estimated value of the collateral that we held at each respective date. The carrying value of the loan at September 30, 2006 is \$0.4 million. Since 2001, we have received a total of \$15.2 million in cash paydowns on the loan. We continue to use reasonable commercial efforts to collect Mr. Musser's outstanding loan obligation. These efforts have included and may, in the future include, the sale of existing collateral, obtaining and selling additional collateral, litigation and a negotiated resolution.

We have received distributions as both a general partner and a limited partner from certain private equity funds. Under certain circumstances, we may be required to return a portion or all the distributions we received as a general partner to the fund for further distribution to the fund's limited partners (the clawback). Assuming for these purposes only that the funds were liquidated or dissolved on September 30, 2006 and, the only distributions from the funds were equal to the carrying value of the funds on the September 30, 2006 financial statements, the maximum clawback we would be required to return for our general partner interest is \$8 million. Management estimates its liability to be approximately \$6 million, which is reflected in Other Long-Term Liabilities on the Consolidated Balance Sheets.

Our previous ownership in the general partners of the funds which have potential clawback liabilities range from 19 -30%. The clawback liability is joint and several, such that we may be required to fund the clawback for other general partners should they default. The funds have taken several steps to reduce the potential liabilities should other general partners default, including withholding all general partner distributions and placing them in escrow and adding rights of set-off among certain funds. We believe our liability under the default of other general partners is remote.

We have outstanding \$129 million of 2.625% convertible senior debentures with a stated maturity of March 15, 2024. Interest on the 2024 Debentures is payable semi-annually. At the note holders' option, the notes are convertible into our common stock before the close of business on March 14, 2024 subject to certain conditions. The conversion rate of the notes at September 30, 2006 was \$7.2174 of principal amount per share. The closing price of our common stock on September 30, 2006 was \$1.96. The note holders may require repurchase of the 2024 Debentures on March 21, 2011, March 20, 2014 or March 20, 2019 at a repurchase price equal to 100% of their respective amount plus accrued and unpaid interest. The note holders may also require repurchase of the notes upon certain events, including sale of all or substantially all of our common stock or assets, liquidation, dissolution or a change in control. Subject to certain conditions, we may redeem all or some of the 2024 Debentures commencing March 20, 2009. During the first quarter of 2006, we repurchased \$5 million of face value of the 2024 Debentures for \$3.8 million. During the third quarter of 2006, we repurchased \$16 million of face value of the 2024 Debentures for \$12.6 million. We may use up to an additional \$3.6 million to repurchase additional 2024 Debentures.

In October 2006, we completed the sale of our interest in Mantas through a merger of Mantas into a wholly-owned US subsidiary of i-flex® Solutions ( i-flex ), for net cash proceeds of approximately \$113 million, including \$19 million to be held in escrow.

For reasons we have discussed, we believe our cash and cash equivalents at September 30, 2006 and other internal sources of cash flow are expected to be sufficient to fund our cash requirements for the next twelve months, including commitments to our existing companies and funds, our current operating plan to acquire interests in new

partner companies and our general corporate requirements.

**Table of Contents*****Consolidated Subsidiaries***

Most of our consolidated subsidiaries incurred losses in 2005 and the first nine months of 2006 and may need additional capital to fund their operations. From time-to-time, some or all of our consolidated subsidiaries may require additional debt or equity financing or credit support from us to fund planned expansion activities. If we decide not to provide sufficient capital resources to allow them to reach a positive cash flow position and they are unable to raise capital from outside resources, they may need to scale back their operations. If Alliance Consulting, Clariant and Pacific Title meet their business plans for 2006 and the related milestones established by us, we believe they will have sufficient cash or availability under established lines of credit to fund their operations for at least the next twelve months. We expect Laureate Pharma will require additional capital during the remainder of 2006 and 2007 to fund their business plan, including their capital expansion program. In June 2006, we provided \$6.0 million in funding to Acsis to support development of its new products, which when combined with their availability under the line of credit of \$4.5 million, which was renewed in August 2006, we believe will provide them with sufficient cash to fund their long-term growth strategies.

Consolidated subsidiaries have outstanding facilities that provide for aggregate borrowings of up to \$44.5 million. These facilities contain financial and non-financial covenants and expire at various points in the first quarter of 2007, with the exception of Acsis' debt facility, which was renewed in August 2006 and expires in 2008.

As of September 30, 2006, outstanding borrowings under these facilities were \$26.6 million.

In September 2006, Clariant entered into a \$5 million senior secured revolving credit agreement. Borrowing availability under the agreement is based on the level of their qualified accounts receivable, less certain reserves. The agreement has a two-year term and bears interest at variable rates based on the lower of LIBOR plus 3.25% or the prime rate plus 0.5%. As of September 30, 2006, Clariant borrowed \$1.0 million and had approximately \$2.0 million available under this facility.

Clariant also entered into a Master Purchase Agreement pursuant to which it sold Automated Cellular Imaging System (ACIS®) cost-per-test units that were previously leased to customers for a gross amount of \$2.3 million in the first quarter of 2006 and an additional \$0.4 million in the third quarter of 2006.

***Analysis of Parent Company Cash Flows***

Cash flow activity for the Parent Company was as follows:

	<b>Nine Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
	<b>(in thousands)</b>	
Net cash used in operating activities	\$ (12,326)	\$ (14,876)
Net cash used in investing activities	(43,169)	(19,330)
Net cash used in financing activities	(14,761)	
	\$ (70,256)	\$ (34,206)

***Cash Used In Operating Activities***

*2006 vs. 2005.* Net cash used in operating activities decreased \$2.6 million in 2006 as compared to 2005. The decline is primarily attributable to reduced net loss in 2006 as compared to 2005.

***Cash Used In Investing Activities***

Cash used in investing activities primarily reflects the acquisition of ownership interests in companies from third parties, partially offset by proceeds from the sales of non-strategic assets and private equity funds.

*2006 vs. 2005.* Net cash used in investing activities increased \$23.8 million in 2006 as compared to 2005. The increase is primarily attributable to a \$37.5 million increase in acquisitions of ownership interests in companies, funds and subsidiaries. Partially offsetting the overall change is a net decrease in restricted cash and marketable securities.

***Cash Used in Financing Activities***



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2006 vs. 2005. Net cash used in financing activities increased \$14.8 million in 2006 as compared to 2005. The increase is primarily attributable to the \$16.2 million of cash used to repurchase \$21 million of face value of the 2024 Debentures.

***Consolidated Working Capital***

Consolidated working capital decreased to \$66 million at September 30, 2006 compared to \$147 million at December 31, 2005. The decrease is primarily attributable to cash expended on new and follow-on holdings as well as to fund continuing operations.

***Analysis of Consolidated Company Cash Flows***

Cash flow activity was as follows:

	<b>Nine Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
	<b>(in thousands)</b>	
Net cash used in operating activities	\$ (25,839)	\$ (15,972)
Net cash used in investing activities	(46,453)	(26,904)
Net cash (used in) provided by financing activities	(3,687)	331
	\$ (75,979)	\$ (42,545)

***Cash Used In Operating Activities***

2006 vs. 2005. Net cash used in operating activities increased \$9.9 million in 2006 as compared to 2005. The increase is primarily attributable to working capital changes partially offset by improved results at partner companies.

***Cash Used In Investing Activities***

2006 vs. 2005. Net cash used in investing activities increased \$19.5 million in 2006 as compared to 2005. The increase is primarily related to a \$31.5 million increase in acquisitions of ownership interests in companies, funds and subsidiaries. Also contributing to the increase is \$6.7 million increase in capital expenditures, partially offset by a \$20.3 million net decrease in restricted cash and marketable securities.

***Cash (Used In) Provided by Financing Activities***

2006 vs. 2005. Cash used in financing activities increased \$4.0 million in 2006 as compared to 2005. The increase is primarily attributable to the \$16.2 million of cash used to repurchase \$21 million of face value of the 2024 Debentures. Partially offsetting the overall change is an increase of \$10.1 million of net borrowings on revolving credit facilities.

**Table of Contents****Contractual Cash Obligations and Other Commercial Commitments**

The following table summarizes our contractual obligations and other commercial commitments as of September 30, 2006 by period due or expiration of the commitment.

	<b>Total</b>	<b>Payments Due by Period</b>			<b>Due after 2010</b>
		<b>Rest of 2006</b>	<b>2007 and 2008</b>	<b>2009 and 2010</b>	
			<b>(in millions)</b>		
Contractual Cash Obligations					
Lines of credit (a)	\$ 24.4	\$ 1.0	\$ 23.4	\$	\$
Long-term debt (a)	5.5	0.5	3.7	1.3	
Capital leases	4.2	0.5	3.2	0.5	
Convertible senior debentures (b)	129.0				129.0
Operating leases	26.1	1.5	11.0	5.7	7.9
Funding commitments (c)	6.5	0.5	5.7	0.3	
Potential clawback liabilities (d)	6.0		1.1		4.9
Other long-term obligations (e)	3.5	0.2	1.6	1.6	0.1
<b>Total Contractual Cash Obligations</b>	<b>\$ 205.2</b>	<b>\$ 4.2</b>	<b>\$ 49.7</b>	<b>\$ 9.4</b>	<b>\$ 141.9</b>

	<b>Total</b>	<b>Amount of Commitment Expiration by Period</b>			<b>Due after 2010</b>
		<b>Rest of 2006</b>	<b>2007 and 2008</b>	<b>2009 and 2010</b>	
			<b>(in millions)</b>		
Other Commitments Letters of credit (f)	\$ 9.4	\$ 3.1	\$	\$	\$ 6.3

(a) We have various forms of debt including lines of credit and term loans. Of our total outstanding guarantees of \$36.5 million, \$26.6 million of outstanding debt associated with the guarantees is included on the Consolidated Balance Sheets at September 30, 2006. The



remaining  
\$9.9 million is  
not reflected on  
the  
Consolidated  
Balance Sheets  
or in the above  
table.

- (b) In February 2004, we completed the issuance of \$150 million of 2.625% convertible senior debentures with a stated maturity of March 15, 2024. During the first and third quarters of 2006, we repurchased \$5 million and \$16 million of the face value of the 2024 Debentures for \$3.8 million and \$12.6 million in cash respectively.
- (c) These amounts include funding commitments to private equity funds and private companies. The amounts have been included in the respective years based on estimated timing of capital calls provided to us by the funds management.

Also included is our \$3.0 million conditional commitment to provide a partner company with additional funding.

- (d) We have received distributions as both a general partner and a limited partner from certain private equity funds. Under certain circumstances, we may be required to return a portion or all the distributions we received as a general partner to the fund for a further distribution to the fund's limited partners (the clawback). Assuming the funds were liquidated or dissolved on September 30, 2006 and the only value provided by the funds was the carrying values represented on the September 30, 2006 financial statements, the maximum clawback we

would be required to return is \$8 million. Management estimates its liability to be approximately \$6 million. This amount is reflected in Other Long-Term Liabilities on the Consolidated Balance Sheets.

- (e) Reflects the amounts payable to our former Chairman and CEO under a consulting contract.
- (f) Letters of credit include a \$6.3 million letter of credit provided to the landlord of CompuCom's Dallas headquarters lease in connection with the sale of CompuCom; and \$3.1 million letters of credit issued by subsidiaries supporting their office leases.

We have retention employment agreements with certain executive officers that provide for severance payments to the executive officer in the event the officer is terminated without cause or the officer terminates his employment for good reason.

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We are involved in various claims and legal actions arising in the ordinary course of business. In the opinion of management, the ultimate disposition of these matters will not have a material adverse effect on the consolidated financial position or results of operations.

### ***Recent Accounting Pronouncements***

See Note 6 to the Consolidated Financial Statements.

### **Factors That May Affect Future Results**

Forward-looking statements in this report and those made from time to time by us through our senior management team are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Factors that could cause actual results to differ materially from results anticipated in forward-looking statements are described in our SEC filings. These factors include, but are not limited to, the following:

### **Risks Related to Our Business**

#### ***Our business depends upon the performance of our partner companies, which is uncertain.***

If our partner companies do not succeed, the value of our assets could be significantly reduced and require substantial impairments or write-offs, and our results of operations and the price of our common stock could decline. The risks relating to our partner companies include:

- § many of our partner companies have a history of operating losses or a limited operating history;
- § intensifying competition affecting the products and services our partner companies offer could adversely affect their businesses, financial condition, results of operations and prospects for growth;
- § inability to adapt to the rapidly changing marketplaces;
- § inability to manage growth;
- § the need for additional capital to fund their operations, which we may not be able to fund or which may not be available from third parties on acceptable terms, if at all;
- § inability to protect their proprietary rights and infringing on the proprietary rights of others;
- § certain of our partner companies could face legal liabilities from claims made against their operations, products or work;
- § the impact of economic downturns on their operations, results and growth prospects;
- § inability to attract and retain qualified personnel; and
- § government regulations and legal uncertainties may place financial burdens on the businesses of our partner companies.

These risks are discussed in greater detail under the caption **Risks Related to Our Partner Companies** below. ***The identity of our partner companies and the nature of our interests in them could vary widely from period to period.***

As part of our strategy, we continually assess the value to our shareholders of our interests in our partner companies. We also regularly evaluate alternative uses for our capital resources. As a result, depending on market conditions, growth prospects and other key factors, we may, at any time, change the partner companies on which we focus, sell some or all of our interests in any of our partner companies or otherwise change the nature of our interests in our partner companies. Therefore, the nature of our holdings in them could vary significantly from period to period.

Our consolidated financial results may also vary significantly based upon the partner companies that are included in our financial statements. For example:

§

For the three and nine months ended September 30, 2006, we consolidated the results of operations of Acsis, Alliance Consulting, Clariant, Laureate Pharma, and Pacific Title.

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§ In December 2005, we completed the purchase of Acsis and we have consolidated the results of operations of the acquired business from the date of the transaction.

§ In October 2006, we sold our ownership interest in Mantas (whose operations are now reflected in Discontinued Operations for all periods presented).

***Our partner companies currently provide us with little cash flow from their operations so we rely on cash on hand, liquidity events and our ability to generate cash from capital raising activities to finance our operations.***

We need capital to acquire new partner companies and to fund the capital needs of our existing partner companies. We also need cash to service and repay our outstanding debt, finance our corporate overhead and meet our funding commitments to private equity funds. As a result, we have substantial cash requirements. Our partner companies currently provide us with little cash flow from their operations. To the extent our partner companies generate any cash from operations, they generally retain the funds to develop their own businesses. As a result, we must rely on cash on hand, liquidity events and new capital raising activities to meet our cash needs. If we are unable to find ways of monetizing our holdings or to raise additional capital on attractive terms, we may face liquidity issues that will require us to curtail our new business efforts, constrain our ability to execute our business strategy and limit our ability to provide financial support to our existing partner companies.

***Fluctuations in the price of the common stock of our publicly traded partner companies may affect the price of our common stock.***

Fluctuations in the market price of the common stock of our publicly traded partner companies are likely to affect the price of our common stock. The market price of our publicly traded partner companies' common stock has been highly volatile and subject to fluctuations unrelated or disproportionate to operating performance. The aggregate market value of our interests in our publicly-traded partner companies at September 30, 2006 (Clariant (Nasdaq: CLRT), eMerge Interactive (Nasdaq: EMRG) and Traffic.com (Nasdaq: TRFC)) was approximately \$38 million.

***Intense competition from other acquirers of interests in companies could result in lower gains or possibly losses on our partner companies.***

We face intense competition from companies with similar business strategies and from other capital providers as we acquire and develop interests in our partner companies. Some of our competitors have more experience identifying and acquiring companies and have greater financial and management resources, brand name recognition or industry contacts than we have. Although most of our acquisitions will be made at a stage when our partner companies are not publicly traded, we may pay higher prices for those equity interests because of higher trading prices for securities of similar public companies and competition from other acquirers and capital providers, which could result in lower gains or possibly losses.

***We may be unable to obtain maximum value for our holdings or sell our holdings on a timely basis.***

We hold significant positions in our partner companies. Consequently, if we were to divest all or part of our holdings in a partner company, we may have to sell our interests at a relative discount to a price which may be received by a seller of a smaller portion. For partner companies with publicly traded stock, we may be unable to sell our holdings at then-quoted market prices. The trading volume and public float in the common stock of our publicly-traded partner companies are small relative to our holdings. As a result, any significant divestiture by us of our holdings in these partner companies would likely have a material adverse effect on the market price of their common stock and on our proceeds from such a divestiture. Additionally, we may not be able to take our partner companies public as a means of monetizing our position or creating shareholder value.

Registration and other requirements under applicable securities laws may adversely affect our ability to dispose of our holdings on a timely basis.

***Our success is dependent on our executive management.***

Our success is dependent on our executive management team's ability to execute our strategy. A loss of one or more of the members of our executive management team without adequate replacement could have a material adverse effect on us.

**Table of Contents*****Our business strategy may not be successful if valuations in the market sectors in which our partner companies participate decline.***

Our strategy involves creating value for our shareholders by helping our partner companies build value and, if appropriate, accessing the public and private capital markets. Therefore, our success is dependent on the value of our partner companies as determined by the public and private capital markets. Many factors, including reduced market interest, may cause the market value of our publicly traded partner companies to decline. If valuations in the market sectors in which our partner companies participate decline, their access to the public and private capital markets on terms acceptable to them may be limited.

***Our partner companies could make business decisions that are not in our best interests or with which we do not agree, which could impair the value of our holdings.***

Although we may seek a controlling equity interest and participation in the management of our partner companies, we may not be able to control the significant business decisions of our partner companies. We may have shared control or no control over some of our partner companies. In addition, although we currently own a controlling interest in some of our partner companies, we may not maintain this controlling interest. Acquisitions of interests in partner companies in which we share or have no control, and the dilution of our interests in or loss of control of partner companies, will involve additional risks that could cause the performance of our interests and our operating results to suffer, including:

- § the management of a partner company having economic or business interests or objectives that are different than ours; and
- § partner companies not taking our advice with respect to the financial or operating difficulties they may encounter.

Our inability to adequately control our partner companies also could prevent us from assisting them, financially or otherwise, or could prevent us from liquidating our interests in them at a time or at a price that is favorable to us. Additionally, our partner companies may not act in ways that are consistent with our business strategy. These factors could hamper our ability to maximize returns on our interests and cause us to recognize losses on our interests in these partner companies.

***We may have to buy, sell or retain assets when we would otherwise not wish to do so in order to avoid registration under the Investment Company Act.***

The Investment Company Act of 1940 regulates companies which are engaged primarily in the business of investing, reinvesting, owning, holding or trading in securities. Under the Investment Company Act, a company may be deemed to be an investment company if it owns investment securities with a value exceeding 40% of the value of its total assets (excluding government securities and cash items) on an unconsolidated basis, unless an exemption or safe harbor applies. We refer to this test as the 40% Test. Securities issued by companies other than majority-owned subsidiaries, depending upon the size of our ownership position and factors, may be considered investment securities for purpose of the Investment Company Act. We are a company that partners with revenue-stage information technology and life sciences companies to build value; we are not engaged primarily in the business of investing, reinvesting or trading in securities. We are in compliance with the 40% Test. Consequently, we do not believe that we are an investment company under the Investment Company Act.

We monitor our compliance with the 40% Test and seek to conduct our business activities to comply with this test. It is not feasible for us to be regulated as an investment company because the Investment Company Act rules are inconsistent with our strategy of actively helping our partner companies in their efforts to build value. In order to continue to comply with the 40% Test, we may need to take various actions which we would otherwise not pursue. For example, we may need to retain a majority interest in a partner company that we no longer consider strategic, we may not be able to acquire an interest in a company unless we are able to obtain majority ownership interest in the company, or we may be limited in the manner or timing in which we sell our interests in a partner company. Our ownership levels may also be affected if our partner companies are acquired by third parties or if our partner companies issue stock which dilutes our majority ownership. The actions we may need to take to address these issues while maintaining compliance with the 40% Test could adversely affect our ability to create and realize value at our

partner companies.



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**Risks Related to Our Partner Companies**

***Many of our partner companies have a history of operating losses or limited operating history and may never be profitable.***

Many of our partner companies have a history of operating losses or limited operating history, have significant historical losses and may never be profitable. Many have incurred substantial costs to develop and market their products, have incurred net losses and cannot fund their cash needs from operations. We expect that the operating expenses of certain of our partner companies will increase substantially in the foreseeable future as they continue to develop products and services, increase sales and marketing efforts and expand operations.

***Our partner companies face intense competition, which could adversely affect their business, financial condition, results of operations and prospects for growth.***

There is intense competition in the information technology and life sciences marketplaces, and we expect competition to intensify in the future. Our business, financial condition, results of operations and prospects for growth will be materially adversely affected if our partner companies are not able to compete successfully. Many of the present and potential competitors may have greater financial, technical, marketing and other resources than those of our partner companies. This may place our partner companies at a disadvantage in responding to the offerings of their competitors, technological changes or changes in client requirements. Also, our partner companies may be at a competitive disadvantage because many of their competitors have greater name recognition, more extensive client bases and a broader range of product offerings. In addition, our partner companies may compete against one another.

***Our partner companies may fail if they do not adapt to the rapidly changing information technology and life sciences marketplaces.***

If our partner companies fail to adapt to rapid changes in technology and customer and supplier demands, they may not become or remain profitable. There is no assurance that the products and services of our partner companies will achieve or maintain market penetration or commercial success, or that the businesses of our partner companies will be successful.

The information technology and life sciences marketplaces are characterized by:

- § rapidly changing technology;
- § evolving industry standards;
- § frequent new products and services;
- § shifting distribution channels;
- § evolving government regulation;
- § frequently changing intellectual property landscapes; and
- § changing customer demands.

Our future success will depend on our partner companies' ability to adapt to this rapidly evolving marketplace. They may not be able to adequately or economically adapt their products and services, develop new products and services or establish and maintain effective distribution channels for their products and services. If our partner companies are unable to offer competitive products and services or maintain effective distribution channels, they will sell fewer products and services and forego potential revenue, possibly causing them to lose money. In addition, we and our partner companies may not be able to respond to the rapid technology changes in an economically efficient manner, and our partner companies may become or remain unprofitable.

***Many of our partner companies may grow rapidly and may be unable to manage their growth.***

We expect some of our partner companies to grow rapidly. Rapid growth often places considerable operational, managerial and financial strain on a business. To successfully manage rapid growth, our partner companies must, among other things:

§ rapidly improve, upgrade and expand their business infrastructures;

§ scale-up production operations;

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§ develop appropriate financial reporting controls;

§ attract and maintain qualified personnel; and

§ maintain appropriate levels of liquidity.

If our partner companies are unable to manage their growth successfully, their ability to respond effectively to competition and to achieve or maintain profitability will be adversely affected.

***Our partner companies may need to raise additional capital to fund their operations, which we may not be able to fund or which may not be available from third parties on acceptable terms, if at all.***

Our partner companies may need to raise additional funds in the future and we cannot be certain that they will be able to obtain additional financing on favorable terms, if at all. Because our resources and our ability to raise capital are limited, we may not be able to provide our partner companies with sufficient capital resources to enable them to reach a cash flow positive position. If our partner companies need to, but are not able to raise capital from other outside sources, then they may need to cease or scale back operations.

***Some of our partner companies may be unable to protect their proprietary rights and may infringe on the proprietary rights of others.***

Our partner companies assert various forms of intellectual property protection. Intellectual property may constitute an important part of our partner companies' assets and competitive strengths. Federal law, most typically, copyright, patent, trademark and trade secret, generally protects intellectual property rights. Although we expect that our partner companies will take reasonable efforts to protect the rights to their intellectual property, the complexity of international trade secret, copyright, trademark and patent law, coupled with the limited resources of these partner companies and the demands of quick delivery of products and services to market, create a risk that their efforts will prove inadequate to prevent misappropriation of our partner companies' technology, or third parties may develop similar technology independently.

Some of our partner companies also license intellectual property from third parties and it is possible that they could become subject to infringement actions based upon their use of the intellectual property licensed from those third parties. Our partner companies generally obtain representations as to the origin and ownership of such licensed intellectual property; however, this may not adequately protect them. Any claims against our partner companies' proprietary rights, with or without merit, could subject our partner companies to costly litigation and the diversion of their technical and management personnel from other business concerns. If our partner companies incur costly litigation and their personnel are not effectively deployed, the expenses and losses incurred by our partner companies will increase and their profits, if any, will decrease.

Third parties may assert infringement or other intellectual property claims against our partner companies based on their patents or other intellectual property claims. Even though we believe our partner companies' products do not infringe any third party's patents, they may have to pay substantial damages, possibly including treble damages, if it is ultimately determined that they do. They may have to obtain a license to sell their products if it is determined that their products infringe another person's intellectual property. Our partner companies might be prohibited from selling their products before they obtain a license, which, if available at all, may require them to pay substantial royalties. Even if infringement claims against our partner companies are without merit, defending these types of lawsuits take significant time, may be expensive and may divert management attention from other business concerns.

***Certain of our partner companies could face legal liabilities from claims made against their operations, products or work.***

The manufacture and sale of certain of our partner companies' products entails an inherent risk of product liability. Certain of our partner companies maintain product liability insurance. Although none of our partner companies to date have experienced any material losses, there can be no assurance that they will be able to maintain or acquire adequate product liability insurance in the future and any product liability claim could have a material adverse effect on our partner companies' revenues and income. In addition, many of the engagements of our partner companies involve projects that are critical to the operation of their clients' businesses. If our partner companies fail to meet their contractual obligations, they could be subject to legal liability, which could adversely affect their business, operating

results and financial condition. The provisions our partner companies typically include in their contracts, which are designed to limit their exposure to legal claims relating to their services and the applications they develop, may not protect our partner companies or may not be enforceable. Also as consultants, some of our partner companies depend on their relationships with their clients and their reputation for high quality

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services and integrity to retain and attract clients. As a result, claims made against our partner companies' work may damage their reputation, which in turn, could impact their ability to compete for new work and negatively impact their revenues and profitability.

***Our partner companies are subject to the impact of economic downturns.***

The results of operations of our partner companies are affected by the level of business activity of their clients, which in turn is affected by the levels of economic activity in the industries and markets that they serve. In addition, the businesses of certain of our information technology companies may lag behind economic cycles in an industry. Any significant downturn in the economic environment, which could include labor disputes in these industries, could result in reduced demand for the products and services offered by our partner companies which could negatively impact their revenues and profitability. In addition, an economic downturn could cause increased pricing pressure which also could have a material adverse impact on the revenues and profitability of our partner companies.

***Our partner companies' success depends on their ability to attract and retain qualified personnel.***

Our partner companies are dependent upon their ability to attract and retain senior management and key personnel, including trained technical and marketing personnel. Our partner companies will also need to continue to hire additional personnel as they expand. Some of our partner companies have employees represented by labor unions. Although these partner companies have not been the subject of a work stoppage, any future work stoppage could have a material adverse effect on their respective operations. A shortage in the availability of the requisite qualified personnel or work stoppage would limit the ability of our partner companies to grow, to increase sales of their existing products and services and to launch new products and services.

***Government regulations and legal uncertainties may place financial burdens on the businesses of our partner companies.***

Failure to comply with applicable requirements of the FDA or comparable regulation in foreign countries can result in fines, recall or seizure of products, total or partial suspension of production, withdrawal of existing product approvals or clearances, refusal to approve or clear new applications or notices and criminal prosecution. Manufacturers of pharmaceuticals and medical diagnostic devices and operators of laboratory facilities are subject to strict federal and state regulation regarding validation and the quality of manufacturing and laboratory facilities. Failure to comply with these quality regulation systems requirements could result in civil or criminal penalties or enforcement proceedings, including the recall of a product or a cease distribution order. The enactment of any additional laws or regulations that affect healthcare insurance policy and reimbursement (including Medicare reimbursement) could negatively affect our partner companies. If Medicare or private payors change the rates at which our partner companies or their customers are reimbursed by insurance providers for their products, such changes could adversely impact our partner companies.

***Some of our partner companies are subject to significant environmental, health and safety regulation.***

Some of our partner companies are subject to licensing and regulation under federal, state and local laws and regulations relating to the protection of the environment and human health and safety, including laws and regulations relating to the handling, transportation and disposal of medical specimens, infectious and hazardous waste and radioactive materials as well as to the safety and health of manufacturing and laboratory employees. In addition, the federal Occupational Safety and Health Administration has established extensive requirements relating to workplace safety.

***Item 3. Quantitative and Qualitative Disclosures About Market Risk***

We are exposed to equity price risks on the marketable portion of our securities. These securities include equity positions in partner companies, many of which have experienced significant volatility in their stock prices. Historically, we have not attempted to reduce or eliminate our market exposure on securities. Based on closing market prices at September 30, 2006, the fair market value of our holdings in public securities was approximately \$38 million. A 20% decrease in equity prices would result in an approximate \$7.5 million decrease in the fair value of our publicly traded securities. At September 30, 2006, the value of the collateral securing the Musser loan included \$0.6 million of publicly traded securities. A 20% decrease in the fair value of these securities would result in a decline in value of approximately \$0.1 million.

In February 2004, we completed the issuance of \$150 million of fixed rate notes with a stated maturity of March 2024. In 2006, we repurchased a total of \$21 million face value of the 2024 Debentures. Interest payments of approximately

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\$1.7 million are due March and September of each year. The holders of the 2024 Debentures may require repurchase of the notes on March 21, 2011, March 20, 2014 or March 20, 2019 at a repurchase price equal to 100% of their respective amount plus accrued and unpaid interest. On October 8, 2004, we utilized approximately \$16.7 million of the proceeds from the CompuCom sale to escrow interest payments due through March 15, 2009.

	Remainder of			After	Fair Market Value
Liabilities	2006	2007	2008	2008	at 9/30/06
Convertible Senior Notes due by year (in millions)				\$ 129.0	\$ 98.5
Fixed Interest Rate	2.625%	2.625%	2.625%	2.625%	2.625%
Interest Expense (in millions)	\$ 3.7	\$ 3.4	\$ 3.4	\$ 54.9	N/A

**Item 4. Controls and Procedures****(a) Evaluation of Disclosure Controls and Procedures**

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures as of the end of the period covered by this report are functioning effectively to provide reasonable assurance that the information required to be disclosed by us in reports filed under the Securities Exchange Act of 1934 is (i) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and (ii) accumulated and communicated to our management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding disclosure. A controls system cannot provide absolute assurance, however, that the objectives of the controls system are met, and no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected.

No change in our internal control over financial reporting occurred during our most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting. Our business strategy involves the acquisition of new businesses on an on-going basis, most of which are young, growing companies. Typically, these companies have not historically had all of the controls and procedures they would need to comply with the requirements of the Securities Exchange Act of 1934 and the rules promulgated thereunder. These companies also frequently develop new products and services. Following an acquisition, or the launch of a new product or service, we work with the company's management to implement all necessary controls and procedures.

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**PART II  
OTHER INFORMATION**

**Item 1A. Risk Factors**

Except as set forth below, there have been no material changes in our risk factors from the information set forth above under the heading "Factors That May Affect Future Results" and in our Annual Report on Form 10-K for the year ended December 31, 2005.

***The identity of our partner companies and the nature of our interests in them could vary widely from period to period.***

As part of our strategy, we continually assess the value to our shareholders of our interests in our partner companies. We also regularly evaluate alternative uses for our capital resources. As a result, depending on market conditions, growth prospects and other key factors, we may, at any time, change the partner companies on which we focus, sell some or all of our interests in any of our partner companies or otherwise change the nature of our interests in our partner companies. Therefore, the nature of our holdings in them could vary significantly from period to period.

Our consolidated financial results may also vary significantly based upon the partner companies that are included in our financial statements. For example:

§ For the three and nine months ended September 30, 2006, we consolidated the results of operations of Acsis, Alliance Consulting, Clariant, Laureate Pharma, and Pacific Title.

§ In December 2005, we completed the purchase of Acsis and we have consolidated the results of operations of the acquired business from the date of the transaction.

§ In October 2006, we sold our ownership interest in Mantas (whose operations are now reflected in Discontinued Operations for all periods presented).

***Fluctuations in the price of the common stock of our publicly traded partner companies may affect the price of our common stock.***

Fluctuations in the market price of the common stock of our publicly traded partner companies are likely to affect the price of our common stock. The market price of our publicly traded partner companies' common stock has been highly volatile and subject to fluctuations unrelated or disproportionate to operating performance. The aggregate market value of our interests in our publicly-traded partner companies at September 30, 2006 (Clariant (Nasdaq: CLRT), eMerge Interactive (Nasdaq: EMRG) and Traffic.com (Nasdaq: TRFC)) was approximately \$38 million.

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2005, which could materially affect our business, financial condition or future results. The risks described in this report and in our Annual Report on Form 10-K are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.



**Table of Contents****Item 6. Exhibits**

## (a) Exhibits.

The following is a list of exhibits required by Item 601 of Regulation S-K filed as part of this Report. For exhibits that previously have been filed, the Registrant incorporates those exhibits herein by reference. The exhibit table below includes the Form Type and Filing Date of the previous filing and the location of the exhibit in the previous filing which is being incorporated by reference herein. Documents which are incorporated by reference to filings by parties other than the Registrant are identified in a footnote to this table.

<b>Exhibit Number</b>	<b>Description</b>	<b>Incorporated Filing Reference</b>	
		<b>Form Type &amp; Filing Date</b>	<b>Original Exhibit Number</b>
10.1	Agreement and Plan of Merger, dated as of August 14, 2006, among Safeguard Scientifics, Inc., Safeguard Delaware, Inc., Safeguard 2001 Capital, L.P., SRA Ventures, LLC, SRA International, Inc., Systems Research and Application Corporation, Mantas, Inc., i-flex solutions, ltd., i-flex America, inc. and Mandarin Acquisition Corp.	Form 8-K 8/15/06	99.2
10.2	Fifth Amendment dated as of August 2, 2006 to Loan and Security Agreement dated as of December 1, 2004, by and between Comerica Bank and Laureate Pharma, Inc.		
31.1	Certification of Peter J. Boni pursuant to Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934		
31.2	Certification of Christopher J. Davis pursuant to Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934		
32.1	Certification of Peter J. Boni pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.		
32.2	Certification of Christopher J. Davis pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.		

Filed herewith

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**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

SAFEGUARD SCIENTIFICS, INC.

Date: November 2, 2006

PETER J. BONI

Peter J. Boni  
*President and Chief Executive Officer*

Date: November 2, 2006

CHRISTOPHER J. DAVIS

Christopher J. Davis  
*Executive Vice President and Chief  
Administrative and Financial Officer*

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