LUNA INNOVATIONS INC
Form 10-Q
August 07, 2008
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2008

OR

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

For the transition period from ______ to

COMMISSION FILE NUMBER 000-52008

LUNA INNOVATIONS INCORPORATED

(Exact name of registrant as specified in its charter)

Delaware	**54-1560050**
(State or Other Jurisdiction of	*(I.R.S. Employer*
Incorporation or Organization)	*Identification Number)*

One Riverside Circle, Suite 400

Roanoke, VA 24016

(Address of Principal Executive Offices)

(540) 769-8400

(Registrant s Telephone Number, Including Area Code)

(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

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

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

Large accelerated filer	¨	Accelerated filer	¨
Non-accelerated filer	¨ (Do not check if a smaller reporting company)	Smaller reporting company	x

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date: As of July 25, 2008, there were 11,000,268 shares of the registrant s common stock outstanding.

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LUNA INNOVATIONS INCORPORATED

QUARTERLY REPORT ON FORM 10-Q

FOR THE QUARTER ENDED JUNE 30, 2008

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PART I. FINANCIAL INFORMATION

ITEM 1. *FINANCIAL STATEMENTS*

Luna Innovations Incorporated

Consolidated Balance Sheets

	June 30, 2008 (unaudited)	December 31, 2007
Assets		
Current assets		
Cash and cash equivalents	$ 15,252,639	$ 12,046,945
Accounts receivable, net	8,496,352	9,716,610
Refundable income taxes	390,661	396,062
Inventory	2,280,710	1,675,239
Other current assets	498,091	333,105
Total current assets	26,918,453	24,167,961
Property and equipment, net	5,771,855	5,859,515
Intangible assets, net	1,883,646	1,911,132
Deferred tax asset	600,000	600,000
Other assets	135,690	10,270
Total assets	**$ 35,309,644**	**$ 32,548,878**
Liabilities and stockholders equity		
Current liabilities		
Current portion of capital lease obligation	$ 12,039	$ 23,885
Current portion of long-term debt payable	714,286	
Accounts payable	3,083,539	3,024,973
Accrued liabilities	5,041,519	5,331,798
Deferred credits	1,374,705	1,672,400
Total current liabilities	10,226,088	10,053,056
Long-term capital lease obligation		4,671
Long-term debt obligation	9,285,714	5,000,000
Deferred credits	354,418	354,418
Total liabilities	19,866,220	15,412,145
Stockholders equity:		
Common stock, par value $0.001, 100,000,000 shares authorized, 10,999,177 and 10,704,456 shares issued and outstanding	10,999	10,704
Additional paid-in capital	36,452,904	34,496,063
Accumulated deficit	(21,020,479)	(17,370,034)
Total stockholders equity	15,443,424	17,136,733
Total liabilities and stockholders equity	**$ 35,309,644**	**$ 32,548,878**

The accompanying notes are an integral part of these consolidated financial statements.

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Luna Innovations Incorporated

Consolidated Statements of Operations

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
	(unaudited)		(unaudited)	
Revenues:				
Technology development revenues	$ 6,947,276	$ 5,852,109	$ 13,549,023	$ 11,138,706
Product and license revenues	2,931,027	2,003,171	5,249,203	3,786,747
Total revenues	9,878,303	7,855,280	18,798,226	14,925,453
Cost of revenues:				
Technology development costs	4,382,001	4,048,424	8,575,648	7,898,039
Product and license costs	1,427,553	911,768	2,769,232	1,712,189
Total cost of revenues	5,809,554	4,960,192	11,344,880	9,610,228
Gross Profit	4,068,749	2,895,088	7,453,346,	5,315,225
Operating expense	5,833,670	5,185,965	11,094,102	10,400,984
Operating loss	(1,764,921)	(2,290,877)	(3,640,756)	(5,085,759)
Other income				
Other income				519
Interest income (expense), net	(33,576)	113,107	(9,689)	225,375
Total other income	(33,576)	113,107	(9,689)	225,894
Loss before income taxes	(1,798,497)	(2,177,770)	(3,650,445)	(4,859,865)
Provision for income taxes				
Net loss	$ (1,798,497)	$ (2,177,770)	$ (3,650,445)	$ (4,859,865)
Net loss per share:				
Basic and Diluted	$ (0.16)	$ (0.21)	$ (0.34)	$ (0.48)
Weighted average shares:				
Basic and Diluted	10,935,370	10,136,446	10,858,367	10,053,371

The accompanying notes are an integral part of these consolidated financial statements.

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Luna Innovations Incorporated

Consolidated Statements of Cash Flows

	Six months ended June 30, 2008	2007
	(unaudited)	
Cash flows used in operating activities		
Net loss	$ (3,650,445)	$ (4,859,865)
Adjustments to reconcile net loss to net cash used in operating activities		
Depreciation and amortization	958,953	892,838
Share-based compensation	1,422,902	1,096,555
Change in assets and liabilities:		
Accounts receivable, net	1,220,259	(766,573)
Refundable income taxes	5,401	
Inventory, net	(605,471)	(491,325)
Other assets	(160,362)	56,721
Accounts payable and accrued expenses	138,964	76,216
Deferred credits	(297,695)	1,443,585
Net cash used in operating activities	(967,494)	(2,551,848)
Cash flows used in investing activities		
Acquisition of property and equipment	(552,355)	(1,171,747)
Intangible property costs	(291,452)	(196,790)
Net cash used in investing activities	(843,807)	(1,368,537)
Cash flows from (used in) financing activities		
Payments on capital lease obligations	(16,517)	(42,504)
Proceeds from (payment of) debt obligations, net	4,928,150	(214,955)
Proceeds from the exercise of options and warrants	105,362	244,206
Net cash from (used in) financing activities	5,016,995	(13,253)
Net change in cash	3,205,694	(3,933,638)
Cash and cash equivalents beginning of period	12,046,945	17,866,753
Cash and cash equivalents end of period	$ 15,252,639	$ 13,933,115
Supplemental disclosure of cash flow information		
Cash paid during the period for:		
Interest	$ 33,781	$ 8,680
Cash received during the period for:		
Income taxes	$ 5,401	$
Supplemental schedule of non-cash activities:		
Warrants issued in connection with debt modification	$ 58,194	$

The accompanying notes are an integral part of these consolidated financial statements.

Luna Innovations Incorporated

Notes to Consolidated Financial Statements

1. Basis of Presentation and Significant Accounting Policies
Nature of Operations

Luna Innovations Incorporated (Luna Innovations) was incorporated in the Commonwealth of Virginia in 1990 and subsequently reincorporated in the State of Delaware in April 2003. We research, develop and commercialize innovative technologies in two primary areas of focus: instrumentation and test & measurement products and healthcare products. We have a disciplined and integrated business model that is designed to accelerate the process of bringing new and innovative products to market. We identify technologies that can fulfill unmet market needs and then take these technologies from the applied research stage through commercialization.

Unaudited Interim Financial Information

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (US GAAP) and with the instructions to Form 10-Q and Article 10 of Regulation S-X of the Securities Exchange Act of 1934. Accordingly, they do not include all of the information and footnotes required by US GAAP for audited financial statements. The unaudited consolidated financial statements have been prepared on the same basis as the annual financial statements and in the opinion of management reflect all adjustments, consisting of only normal recurring accruals, considered necessary to present fairly our financial position at June 30, 2008 and results of operations and cash flows for the three and six months ended June 30, 2008 and 2007. The results of operations for the three and six months ended June 30, 2008 are not necessarily indicative of the results that may be expected for the year ending December 31, 2008.

The consolidated financial statements, including the Company s significant accounting policies, should be read in conjunction with the audited Consolidated Financial Statements and the notes thereto included in the Company s Form 10-K as filed with the Securities and Exchange Commission on March 19, 2008. As used herein, the terms Luna , Company , we , our and us mean Luna Innovations Incorporated and its consolidated subsidiaries.

Consolidation Policy

Our consolidated financial statements are prepared in accordance with US GAAP and include the accounts of the Company, its wholly owned subsidiaries and other entities in which the Company has a controlling financial interest. We eliminate from our financial results all significant intercompany transactions. We do not have any investments in entities we believe are variable interest entities for which the Company is the primary beneficiary.

Use of Estimates

The preparation of our consolidated financial statements in accordance with US GAAP requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and the disclosure of contingent assets and liabilities in our consolidated financial statements and accompanying notes. Although these estimates and assumptions are based on our knowledge of current events and actions we may undertake in the future, actual results may differ.

Net Loss Per Share

We compute net loss per share in accordance with Statement of Financial Accounting Standards (SFAS) No. 128, *Earnings Per Share*. Basic per share data is computed by dividing loss available to common shareholders by the weighted average number of shares outstanding during the period. Diluted per share data is computed by dividing loss available to common shareholders by the weighted average shares outstanding during the period increased to include, if dilutive, the number of additional common share equivalents that would have been outstanding if potential common shares had been issued using the treasury stock method. Diluted per share data would also include the potential common share equivalents relating to convertible securities by application of the if-converted method.

The effect of 3,355,336 and 3,239,961 common stock equivalents are ignored for the three months ended June 30, 2008 and 2007, respectively, as they are antidilutive to earnings per share. The effect of 3,312,639 and 3,203,316 common stock equivalents for the six months ended June 30, 2008 and 2007, respectively, are similarly ignored. In addition, the conversion of $5.0 million in convertible promissory notes would have been antidilutive for such periods.

Share Based Compensation

We have a stock-based compensation plan, which is described further in Note 9 to the Financial Statements in our Form 10-K as filed with the Securities and Exchange Commission on March 19, 2008. We apply SFAS No. 123R, *Share-Based Payment* (SFAS No. 123R) in determining the compensation expense recognized under our stock-based compensation plan. Compensation expense is computed using the Black-Scholes option pricing model. We amortize share-based compensation for such awards on a straight-line basis over the related service period of the awards taking into account the effects of the employees expected exercise and post-vesting employment termination behavior. We account for equity instruments issued to non-employees in accordance with the provisions of SFAS No. 123R and Emerging Issues Task Force (EITF) Issue No. 96-18.

The fair value of each option granted is estimated as of the grant date using the Black-Scholes option pricing model with the following assumptions:

	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
Risk-free interest rate	3.78 to 3.87 %	4.63%
Expected life of option (years)	7.5	7.5
Expected stock price volatility	63%	63%
Expected dividend yield		

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The risk-free interest rate is based on US Treasury interest rates, the terms of which are consistent with the expected life of the stock options. Expected volatility for the six months ended June 30, 2008 and 2007, respectively, is based upon the average volatility of comparable public companies due to the lack of historical market price data for our stock on such date. The expected life and estimated post employment termination behavior is based upon historical experience of homogeneous groups within our company.

A summary of the status of our 2003 Stock Plan and 2006 Equity Incentive Plan is presented below for the periods indicated:

	Options Outstanding				Options Exercisable		
	Number of Shares	Price per Share Range	Weighted Average	Aggregate Intrinsic Value (1)	Number of Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value (1)
Balance, December 31, 2007	4,747,815	$ 0.35 -$8.20	$ 1.95	$ 31,477,522	2,543,218	$ 0.96	$ 19,366,620
Granted	502,750	$ 6.55- $6.74	$ 6.55				
Exercised	(132,133)	$ 0.35 -$1.77	$ 0.56				
Canceled	(83,241)	$ 0.35 -$6.00	$ 2.10				
Balance, March 31, 2008	5,035,191	$ 0.35 -$8.20	$ 2.51	$ 27,941,472	2,557,187	$ 1.02	$ 17,818,506
Granted	175,400	$ 8.04 -$8.04	$ 8.04				
Exercised	(96,666)	$ 0.35 -$6.00	$ 0.45				
Canceled	(20,456)	$ 0.35 -$6.00	$ 3.94				
Balance, June 30, 2008	5,093,469	$ 0.35 -$8.20	$ 2.67	12,284,795	2,673,023	$ 1.12	9,474,494

(1) The intrinsic value of an option represents the amount by which the market value of the stock exceeds the exercise price of in-the-money options only. The aggregate intrinsic value is based on the price of $4.62, which was the closing price of the Company s Common Stock on the NASDAQ Global Market on June 30, 2008.

At June 30, 2008, our 5,093,469 outstanding stock options had a weighted average remaining contractual term of 7.7 years, and of these 2,673,023 are exercisable and have a weighted average remaining contractual term of 6.8 years.

The aggregate intrinsic value of grants exercised during the three months ending June 30, 2008 and 2007 was $0.5 million and $0.7 million, respectively. The total aggregate intrinsic value represents the total amount by which the fair market value of stock exceeded the exercise price for options exercised.

For the three months ended June 30, 2008 and 2007, we recognized $663,260 and $558,343 in share-based payment expense and for the six months ended June 30, 2008 and 2007, we recognized $1,422,902 and $1,096,555 in share-based payment expense. We expect to recognize approximately $7.3 million over the remaining requisite service period of approximately five years for options outstanding as of June 30, 2008.

Income Taxes

A deferred tax asset of $600,000 was recorded at June 30, 2008 and December 31, 2007, based upon management s assessment that more likely than not the benefit will be realized in future periods.

Inventory

Inventory consists of finished goods and parts valued at the lower of cost (determined on the first-in, first-out basis) or market. We provide reserves for estimated obsolescence or unmarketable inventory equal to the difference between the cost of the inventory and the estimated market value based upon assumptions about future demand and market conditions. Inventory reserves at June 30, 2008 and December 31, 2007 were $44,206 and $41,108, respectively.

Subordinated Notes, Warrants, Amortization of Debt Discount, and Fair Value Determination

In May 2008 we amended the terms of our notes with principal amounts totaling $5.0 million with Carilion Clinic to extend their due date to December 31, 2012 and to subordinate them to our new credit facility with Silicon Valley Bank. We issued warrants to purchase 10,000 shares of Luna Common Stock at a price of $7.98 per share in connection with the amended terms. The warrants expire on December 31, 2017. We valued the warrants using the Black-Scholes option pricing model, recorded a deferred prepaid financing charge, and recorded the warrant issuance as equity.

Recent Accounting Pronouncements

In June 2008, the Financial Accounting Standards Board (FASB) ratified Emerging Issues Task Force (EITF) 07-5, *Determining Whether an Instrument (or Embedded Feature) is Indexed to an Entity s Own Stock* (EITF 07-5). EITF 07-5 addresses the determination of whether a financial instrument (or an embedded feature) is indexed to an entity s own stock. EITF 07-5 is effective for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. The adoption of EITF 07-5 is not expected to have a material impact on our consolidated financial statements.

In May 2008, the FASB issued SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles*. SFAS 162 identifies a hierarchy for selecting accounting principles to be used in preparing financial statements that are presented in conformity with U.S. GAAP for nongovernmental entities. SFAS 162 is effective 60 days following the SEC s approval of the Public Company Accounting Oversight Board amendments to AU Section 411, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles*.

In December 2007, the FASB issued SFAS No. 141(R), *Business Combinations*. SFAS No. 141(R) requires entities to recognize assets acquired, liabilities assumed, and any noncontrolling interest in an acquiree, measured at the fair market value at the acquisition date. SFAS No. 141(R) is applied prospectively to business combinations for which the acquisition date is on or after the beginning of the first fiscal year beginning after December 15, 2008. Since we have no current acquisition plans, we do not believe that the adoption of SFAS No. 141(R) will have a material impact on our financial statements.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements*. SFAS No. 160 establishes accounting and reporting standards for the noncontrolling interest in a subsidiary and the deconsolidation of a subsidiary. It requires consolidated net income to be reported at amounts that include the amounts attributable to both the parent and a noncontrolling interest. SFAS No. 160 is effective for fiscal years ending on or after December 15, 2008. We do not believe that the adoption of SFAS No. 160 will have a material impact on our financial statements.

In June 2007, the FASB ratified EITF 07-3, *Accounting for Nonrefundable Advance Payments for Goods or Services Received for Use in Future Research and Development Activities* (EITF 07-3). EITF 07-3 requires that nonrefundable advance payments for goods or services that will be used or rendered for future research and development activities be deferred and capitalized and recognized as an expense as the goods are delivered or the related services are performed. EITF 07-3 is effective, on a prospective basis, for fiscal years beginning after December 15, 2007. The adoption of EITF 07-3 did not have a material impact on our consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115*. SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value. Unrealized gains and losses on items for which the fair value option has been elected will be recognized in earnings at each subsequent reporting date. The adoption of SFAS No. 159 did not have a material impact on our financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. SFAS No. 157 clarifies the principle that fair value should be based on the assumptions market participants would use when pricing an asset or liability and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. SFAS No. 157 is effective for the fiscal year beginning January 1, 2007. Our adoption of SFAS No. 157 did not have a material impact on our consolidated financial statements.

2. Line of Credit & Debt Facility

On May 21, 2008, the Company canceled its previous line of credit agreement with First National Bank, and entered into a $10 million maximum debt facility with Silicon Valley Bank. Included in this facility is a four year term debt of $5 million and a revolving line of credit facility available for the remaining $5 million. The facility has a total debt capacity of $10 million. At June 30, 2008, there was an outstanding balance of $5 million under the term loan, and no outstanding balance under the revolving facility. As part of the facility, Silicon Valley Bank issued a $479,667 letter of credit on our behalf to the Industrial Development Authority of Montgomery County, Virginia, as required under an office lease. The Silicon Valley Bank letter of credit was issued as a replacement for the previous letter of credit issued on our behalf by First National Bank in the amount of $599,583.

3. Capital Structure

For the six months ended June 30, 2008, our capital structure changed as follows:

	Common Stock		Additional Paid-in
	Shares	$	Capital
Balances, December 31, 2007	10,704,456	$ 10,704	$ 34,496,063
Exercise of stock options	135,133	136	75,533
Shares issued in lieu of cash bonus	62,922	63	309,153
Adjustment of estimated IPO-related expenses			61,427
Share-based compensation			759,642
Balances, March 31, 2008	10,902,511	$ 10,903	$ 35,701,818
Exercise of stock options	96,666	96	29,632
Warrants issued in exchange for debt modification, representing deferred loan costs			58,194
Share-based compensation			663,260
Balances, June 30, 2008	10,999,177	10,999	36,452,904

4. Operating Segments

Our operations are divided into two operating segments Technology Development and Product and Licensing.

The Technology Development segment provides applied research to customers in our areas of focus. Our engineers and scientists collaborate with our network of government, academic and industry experts to identify technologies and ideas with promising market potential. We then compete to win fee-for-service contracts from government agencies and industrial customers who seek innovative solutions to practical problems that require new technology. The Technology Development segment derives its revenue primarily from services.

The Product and Licensing segment develops and sells products or licenses technologies based on commercially viable concepts developed, in whole or in part, by the Technology Development segment. The Product and Licensing segment derives its revenue from product sales, product development fees and technology licenses.

The Chief Executive Officer and his direct reports collectively represent our chief operating decision makers, and they evaluate segment performance based primarily on revenue and operating income or loss. The accounting policies of our segments are the same as those described in the summary of significant accounting policies. See Note 1 to our Financial Statements, Organization and Summary of Significant Accounting Policies, presented in Form 10-K as filed with the Securities and Exchange Commission on March 19, 2008.

The table below presents revenues and operating loss for reportable segments:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	**2007**	**2008**	**2007**
Technology Development Revenue	$ 6,947,276	$ 5,852,109	$ 13,549,023	$ 11,138,706
Product and License Revenue	2,931,027	2,003,171	5,249,203	3,786,747
Total Revenue	$ 9,878,303	$ 7,855,280	$ 18,798,226	$ 14,925,453
Technology Development Operating Loss	$ (301,455)	$ (830,162)	$ (591,104)	$ (1,940,975)
Product and License Operating Loss	(1,463,466)	(1,460,715)	(3,049,652)	(3,144,784)
Total Operating Loss	$ (1,764,921)	$ (2,290,877)	$ (3,640,756)	$ (5,085,759)

Additional segment information is as follows:

	June 30, 2008	December 31, 2007
Total segment assets:		
Technology Development	$ 30,434,233	$ 27,806,034
Product and License	4,875,411	4,742,844
Total	$ 35,309,644	$ 32,548,878

There are no material inter-segment revenues for any period presented.

The United States Government accounted for approximately 74% and 81% of total consolidated revenues for the three months ended June 30, 2008 and 2007, and 71% and 82% of revenues for the six months ending June 30, 2008 and June 30, 2007, respectively.

International revenues (customers outside of the United States) accounted for 6.3% and 0.0% of total revenues for the three months ended June 30, 2008 and 2007, and 5.1% and 0.6% of total revenues for the six months ended June 30, 2008 and 2007.

5. Contingencies and Guarantees

On September 10, 2007, we filed a complaint against our former auditing and accounting firm in connection with the firm s auditing and opining on the accuracy of several years of our consolidated financial statements in preparation for our registration with the Securities and Exchange Commission and our Initial Public Offering, or IPO, of securities. On July 23, 2008, the parties settled the litigation at a mediation without any admission of liability, or adjudication of fact or law. The material terms of settlement include payment to Luna of $1.0 million in exchange for mutual releases of all claims and counterclaims and dismissal with prejudice of all claims and counterclaims.

We are from time to time involved in certain legal proceedings in the ordinary course of conducting our business. While the ultimate liability pursuant to these actions cannot currently be determined, if we are unsuccessful in our litigation with Hansen Medical, Inc., our business may be materially harmed.

We have an outstanding letter of credit at June 30, 2008, of $479,667 to the Industrial Development Authority of Montgomery County, Virginia, to support a lease of office space. This letter of credit expires in 2011.

In June 2007, our Luna Technologies Division executed a non-cancelable, non-reschedulable $1.3 million purchase order for multiple shipments of tunable lasers to be delivered over an 18-month period beginning in September 2007. As of June 30, 2008, approximately $0.3 million of this commitment remained.

In March 2004, we received a grant of $0.9 million from the City of Danville, Virginia under a Grant Agreement to support the expansion of economic and commercial growth within the City. Under the Grant Agreement, we agreed to locate a nanomaterials manufacturing and research facility and maintain its operations in Danville until March 25, 2009. As of September 25, 2006, we had not fully met the capital expenditures and job milestones under this agreement, and, as a result, we may be obligated to repay the City of Danville a portion of the $0.9 million in funds based on a formula of the pro rata shortfall of such expenditures and jobs falling below such required levels. Because of the failure to meet these milestones and the continuing obligation to maintain our investment and employees at this location through March 25, 2009, we currently have classified the full amount of the grant as a liability on our balance sheet in anticipation of potentially returning the funds.

We have entered into indemnification agreements with our officers and directors, to the extent permitted by law, pursuant to which we have agreed to reimburse the officers and directors for legal expenses in the event of litigation and regulatory matters. The terms of these indemnification agreements provide for no limitation to the maximum potential future payments. We have a directors and officers insurance policy that may, in certain instances, mitigate the potential liability and payments.

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

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and the related notes to those statements included elsewhere in this report. In addition to historical financial information, the following discussion and analysis contains forward-looking statements that involve risks, uncertainties and assumptions. Our actual results and timing of selected events may differ materially from those anticipated in these forward-looking statements as a result of many factors, including those discussed under Risk factors and elsewhere in this report.

Overview

We research, develop and commercialize innovative technologies in two primary areas of focus: instrumentation and test & measurement, sensing, and instrumentation products and healthcare products. We have a disciplined and integrated business model that is designed to accelerate the process of bringing new and innovative products to market. We identify technologies that can fulfill large and unmet market needs and then take these technologies from the applied research stage through commercialization. Although revenues from product sales currently represent less than half of our total revenues, we continue to invest in product development and commercialization, which we anticipate will lead to increased product sales growth. In the future, we expect that revenues from product sales will represent a larger proportion of our total revenues. In addition, we anticipate that these revenues will reflect a broader and more diversified mix of products as we develop and commercialize new products.

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We have developed a disciplined and integrated process to accelerate the development and commercialization of innovative technologies. Our business model employs a market-driven approach and provides the infrastructure, resources and know-how throughout the process of developing and commercializing new products. To manage a diverse set of products effectively across a range of development stages, we are organized into two main groups: our Technology Development Division and our Products Division. These groups work together through all product development stages, including:

- Searching for emerging technologies based on market needs;
- Conducting applied research;
- Developing and commercializing innovative products; and
- Applying proven technologies and products to new market opportunities.

Our revenues were $9.9 million and $7.9 million during the three months ended June 30, 2008 and 2007, respectively, and we had net losses of $1.8 million and $2.3 million for the same periods, respectively. We generate revenues through technology development services provided under contractual arrangements, product sales and license fees. Historically, our technology development revenues have accounted for a large and growing proportion of our total revenues, and we expect that they will continue to represent a significant portion of our total revenues for the foreseeable future. Our technology development revenues grew from $5.9 million to $6.9 million for the three month periods ended June 30, 2007 and June 30, 2008, respectively. We regularly have a backlog of contracts for which work has been scheduled, but for which a specified portion of work has not yet been completed. We define backlog as the dollar amount of obligations payable to us under negotiated contracts upon completion of a specified portion of work that has not yet been completed, exclusive of revenues previously recognized for work already performed under these contracts, if any. The approximate value of our backlog was $28.8 million as of June 30, 2008.

Revenues from product sales currently represent a smaller proportion of our total revenues, and, historically, we have derived most of these revenues from the sales of our sensing systems and products that make use of light-transmitting optical fibers, or fiber optics. License revenues associated with our proprietary technologies have been significant in prior years. In the near term, we expect revenues from product sales to increase primarily in areas associated with our fiber optic instrumentation and test and measurement platforms. We also expect to increase our investments in product development and commercialization, which we anticipate will lead to increased product sales growth. In the future, we expect that revenues from product sales will represent a larger proportion of our total revenues and that as we develop and commercialize new products, these revenues will reflect a broader and more diversified mix of products.

We incurred consolidated net losses of approximately $3.7 million and $4.9 million for the six month periods ended June 30, 2008 and 2007, respectively. We expect to continue to incur significant additional expenses as we expand our business, including increased expenses for research and development, sales and marketing, manufacturing, and finance and accounting personnel. We may also grow our business in part through acquisitions of additional companies and complementary technologies which could cause us to incur transaction expenses, amortization or write-offs of intangible assets and other acquisition-related expenses. As a result, we expect that we will continue to incur losses in 2008 and that these losses could be substantial.

Our operating expenses include stock-based compensation charges. We recorded stock-based compensation charges of $1.4 million for the six months ended June 30, 2008. We also expect to record an aggregate stock-based compensation charge for stock options granted through June 30, 2008 of $7.3 million, to be recognized in future periods through 2013.

Description of Our Revenues, Costs and Expenses

Revenues

We generate revenues from technology development (contract research), contract product development, and product sales. We derive technology development revenues from providing research and development services to third parties, including government entities, academic institutions and corporations, and from achieving milestones established by some of these contracts and in collaboration agreements. In general, we complete contracted research over periods ranging from six months to three years, and recognize these revenues over the life of the contract as costs are incurred or upon the achievement of certain milestones built into the contracts. Our product revenues reflect amounts that we receive from sales of our products or development of products for third parties and currently represent approximately 28% of our total revenues.

Cost of Revenues

Cost of revenues associated with technology development revenues consists of costs associated with performing the related research activities, including direct labor, amounts paid to subcontractors and overhead allocated to technology development activities.

Cost of revenues associated with product sales and license revenues consists of license fees for use of certain technologies; product manufacturing costs including all direct material and direct labor costs; amounts paid to our contract manufacturers; manufacturing, shipping and handling; provisions for product warranty; and inventory obsolescence, as well as overhead allocated to these activities.

Operating Expense

Operating expense consists of selling, general and administrative expenses, as well as expenses related to research and development, depreciation of fixed assets and amortization of intangible assets. These expenses also include: compensation for employees in executive and operational functions including certain non-cash charges related to expenses from option grants; facilities costs; professional fees; salaries, commissions, travel expense and related benefits of personnel engaged in sales, product management and marketing activities; costs of marketing programs and promotional materials; salaries, bonuses and related benefits of personnel engaged in our own research and development beyond the scope and activities of our Technology Development Division; product development activities not provided under contracts with third parties; and overhead costs related to these activities.

Interest Income/Expense

On May 21, 2008, we had canceled our senior secured revolving credit facility with First National Bank, and entered into a new $10 million debt facility with

Silicon Valley Bank. At June 30, 2008, a $5 million term loan was outstanding under this new facility. Interest expense includes interest accrued on the outstanding aggregate principal of the senior convertible promissory notes issued to Carilion Clinic on December 30, 2005, and interest payable on the Silicon Valley Bank debt term loan.

Interest income includes amounts earned on our cash deposits with financial institutions. During 2007 and the first two quarters of 2008, we invested the proceeds of the Carilion financing transactions and the net proceeds from our initial public offering in a money market account, and we draw from that account as needed to fund ongoing operations. We have currently invested the proceeds from the Silicon Valley Bank debt facility in a money market account.

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States (US GAAP). The preparation of these financial statements requires us to make estimates, assumptions and judgments that affect the amounts reported in our financial statements and the accompanying notes. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or judgments. Our significant accounting policies are described in the Management Discussion and Analysis section and the notes to our audited consolidated financial statements previously included in our Annual Report on Form 10-K for the period ended December 31, 2007, as filed with the Securities and Exchange Commission on March 19, 2008.

Results of Operations

Three Months Ended June 30, 2008 Compared to Three Months Ended June 30, 2007

Revenues

Total revenues increased 26% to $9.9 million for the three months ended June 30, 2008, from $7.9 million for the three months ended June 30, 2007. Approximately 54% of the growth in revenues from the corresponding period in 2007 was due to increased revenues from our Technology Development Division, and approximately 46% of the increase was due to increased product sales and product development revenues. We generated approximately $2.9 million in product sales in the second quarter of 2008 as compared with $2.0 million in the second quarter of 2007, an increase of approximately 45%, due primarily to increases in product development revenue and increased sales of fiber optic test and measurement equipment by our Luna Technologies division.

Growth in our technology development revenues contributed to our overall growth in revenues for the second quarter of 2008 as compared with the second quarter of 2007. Technology development revenues increased 19% to $6.9 million for the three months ended June 30, 2008 from $5.9 million for the corresponding 2007 period. This increase was primarily a result of a continued strong success in obtaining research contracts, an increase in the size of certain awards, and the addition of direct contract personnel.

Cost of Revenues

Cost of revenues increased 17% to $5.8 million for the three months ended June 30, 2008 from $5.0 million for the corresponding 2007 period. The main component of this overall increase was increased costs of labor and materials related to increases in product development and fiber optic product sales. Technology development cost of sales increases accounted for approximately $0.3 million, or 39%, and product sales cost increases accounted for approximately $0.5 million, or 61%, respectively, of the overall increase in costs of revenues.

Technology development costs increased 8% to $4.4 million for the three months ended June 30, 2008 from $4.0 million in the same period in 2007. This increase was comprised primarily of additional direct labor and the associated overhead related to our growing portfolio of funded research contracts.

Our overall gross margin improved as compared with the second quarter of 2007. Our overall gross margin during the three months ended June 30, 2008 was 41% compared to 37% during the same period in 2007. During the three months ended June 30, 2008, technology development activity returned a gross margin of approximately 37% compared to 31% in the same period of 2007. The gross margin increase was partially attributable to increasing participation in non-SBIR-funded contracts, which typically provide for higher billing rates than SBIR-funded contracts. Product sales activity returned a gross margin of 51% for the three months ended June 30, 2008, compared to 55% for the same period in 2007. This decrease is primarily due to increased costs on certain product development contracts for the quarter ended June 30, 2008, relative to the quarter ended June 30, 2007.

Operating Expense

Operating expense increased 12% to $5.8 million for the three months ended June 30, 2008 from $5.2 million for the corresponding quarter in 2007. The increase in the second quarter of 2008 as compared to the same period in 2007 was due primarily to increased legal expenses associated with on-going legal matters.

Other Income (Expense)

Net interest income decreased from approximately $113,000 for the three months ended June 30, 2007, to a net interest expense of $34,000 for the three months ended June 30, 2008. This decrease was attributable to a reduction in invested cash and lower interest rates, combined with an increase in interest payments due to the addition of a $5.0 million term loan from the Silicon Valley Bank debt facility.

With the exception of approximately $30,000 in interest expense incurred on the $5.0 million Silicon Valley Bank term loan, nearly all of the interest expense incurred during the three months ended June 30, 2008, was incurred on our convertible promissory notes issued to Carilion Clinic on December 30, 2005. These notes have an aggregate outstanding principal of approximately $5.0 million and accrue simple interest at a rate of 6.0% per year. During the three month period ended June 30, 2008, interest expense on the Carilion notes was approximately $75,000. In addition, interest income for the three months ended June 30, 2008, totaled $78,000.

Six Months Ended June 30, 2008 Compared to Six Months Ended June 30, 2007

Revenues

Total revenues increased 26% to $18.8 million for the six months ended June 30, 2008, from $14.9 million for the six months ended June 30, 2007. Approximately 62% of the growth in revenues from the corresponding period in 2007 was due to increased revenues from our Technology Development Division, and approximately 38% of the increase was due to increased product sales and product development revenues. Product sales and product development revenues increased 39%, to $5.2 million for the six months ended June 30, 2008, as compared to $3.8 million for the six months ended June 30, 2007. This increase was primarily a result of increased sensing product sales as well as an increase in product development activity.

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Growth in our technology development revenues also contributed to our overall growth in revenues for the first and second quarter of 2008 as compared with the same period in 2007. Technology development revenues increased 22% to $13.5 million for the six months ended June 30, 2008 from $11.1 million for the corresponding 2007 period. This increase was primarily a result of a continued strong success in obtaining research contracts, an increase in the size of certain awards, and the addition of direct contract personnel.

During the period ending March 31, 2008, we identified certain product development contracts, which we account for using the percentage of completion method, where our estimated cost to complete increased significantly from our prior estimates. The resulting decrease in the overall percentage of completion resulted in an adjustment to reduce revenues previously recognized. Pursuant to the provisions of SOP 81-1, *Accounting for the Performance of Construction-Type and Certain Production-Type Contracts*, we reduced our product and licensing revenues for the period ending March 31, 2008 on a cumulative basis in the amount of $0.3 million.

Cost of Revenues

Cost of revenues increased 18% to $11.3 million for the six months ended June 30, 2008 from $9.6 million for the corresponding 2007 period. The main component of this overall increase was increased costs of labor and materials related to increases in product sales and product development revenue. New technology development cost of sales increases accounted for approximately $0.7 million, or 39%, and product sales cost increases accounted for approximately $1.1 million, or 61%, respectively, of the overall increase in costs of revenues.

Technology development costs increased 9% to $8.6 million for the six months ended June 30, 2008 from $7.9 million in the same period in 2007. This increase was comprised primarily of additional direct labor and the associated overhead related performing under our research contracts.

Our overall gross margin improved as compared with the first six months of 2007. Our overall gross margin during the six months ended June 30, 2008 was 40% compared to 36% during the same period in 2007. During the six months ended June 30, 2008, technology development activity returned a gross margin of approximately 37% compared to 29% in the same period of 2007. Product and license activity returned a gross margin of 47% for the six months ended June 30, 2008, compared to 55% for the same period in 2007. The decrease in gross margin associated with our product and license segment was primarily attributable to the cumulative adjustment in product and license revenue described above.

Operating Expense

Operating expense increased 7% to $11.1 million for the six months ended June 30, 2008 from $10.4 million for the corresponding period in 2007. The primary driver of the increase in the first six months of 2008 as compared to the same period in 2007 was increased legal expenses associated with on-going legal matters.

Other Income (Expense)

Net interest income decreased from $0.2 million in net interest income for the six months ended June 30, 2007 to approximately $9,000 in net interest expense for the six months ended June 30, 2008. This decrease was attributable to a reduction in invested cash and lower interest rates, and an increase in interest payments due to the addition of a $5.0 million term loan from the Silicon Valley Bank debt facility.

With the exception of approximately $30,000 in interest expense incurred on the $5.0 million Silicon Valley Bank term loan, nearly all of the interest expense during the six months ended June 30, 2008, was incurred on our convertible promissory notes issued to Carilion Clinic on December 30, 2005. These notes have an aggregate outstanding principal of approximately $5.0 million and accrue simple interest at a rate of 6.0% per year. During the six month period ended June 30, 2008, interest expense on such notes was approximately $0.2 million. Interest income for the six months ended June 30, 2008 totaled $0.2 million.

Liquidity and Capital Resources

Until May 2008, we had a $3.0 million senior secured revolving credit facility with First National Bank that was collateralized by a security interest in substantially all of our assets. The interest rate on borrowings under our secured revolving credit facility was equal to the prime rate, limited to no less than 6.0% and no greater than 10.0% per annum, with interest payable monthly. This agreement also provided a $1.0 million sub-limit for letters of credit.

Beginning in May 2008, we canceled our $3.0 million senior secured revolving credit facility with First National Bank, and entered into a $10.0 million credit facility with Silicon Valley Bank, which includes a four year term debt of $5.0 million and a remaining facility of up to $5.0 million available under a four-year revolving line of credit, based on the balance of our term loan at June 30, 2008. As we repay the term debt principal, the revolving facility available increases, so that at any time, the term debt plus the revolving debt may be equal to up to $10 million. For the remainder of 2008, we will pay only the interest portion of the loan. The interest rate on borrowings under the secured revolving facility is a floating per annum rate of one half of one percentage point above the prime interest rate. Interest on the term loan is a floating per annum rate of one percentage point above the prime interest rate. Beginning in January, 2009, we will begin to pay interest and principal monthly, so that principal is paid back ratably over 42 months. This agreement also provided a $1.0 million sub-limit for letters of credit. The facility is secured by certain company assets and is subject to customary covenants, including covenants requiring us to meet EBITDA milestones and liquidity ratios. In connection with the credit facility with Silicon Valley Bank, Carilion Clinic agreed to extend the maturity date of the existing $5.0 million aggregate principal amount in notes payable to Carilion Clinic to December 31, 2012, from the original date of December 30, 2009, and to subordinate the Carilion Clinic debt to that of Silicon Valley Bank.

Discussion of Cash Flows

Recent Activity

We used approximately $1.0 million and $2.6 million of net cash from operations during the six months ended June 30, 2008 and 2007, respectively. The decrease in cash used in operations resulted from a decrease of $1.2 million in net loss, as well as other working capital account changes. The change in working capital accounts for the six months ended June 30, 2008 includes a $0.6 million decrease in deferred revenue arising from the timing difference between receipt of cash and the recognition of revenue for certain long-term development contracts to be accounted for using the percentage of completion method, and a $1.2 million increase due to improved accounts receivable collections.

Cash used in investing activities for the six months ended June 30, 2008 related primarily to the purchase of property and equipment and legal fees associated with securing patent rights to certain technology. Our overall cash used in investing activities was $0.8 million in the six months ended June 30, 2008, compared to $1.4 million in the corresponding June 30, 2007 period. This decrease reflects higher capital spending incurred in 2007 in support of our facilities expansions.

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Cash flows generated by financing activities for the six months ended June 30, 2008 was $5.0 million representing an increase compared to cash flow used in financing activities for the six months ended June 30, 2007. This increase was primarily attributable to the $5.0 million draw from our credit facility with Silicon Valley Bank, with interest-only payable for the remainder of 2008, and principal payments (with interest) paid ratably over 42 months.

At June 30, 2008, total cash and cash equivalents were approximately $15.3 million. We believe that our current cash on hand and cash available under our line of credit agreement will be sufficient to fund operations for the next 12 months.

Summary of Contractual Obligations

We lease our facilities in Blacksburg, Charlottesville, Danville, Hampton, and Roanoke, Virginia under operating leases that expire on various dates through January 2014 or under a month-to-month arrangement. Upon expiration of the leases, we may exercise certain renewal options as specified in the leases.

We also lease certain computer equipment and software under capital lease agreements that expire through January 2010. The assets subject to these obligations are included in property and equipment on our consolidated balance sheet.

Our Luna Technologies Division has an agreement with a supplier to purchase tunable lasers and estimates its non-cancellable obligation to be approximately $0.3 million through 2008.

In March 2004, we received a grant of $0.9 million from the City of Danville, Virginia under a Grant Agreement to support the expansion of economic and commercial growth within the City. Under the Grant Agreement, we agreed to locate a nanomaterials manufacturing and research facility and maintain its operations in Danville until March 25, 2009. As of September 25, 2006, we had not fully met the capital expenditures and job milestones under this agreement, and, as a result, we may be obligated to repay the City of Danville a portion of the $0.9 million in funds based on a formula of the pro rata shortfall of such expenditures and jobs falling below such required levels. Because of the failure to meet these milestones and the continuing obligation to maintain our investment and employees at this location through March 25, 2009, we currently have classified the full amount of the grant as a liability on our balance sheet in anticipation of potentially returning the funds.

Off-Balance Sheet Arrangements

We have no material off-balance sheet arrangements as defined in Regulation S-K 303(a)(4)(ii).

ITEM 3. ***QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK***

Market risk represents the risk of loss that may impact our financial position due to adverse changes in financial market prices and rates. We do not hold or issue financial instruments for trading purposes or have any derivative financial instruments. Our exposure to market risk is limited to interest rate fluctuations due to changes in the general level of United States interest rates, particularly because as of June 30, 2008, our cash reserves were maintained in money market investment accounts and were not exposed to material market risks.

Interest Rate Risk

We do not use derivative financial instruments as a hedge against interest rate fluctuations, and, as a result, interest income earned on our cash and cash equivalents and short-term investments is subject to changes in interest rates. However, we believe that the impact of these fluctuations does not have a material effect on our financial position due to the immediate available liquidity or short-term nature of these financial instruments. As of June 30, 2008 we had $15.3 million deposited in cash and cash equivalents bearing a weighted-average interest rate of 2.45%.

We are exposed to interest rate fluctuations, as a result of our Silicon Valley Bank term loan and revolving debt facility both having interest rates subject to market fluctuations. We do not currently use derivative instruments to alter the interest rate characteristics of any of our debt. The interest rate on our revolving debt facility with Silicon Valley Bank is at prime plus one half of one percentage point. The interest rate on our term loan with Silicon Valley Bank is at prime plus one percentage point. At June 30, 2008 this resulted in a 5.5% and 6.0% rate for the revolving debt facility and the term loan, respectively. A 10% fluctuation in interest rates would not have a material impact on our financial statements.

Foreign Currency Exchange Rate Risk

Our product sales to foreign customers are denominated in U.S. dollars and we do not receive payments in foreign currency. As such, we are not directly exposed to currency gains or losses resulting from fluctuations in foreign exchange rates.

ITEM 4. ***CONTROLS AND PROCEDURES***

Evaluation of Disclosure Controls and Procedures

Our Chief Executive Officer and our Chief Financial Officer, after evaluating the effectiveness of our disclosure controls and procedures (as defined in Securities Exchange Act of 1934 (the Exchange Act) Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this report (the Evaluation Date), have concluded that as of the Evaluation Date, our disclosure controls and procedures were effective to ensure that information required to be disclosed in the reports that we file or submit under the Exchange Act (i) is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission and (ii) is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

Changes in Internal Control Over Financial Reporting

There were no changes in our internal control over financial reporting that occurred during our last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. Internal control over financial reporting means a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

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PART II. OTHER INFORMATION

ITEM 1. *LEGAL PROCEEDINGS*

From time to time, we may become involved in litigation in relation to claims arising out of our operations in the normal course of business. While management currently believes the amount of ultimate liability, if any, with respect to these actions will not materially affect our financial position, results of operations, or liquidity, the ultimate outcome of any litigation is uncertain. Were an unfavorable outcome to occur, or if protracted litigation were to ensue, the impact could be material to us.

On September 10, 2007, we filed a complaint against our former auditing and accounting firm in connection with the firm s auditing and opining on the accuracy of several years of our consolidated financial statements in preparation for our registration with the Securities and Exchange Commission and our Initial Public Offering, or IPO, of securities. The complaint alleges that the firm breached its contract with us and committed negligence when it failed to ensure that it was independent to audit our financial statements as required by the SEC regulations and by failing to inform us that it was not independent to audit our financial statements. These actions, resulting in our termination of this firm and our hiring of a new independent firm, caused a delay in our IPO, thereby resulted in a lower amount of capital raised, and the incurrence of significant additional expenses. The defendant answered our complaint and counterclaimed alleging breach of contract, breach of implied contract and unjust enrichment. The firm s counterclaim alleges that we failed to pay it certain fees for services performed. We answered the counterclaim. On July 23, 2008, the parties settled the litigation at a mediation without any admission of liability, or adjudication of fact or law. The material terms of settlement include payment to Luna of $1.0 million and a mutual general release, as well as joint dismissal with prejudice of all claims and counterclaims.

On June 22, 2007, Hansen Medical Inc., a company for which we had conducted certain research and performed certain services, filed a complaint against us in the Superior Court of the State of California, County of Santa Clara. On March 18, 2008, the Complaint was amended and alleges misappropriation of trade secrets, aiding and abetting breach of fiduciary duty, unfair competition, breach of contract, conversion, intentional interference with contract, breach of implied covenant of good faith and fair dealing, declaratory judgment, and fraud. In addition to money damages in an unspecified amount, the plaintiff company seeks, among other things, equitable relief, including an injunction against our using the allegedly misappropriated Hansen trade secrets in connection with our work with Intuitive Surgical, Inc. (Intuitive) or otherwise. We have answered the complaint and intend to defend ourselves vigorously in this matter. We also filed a counterclaim against the plaintiff company and an amended counterclaim on March 18, 2008. Our counterclaim asserts claims for declaratory judgment, misappropriation of trade secrets, breach of contract, unfair competition under the California Business and Professional Code, breach of implied covenant of good faith and fair dealing, declaratory judgment, and unjust enrichment. We seek money damages from the counterclaim defendant in an amount to be proven at trial and equitable, including declaratory, relief. In April 2008, the parties participated in a non-binding arbitration. In May 2008, the arbitrator rendered a non-binding award. In June 2008, Luna rejected the non-binding award, and the case is proceeding to trial on the merits. While we believe the plaintiff s claims are without merit, we cannot predict the ultimate outcome of this litigation.

On May 30, 2006, we were served with a complaint filed by a former employee in the Circuit Court for the City of Roanoke, Virginia, alleging that we breached a consulting agreement with the former employee, and that we are indebted to the former employee in an unspecified amount of at least $100,000. We have answered the complaint and intend to defend ourselves vigorously in this matter. While we believe the former employee s claims are without merit, counsel for such former employee has indicated that he may file additional claims against us. To date, no such additional claims have been filed. However, we cannot predict whether such former employee will file additional litigation against us or our subsidiaries or the ultimate outcome of any such litigation.

ITEM 1A. *RISK FACTORS*

You should carefully consider the risks described below before deciding whether to invest in our common stock. The risks described below are not the only ones we face. Additional risks not presently known to us or that we currently believe are immaterial may also impair our business operations and financial results. If any of the following risks actually occurs, our business, financial condition or results of operations could be adversely affected. In such case, the trading price of our common stock could decline and you could lose all or part of your investment. Our filings with Securities and Exchange Commission also contain forward-looking statements that involve risks or uncertainties. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors, including the risks we face described below.

RISKS RELATING TO OUR BUSINESS

If we are unable to manage our growth effectively, our revenue and net loss could be adversely affected.

While historically we have developed and commercialized only a few products at a time, we plan to grow by developing and commercializing multiple products concurrently across many industries, technologies and markets. Our ability to grow by developing and commercializing multiple products simultaneously requires that we manage a diverse range of projects and expand our personnel resources. Our inability to do any of these could prevent us from successfully implementing our growth strategy, and our revenues and profits could be adversely affected.

To advance the development of multiple promising potential products concurrently, we need to manage effectively the logistics of maintaining the requisite corporate, operational, administrative and financing functions for each of these product opportunities. Potentially expanding our operations into new geographic areas and relying on multiple facilities to develop and manufacture different products concurrently pose additional challenges. We have little experience in managing these functions simultaneously for multiple projects in development or in building new infrastructure and integrating the operations of various facilities. If we cannot manage this process successfully, we may be subject to operating difficulties, additional expenditures and limited revenue growth.

We need to expand our personnel resources to grow our business effectively. We believe that sustained growth at a higher rate will place a strain on our management, as well as on our other human resources. To manage this growth, we must continue to attract and retain qualified management, professional, scientific and technical and operating personnel. During the most recently completed calendar quarter, the labor market, particularly for highly-specialized scientists and engineers remained tight. If we are unable to recruit a sufficient number of qualified personnel, we may be unable to staff and manage projects adequately, which may slow the rate of growth of our technology development revenue or our product development efforts.

We have incurred recent losses, and because our strategy for expansion may be costly to implement, we may experience continuing losses which may be significant.

We incurred consolidated net losses of approximately $7.8 million for the year ended December 31, 2007, and $3.7 million for the six months ending June 30, 2008. We expect to continue to incur significant additional expenses as we expand our business, including increased expenses for research and development, sales and marketing, manufacturing, finance and accounting personnel and expenses associated with being a public company. We may also grow our business in part through acquisitions of additional companies and complementary technologies which could cause us to incur significant transaction expenses, amortization or write-offs of intangible assets and other acquisition-related expenses. As a result, we expect that we may likely continue to incur losses for the foreseeable future, and these losses could be substantial.

Because of the numerous risks and uncertainties associated with our business and our expansion strategy, we are unable to predict when or if we will be able to achieve profitability again. If our revenues do not increase, or if our expenses increase at a greater rate than our revenues, we will continue to experience losses. Even if we do achieve profitability, we may not be able to sustain or increase our profitability on a quarterly or annual basis.

If we cannot successfully transition our revenue mix from technology development revenues to product sales and license revenues, we may not be able to fully execute our business model or grow our business.

Our business model and future growth depend on our ability to transition to a revenues mix that contains significantly larger product sales and license revenues components. Product sales and license revenues potentially offer greater scalability and higher gross margins than services-based technology development revenues. Our current plan is to increase our portfolio of commercial products and, accordingly, we expect that our future product sales and license revenues will represent a larger percentage of total revenues. However, if we are unable to develop and grow our product sales and license revenues to augment our technology development revenues, our ability to execute our business model or grow our business could suffer.

We may not be successful in identifying market needs for new technologies and developing new products to meet those needs.

The success of our business model depends on our ability to identify correctly market needs for new technologies. We intend to identify new market needs, but we may not always have success in doing so, in part because our technology development largely centers on identification and development of unproven technologies, often for new or emerging markets. Furthermore, we must identify the most promising technologies from a sizable pool of projects. If our commercialization strategy process fails to identify projects with commercial potential or if management does not ensure that such projects advance to the commercialization stage, we may not successfully commercialize new products and grow our revenues.

Our growth strategy requires that we not only identify new technologies that meet market needs, but that we also develop successful commercial products that address those needs. We face several challenges in developing successful new products. Many of our existing products and those currently under development-including our Trimetasphere® carbon nanomaterials, which are nanomaterials in the form of a carbon sphere with three metal atoms enclosed inside-are technologically innovative and require significant and lengthy product development efforts. These efforts include planning, designing, developing and testing at the technological, product and manufacturing-process levels. These activities require us to make significant investments. Although there are many potential applications for our technologies, our resource constraints require us to focus on specific products and to forgo other opportunities. We expect that one or more of the potential products we choose to develop will not be technologically feasible or will not achieve commercial acceptance, and we cannot predict which, if any, of our products we will successfully develop or commercialize. The technologies we research and develop are new and steadily changing and advancing. The products that are derived from these technologies may not be applicable or compatible with the state of technology or demands in existing markets. Our existing products and technologies may become uncompetitive or obsolete if our competitors adapt more quickly than we do to new technologies and changes in customers requirements. Furthermore, we may not be able to identify if and when new markets will open for our products given that future applications of any given product may not be readily determinable, and we cannot reasonably estimate the size of any markets that may develop. If we are not able to successfully develop new products, we may be unable to increase our product revenues.

Our failure to attract, train and retain skilled employees would adversely affect our business and operating results.

The availability of highly trained and skilled technical and professional personnel is critical to our future growth and profitability. Competition for scientists, engineers, technicians and professional personnel is intense and competitors aggressively recruit key employees. In the past, we have experienced difficulties in recruiting and hiring these personnel as a result of the tight labor market in certain fields. This fact, combined with our growth strategy and future needs for additional experienced personnel, particularly in highly specialized areas such as nanomaterial manufacturing and innovative ultrasound technologies, may make it more difficult to meet all of our needs for these employees in a timely manner. Although we intend to continue to devote significant resources to recruit, train and retain qualified employees, we may not be able to attract and retain these employees, especially in technical fields where the supply of experienced qualified candidates is limited. Any failure to do so would have an adverse effect on our business.

In addition, our future success depends in a large part upon the continued service of key members of our senior management team. In particular, our Chairman, CEO and founder, Kent A. Murphy, Ph.D., is essential to our overall management as well as the development of our technologies, our culture and our strategic direction. All of our executive officers and key employees are at-will employees, and, except with respect to Kent A. Murphy, Ph.D., we do not maintain any key-person life insurance policies. The loss of any of our management or key personnel could seriously harm our business.

We rely and will continue to rely on contract research, including government-funded research contracts, for a significant portion of our revenues. A decline in government funding of existing or future government research contracts, including Small Business Innovation Research (or SBIR) revenues, could adversely affect our revenues and cash flows and our ability to fund our growth.

Technology development revenue, which consists primarily of government-funded research, accounted for approximately 70% and 74% of our consolidated total revenues for the three months ended June 30, 2008 and 2007, respectively. As a result, we are vulnerable to adverse changes in our revenues and cash flows if a significant number of our research contracts and subcontracts are simultaneously delayed or canceled for budgetary, performance or other reasons. The U.S. government, for example, may cancel these contracts at any time without cause and without penalty or may change its requirements, programs or contract budget, any of which could reduce our revenues and cash flows from U.S. government research contracts. Our revenues and cash flows from U.S. government research contracts and subcontracts could also be reduced by declines or other changes in U.S. defense, homeland security and other federal agency budgets. In addition, we compete as a small business for some of these contracts, and in order to maintain our eligibility to compete as a small business, we (together with any affiliates) must continue to meet size and revenue limitations established by the U.S. government.

In addition to contract cancellations and changes in agency budgets, our future financial results may be adversely affected by curtailment of the U.S. government s use of contract research providers, including curtailment due to government budget reductions and related fiscal matters. These or other factors could cause U.S. defense and other federal agencies to conduct research internally rather than through commercial research organizations, to reduce their overall contract research requirements or to exercise their rights to terminate contracts. Any of these actions could limit our ability to obtain new contract awards and adversely affect our revenues and cash flows and our ability to fund our growth.

We also derive a significant portion of our technology development revenues from SBIR contracts. SBIR revenues accounted for approximately 44% and 61% of our consolidated total revenues for the three months ended June 30, 2008 and 2007, respectively. Contract research, including SBIR, will remain a significant portion of our consolidated total revenues for the foreseeable future. Our strategy for developing innovative technologies and products depends in large part on our ability to continue to enter into and generate revenues from non-SBIR contract research.

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Our contract research customer base includes government agencies, corporations and academic institutions. Our customers are not obligated to extend their agreements with us. In addition, we may not be successful in securing future contracts. Our customers priorities regarding funding for certain projects may change and funding resources may no longer be available at previous levels.

We rely and will continue to rely on contracts and grants awarded under the SBIR program for a significant portion of our revenues. A finding by the Small Business Administration, or SBA, that we no longer qualify to receive SBIR funding could adversely affect our business.

We may not qualify to participate in the Small Business Administration s, or SBA s, SBIR program or receive new SBIR awards from federal agencies in the future. In order to qualify for SBIR contracts and grants, at least 51% of our equity must be owned and controlled by U.S. citizens or permanent resident aliens, or by another entity that is at least 51% owned or controlled by U.S. citizens or permanent resident aliens, and we must have 500 or fewer employees. These eligibility criteria are applied as of the time of the award of a contract or grant. In determining whether we satisfy the 51% equity ownership requirement, agreements to merge, stock options, convertible debt and other similar instruments are given present effect by the SBA, as though the underlying securities were actually issued unless the exercisability or conversion of such securities is speculative, remote or beyond the control of the security holder. We therefore believe our outstanding options and warrants held by eligible individuals may be counted as, and our convertible debt may be excluded from, outstanding equity for purposes of meeting the 51% equity ownership requirement.

We believe that we are currently in compliance with the SBIR eligibility criteria but we cannot provide assurance that the SBA will interpret its regulations in our favor. We believe that over 60% of our equity is owned or controlled by U.S. citizens, and that we currently have fewer than 500 employees. We must be able to certify that we meet the SBIR ownership and size requirements as of the time we enter into each SBIR contract or grant, and SBA may review our size status in connection with each SBIR contract or grant. As we grow our business, it is foreseeable that we will eventually exceed the SBIR eligibility limitations and we may need to find other sources to fund our research and development efforts. If we are unsuccessful in obtaining additional contracts or funding grants because we cannot meet the eligibility requirements or if our customers decide to reduce or discontinue support of our products, we may be required to seek alternative sources of revenues or capital.

The SBA could determine that, as a result of Carilion Clinic s equity ownership, the number of our employees exceeds the size limitation pfont> $17,887 $7,721

Net (loss) income attributable to Steel Excel

$(1,177) $3,816

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4. Stock Benefit Plans

The Company grants stock options and other stock-based awards to employees, directors and consultants under two equity incentive plans, the 2004 Equity Incentive Plan and the 2006 Director Plan. As of March 31, 2012, the Company had an aggregate of 1.8 million shares of its common stock reserved for issuance under its 2004 Equity Incentive Plan, of which 59,792 shares were subject to outstanding options and other stock-based awards and 1.7 million shares of were available for future grants of options and other stock-based awards. As of March 31, 2012, the Company had an aggregate of 0.4 million shares of its common stock reserved for issuance under its 2006 Director Plan, of which 48,069 shares were subject to outstanding options and other stock-based awards and 0.4 million shares were available for future grants of options and other stock-based awards.

Stock Benefit Plan Activities

Stock Options: A summary of option activity under all of the Company's equity incentive plans as of March 31, 2012 and changes during the three-month period then ended is as follows:

	Shares	Weighted Average Exercise Price	Weighted Average Contractual Term (Years)	Aggregate Instrinsic Value
Outstanding at December 31, 2011	94	$31.89		
Granted	-	$-		
Exercised	-	$-		
Forfeited	-	$-		
Expired	-	$-		
Outstanding at March 31, 2012	94	$31.89	5.44	$6,987.50
Options vested and expected to vest at March 31, 2012	84	$32.27	5.34	$3,863.69
Options exercisable at March 31, 2012	70	$32.98	5.12	$-

The aggregate intrinsic value is calculated as the difference between the closing price of the Company's common stock on the OTCQB Market and the exercise price of the underlying awards for the 3,250 shares subject to options that were in-the-money as of March 31, 2012. During both three-month periods ended March 31, 2012 and April 1, 2011, the aggregate intrinsic value of options exercisable under the Company's equity incentive plans was minimal. As of March 31, 2012, the total unamortized stock-based compensation expense related to non-vested stock options, net of estimated forfeitures was approximately $0.1 million and this expense is expected to be recognized over a remaining weighted-average period of 0.5 years.

Restricted Stock: Restricted stock awards and restricted stock units (collectively, "restricted stock") were granted under the Company's 2004 Equity Incentive Plan and the 2006 Director Plan. As of March 31, 2012, there were 947 shares of service-based restricted stock awards and 16,417 shares of restricted stock units outstanding, respectively. The cost of restricted stock, determined to be the fair market value of the shares at the date of grant, is expensed ratably over the period the restrictions lapse.

A summary of activity for restricted stock units as of March 31, 2012 and changes during the three-month period then ended is as follows:

	Shares	Weighted Average Grant-Date Fair Value
Non-vested restricted stock units at December 31, 2011 1	17	$0.01
Awarded	-	$-
Vested	-	$0.01
Forfeited	-	$-
Non-vested restricted stock units at March 31, 2012 1	17	$0.01

(1) Non-vested restricted stock units at each period included shares to certain non-employee directors in which vesting will occur immediately if the relationship between the Company and the non-employee director ceases for any reason. These non-vested shares were recognized and fully expensed as stock-based compensation in the Condensed Statements of Operations at the date of grant or the date of modification.

All restricted stock units were awarded at the par value of $0.001 per share (adjusted to $0.01 per share to reflect the Reverse/Forward Split). As of March 31, 2012, the total unamortized stock-based compensation expense related to non-vested restricted stock that is expected to vest, net of estimated forfeitures, was approximately $0.1 million, and this expense is expected to be recognized over a remaining weighted-average period of 0.5 years.

Stock-Based Compensation

The Company measures and recognizes stock-based compensation expense for all stock-based awards made to its employees, directors and consultants based on estimated fair values using a straight-line amortization method over the respective requisite service period of the awards and adjusted it for estimated forfeitures. In addition, the Company applies the simplified method to establish the beginning balance of the additional paid-in capital pool related to the tax effects of employee stock-based compensation, which is available to absorb tax shortfall.

Stock-based compensation expenses included in the Condensed Statements of Operations for the three-month period ended March 31, 2012 and April 1, 2011 were as follows:

	Three-month Period Ended:	
	March 31, 2012	April 1, 2011
	(in thousands)	
Stock-based compensation expense by caption:		
Selling, marketing and administrative	$25	$8
Stock-based compensation expense by award type:		
Stock options	$16	$4
Retricted stock	9	4
Total	$25	$8

The stock-based compensation expense in the above table does not reflect any significant tax expense, which is consistent with the Company's treatment of income or loss from its United States operations. For the three-month periods ended March 31, 2012 and April 1, 2011, there were no income tax benefits realized for the tax deductions from option exercises of the stock-based payment arrangements. In addition, there was no stock-based compensation costs capitalized as part of an asset in the three-month periods ended March 31, 2012 and April 1, 2011.

Valuation Assumptions

The Company uses the Black-Scholes option pricing model for determining the estimated fair value for all stock-based awards. No grants were made in the three-month periods ended March 31, 2012 and April 1, 2011 for stock options and other stock-based awards.

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5. Marketable Securities

The Company's investment policy focuses on three objectives: to preserve capital, to meet liquidity requirements, and to maximize total return. The Company's investment policy establishes minimum ratings for each classification of investments when purchased and investment concentration is limited to minimize risk. The policy also limits the final maturity on any investment and the overall duration of the portfolio. During the three-month period ended March 31, 2012, the Company's Board of Directors executed a written consent permitting the Company to invest up to $10 million in publicly traded companies engaged in certain oilfield servicing, energy services, and related businesses, which is an exception to our investment policy. Additional exceptions to the investment policy may be approved in the future. Given the overall market conditions, the Company regularly reviews its investment portfolio to ensure adherence to its investment policy and to monitor individual investments for risk analysis and proper valuation.

The Company's portfolio of marketable securities at March 31, 2012 was as follows:

	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
		(in thousands)		
Available-for-sale securities:				
Short-term deposits	$29,148	$-	$-	$29,148
United States government securities	220,580	327	(29)	220,878
Government agencies	3,503	11	-	3,514
Corporate obligations	1,506	3	-	1,509
Total available-for-sale securities	254,737	341	(29)	255,049
Amounts classified as cash equivalents	(31,036)	-	-	(31,036)
Amounts classified as marketable securities	$223,701	$341	$(29)	$224,013

The Company's portfolio of marketable securities at December 31, 2011 was as follows:

	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
		(in thousands)		
Available-for-sale securities:				
Short-term deposits	$3,029	$-	$-	$3,029
United States government securities	309,189	593	(3)	309,779
Government agencies	3,505	21	-	3,526
Corporate obligations	1,513	8	-	1,521
Total available-for-sale securities	317,236	622	(3)	317,855
Amounts classified as cash equivalents	(2,914)	-	-	(2,914)
Amounts classified as marketable securities	$314,322	$622	$(3)	$314,941

Sales of marketable securities resulted in gross realized gains of $0.1 million and $0.5 million during the three-month periods ended March 31, 2012 and April 1, 2011, respectively. Sales of marketable securities resulted in gross realized losses of $0.1 million during the three-month period ended April 1, 2011. The gross realized losses for the three-month period ended March 31, 2012 was immaterial.

The following table summarizes the fair value and gross unrealized losses of the Company’s available-for-sale marketable securities, aggregated by type of investment instrument and length of time that individual securities have been in a continuous unrealized loss position, at March 31, 2012:

	Less than 12 Months		12 Months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
	(in thousands)					
U.S. government securities	$87,152	$(30)	$-	$-	$87,152	$(30)

The following table summarizes the fair value and gross unrealized losses of the Company’s available-for-sale marketable securities, aggregated by type of investment instrument and length of time that individual securities have been in a continuous unrealized loss position at December 31, 2011:

	Less than 12 Months		12 Months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
	(in thousands)					
U.S. government securities	$15,186	$(3)	$-	$-	$15,186	$(3)

The Company’s investment portfolio consists of both corporate and government securities that generally mature within three years. The longer the duration of these securities, the more susceptible they are to changes in market interest rates and bond yields. As yields increase, those securities purchased with a lower yield-at-cost show a mark-to-market unrealized loss. All unrealized losses are due to changes in interest rates and bond yields. The Company has considered all available evidence and determined that the marketable securities in which unrealized losses were recorded in the three-month periods ended March 31, 2012 and April 1, 2011 were not deemed to be other-than-temporary. The Company holds its marketable securities as available-for-sale and marks them to market.

The amortized cost and estimated fair value of investments in available-for-sale securities as March 31, 2012 and December 31, 2011, by contractual maturity, were as follows:

	Cost	Estimated Fair Value
	(in thousands)	
Mature in one year or less	$215,969	$216,051
Mature after one year through three years	38,767	38,997
Total	$254,736	$255,048

6. Fair Value Measurements

Fair value is defined as the price that would be received for selling an asset or paid to transfer a liability in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. The accounting standard surrounding fair value measurements establishes a fair value hierarchy, consisting of three levels, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

Financial Assets Measured at Fair Value on a Recurring Basis

The Company utilized levels 1, 2 and 3 to value its financial assets on a recurring basis. Level 1 instruments use quoted prices in active markets for identical assets or liabilities, which include the Company's cash accounts, short-term deposits and money market funds as these specific assets are liquid. Level 1 instruments also include United States government securities, government agencies, and state and municipalities, as these securities are backed by the federal or state governments and traded in active markets frequently with sufficient volume. Level 2 instruments are valued using the market approach, which uses quoted prices in markets that are not active or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities and include mortgage-backed securities, corporate obligations and asset-backed securities as similar or identical instruments can be found in active markets. Level 3 is supported by little or no market activity and requires a high level of judgment to determine fair value, which includes the Company's two venture fund investments. The Company periodically monitors its two venture capital funds and records these investments within "Other long-term assets" on the Condensed Balance Sheets based on quarterly statements the Company receives from each of the funds. The statements are generally received one quarter in arrears, as more timely valuations are not practical. The statements reflect the net asset value, which the Company uses to determine the fair value for these investments, which (a) do not have a readily determinable fair value and (b) either have the attributes of an investment company or prepare their financial statements consistent with the measurement principles of an investment company. The assumptions used by the Company, due to lack of observable inputs, may impact the fair value of these equity investments in future periods. In the event that the carrying value of its equity investments exceeds their fair value, or the decline in value is determined to be other-than-temporary, the carrying value is reduced to its current fair value, which is recorded in "Interest and other income, net," in the Condensed Statements of Operations. At March 31, 2012, there were no significant transfers that occurred between any of the levels of the Company's financial assets.

A summary of financial assets measured at fair value on a recurring basis at March 31, 2012 was as follows:

	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
		(in thousands)		
Cash, including short-term deposits 1	$43,550	$43,550	$-	$-
United States government securities 2	220,878	220,878	-	-
Government agencies 2	3,514	3,514	-	-
Corporate oligations 2	1,509	-	1,509	-
Non-controlling interests in certain funds 3	1,117	-	-	1,117
	$270,568	$267,942	$1,509	$1,117

(1) At March 31, 2012, the Company recorded $43.4 million and $0.1 million within "Cash and cash equivalents" and "Marketable securities," respectively.

(2) Recorded within "Marketable securities."

(3) Recorded within "Other long-term assets."

A summary of financial assets measured at fair value on a recurring basis at December 31, 2011 was as follows:

	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
		(in thousands)		
Cash, including short-term deposits 1	$8,601	$8,601	$-	$-
United States government securities 2	309,780	309,780	-	-
Government agencies 2	3,526	3,526	-	-
Corporate oligations 2	1,521	-	1,521	-
Non-controlling interests in certain funds 3	1,117	-	-	1,117
Total	$324,545	$321,907	$1,521	$1,117

(1) At December 31 2011, the Company recorded $8.5 million and $0.1 million within “Cash and cash equivalents” and “Marketable securities,” respectively.

(2) Recorded within “Marketable securities.”

(3) Recorded within “Other long-term assets.”

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The Company's other financial instruments include accounts payable and accrued and other liabilities. Carrying values of these financial liabilities approximate their fair values due to the relatively short maturity of these items. The related cost basis for the Company's 3/4% Convertible Senior Notes due December 22, 2023 (the "3/4% Notes") at March 31, 2012 and December 31, 2011 was approximately $0.3 million on both dates. Although the remaining balance of its 3/4% Notes is relatively small and the market trading is very limited, the Company expects the cost basis for the 3/4% Notes of approximately $0.3 million at March 31, 2012 to approximate fair value. The Company's convertible debt is recorded at its carrying value, not the estimated fair value. The Company may seek to make open market repurchases of the remaining balance of its 3/4% Notes within the next twelve months.

Non-Financial Assets Measured at Fair Value on a Non-Recurring Basis

The Company has no non-financial assets measured at fair value on a non-recurring basis as of March 31, 2012 and December 31, 2011.

7. Long-Lived Assets

The Company regularly performs reviews of its long-lived assets to determine if facts or circumstances are present, either internal or external, which would indicate that the carrying values of its long-lived assets may not be recoverable. For more details, refer to the Summary of Significant Accounting Policies in Note 1 to the Consolidated Financial Statements in the Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

Property and Equipment, Net

The components of property and equipment, net, as of March 31, 2012 and December 31, 2011 were as follows:

	March 31, 2012	December 31, 2011
	(in thousands)	
Rigs and workover equipment	$27,415	$11,750
Other equipment	11,971	3,205
Leasehold improvements	6,075	5,677
Vehicles	1,018	648
Furniture and fixtures	8	100
Assets in progress	225	-
	46,712	21,380
Accumulated depreciation	(1,338)	(320)
Property and equipment, net	$45,374	$21,060

Depreciation expense for the three-month period ended March 31, 2012 aggregated $1.0 million, with $0.9 million in "Cost of revenues" and $0.1 million in "Selling, general and administrative" expenses in the Condensed Statement of Operations. There was no depreciation expense in the three-month period ended April 1, 2011.

During the three-month period ended March 31, 2012, the Company wrote down $0.1 million of property and equipment from The Show to zero-value, as The Show is not meeting forecasted projections, with no expectation to perform as represented when acquired. This write-down is included in "Selling, general and administrative" expenses in the Condensed Statement of Operations.

Intangible Assets, Net

The components of intangible assets, net, as of March 31, 2012 were as follows:

	Cost	Accumulated Amortization (in thousands)	Net	Amortization Method	Estimated Useful Life
Sports-Related:					
Customer relationships	$235	$(31)	204	Straight-line	5 years
Oilfield Servicing:					
Customer relationships	19,000	(711)	18,289	Accelerated	10 years
Trade names	900	(120)	780	Accelerated	5 years
	19,900	(831)	19,069		
Intangible assets, net	$20,135	$(862)	$19,273		

The components of intangible assets, net, as of December 31, 2011 were as follows:

	Cost (in thousands)	Accumulated Amortization	Net	Amortization Method	Estimated Useful Life
Sports-Related:					
Customer relationships	$235	$(20)	215	Straight-line	5 years
Oilfield Servicing:					
Customer relationships	4,700	(29)	4,671	Accelerated	10 years
Trade names	900	-	900	Accelerated	5 years
	5,600	(29)	5,571		
Intangible assets, net	$5,835	$(49)	$5,786		

Amortization expense for the three-month periods ended March 31, 2012 and April 1, 2011 was $0.8 million and $0, respectively, and is included in "Selling, general and administrative" expenses in the Condensed Statements of Operations.

Estimated aggregate future amortization expenses for the next five years for the intangible assets by reporting segment are as follows:

	Sports-Related	Oilfield Servicing
	(in thousands)	
For the year ended December 31:		
2012 (remaining nine months)	$35	$3,183
2013	47	3,295
2014	47	2,585
2015	47	2,126
2016	27	1,669
	$203	$12,858

Goodwill

During the three-month period ended March 31, 2012, the Company wrote off goodwill from The Show of $1.7 million, as The Show is not meeting forecasted projections, with no expectation to perform as represented when acquired. This is included in "Selling, general and administrative" expenses in the Condensed Statement of Operations.

Goodwill by reporting segment as of March 31, 2012 was as follows:

	Sports-Related	Oilfield Services (in thousands)	Total
Balance, December 31, 2011	$1,989	$6,255	$8,244
Acquired goodwill	-	10,126	10,126
Impairment loss	(1,796)	-	(1,796)
Balance, March 31, 2012	$193	$16,381	$16,574

8. Liabilities

The Company's "Accrued and other liabilities" as of March 31, 2012 and December 31, 2011 were as follows:

	March 31, 2012	December 31, 2011
	(in thousands)	
Tax-related	$317	$56
Accrued compensation and related taxes	2,456	1,593
Deferred revenue	1,232	278
Professional services	549	485
Accrued workers compensation	-	1,233
Other	461	181
Total	$5,015	$3,826

The Company's "Other long-term liabilities" as of March 31, 2012 and December 31, 2011 were as follows:

	March 31, 2012	December 31, 2011
	(in thousands)	
Tax-related	$10,737	$10,737
Other	16	-
	$10,753	$10,737

9. Commitments and Contingencies

Contractual Obligations

Through its recent acquisitions, the Company assumed leases of property expiring in various dates through 2016 with the following non-cancelable obligations:

	Amount (in thousands)
For the year ended December 31:	
2012 (remaining nine months)	$452
2013	457
2014	431
2015	431
2016	425
	$2,196

Legal Proceedings

The information contained under the heading, "Legal Proceedings," set forth under Part II, Item 1 of this Quarterly Report on Form 10-Q is incorporated herein by reference.

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10. Restructuring Charges

The Company implemented restructuring plans during its nine-month transition period ended December 31, 2010 and during fiscal 2010 and 2009. The goals of these plans were to bring the Company's operational expenses to appropriate levels relative to its historical net revenues, while simultaneously implementing extensive company-wide expense-control programs. All expenses, including adjustments, associated with the Company's restructuring plans are included in "Restructuring charges" in the Condensed Statements of Operations. These plans were completed as of December 31, 2011 so there is no restructuring activity in the three-month period ended March 31, 2012.

Activity in the restructuring accrual for all outstanding plans for the three-month period ended April 1, 2011 was as follows:

	Severance and Benefits	Other Charges (in thousands)	Total
Accrual balance at December 31, 2010	$881	$350	$1,231
Accrual adjustments	38	-	38
Cash paid	(813)	(111)	(924)
Accrual balance at April 1, 2011	$106	$239	$345

11. Interest and Other Income (Expense), Net

The components of "Interest and other income (expense), net" for the three-month periods ended March 31, 2012 and April 1, 2011 were as follows:

	Three-Month Period Ended: March 31, 2012	April 1, 2011
	(in thousands)	
Interest income, net	$303	$1,390
Realized currency translation gains	49	3,846
Write-off of loan to The Show	(500)	-
Other	(81)	96
	$(229)	$5,332

The realized currency translation gains are primarily the result of substantial liquidations of certain of the Company's foreign subsidiaries. The Company wrote off its loan to The Show because The Show is not meeting forecasted projections, with no expectation to perform as represented when acquired. Therefore, the Company does not anticipate repayment of its loan by The Show.

12. Income Taxes

Income tax provisions for interim periods are based on the Company's estimated annual income tax rate for entities that were profitable. Entities that had operating losses with no tax benefit were excluded. The estimated annual tax for the three-month periods ended March 31, 2012 and April 1, 2011 include foreign taxes related to the Company's foreign subsidiaries and certain state minimum taxes. Interest is accrued on prior years' tax disputes and refund claims as a discrete item each period. Although the Company believes its tax estimates are reasonable, the ultimate tax outcome may materially differ from the tax amounts recorded in its Financial Statements and may cause a higher effective tax rate that could materially affect its income tax provision, results of operations or cash flows in the period or periods for which such determination is made.

The Company recorded a tax expense of $0.1 million for the three-month period ended March 31, 2012. This is primarily the result of two discrete tax expenses of which one is related to the amortization of indefinite lived intangible assets, and the other is related to mark-to-market adjustments to the value of available-for-sale securities. For the three-month period ended April 1, 2011, the Company recorded a tax provision of $1.1 million as it realized certain currency translation gains due to substantial liquidation of certain of its foreign subsidiaries during the period. This was offset by income tax benefits from losses incurred in other foreign jurisdictions and the reversal of foreign taxes reserves.

The Company continues to monitor the status of its NOLs, which may be used to offset future taxable income. If the Company underwent an ownership change, the NOLs would be subject to an annual limit on the amount of the taxable income that may be offset by its NOLs generated prior to the ownership change and additionally, the Company may be unable to use a significant portion of its NOLs to offset taxable income. The Company has adopted a tax benefits preservation plan with the intention of reducing the likelihood of an ownership change. However, the Company cannot ensure that this plan will be effective in deterring all transfers of the Company's common stock that could result in such an ownership change. Additionally, if stockholders holding a majority of the Company's outstanding shares of common stock do not approve the plan prior to the final adjournment of the Company's 2012 Annual Meeting of Stockholders, the plan will expire. For details regarding the Company's NOL carryforwards prior to the three-month period ended March 31, 2012, please refer to Note 14 of the Notes to Financial Statements included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

As of March 31, 2012, the Company's total gross unrecognized tax benefits were $29.9 million, of which $9.2 million, if recognized, would affect the effective tax rate. There have been no material changes to the Company's total gross unrecognized tax benefits from December 31, 2011.

The Company is subject to U.S. federal income tax as well as income taxes in many U.S. states and foreign jurisdictions in which the Company operates or formerly operated. As of March 31, 2012, fiscal years 2004 onward remained open to examination by the U.S. taxing authorities and fiscal years 1999 onward remained open to examination in various foreign jurisdictions. U.S. tax attributes generated in fiscal years 1999 onward also remain subject to adjustment in subsequent audits when they are utilized.

The calculation of unrecognized tax benefits involves dealing with uncertainties in the application of complex global tax regulations. Management regularly assesses the Company's tax positions in light of legislative, bilateral tax treaty, regulatory and judicial developments in the countries in which the Company conducts or formerly conducted business. Management believes that it is not reasonably possible that the gross unrecognized tax benefits will change significantly within the next 12 months; however, tax audits remain open and the outcome of any tax audits are inherently uncertain, which could change this judgment in any given quarter.

13. Segment Information

The Company currently reports its business in two reportable segments: sports-related and oilfield services. The Company also maintains general operations as it continues to explore additional working capital redeployment opportunities. There were no reportable segments in the three-month period ended April 1, 2011.

Segment information as of March 31, 2012 and for the three-month period then ended is as follows:

	Sports-Related	Oilfield Services	General Corporate	Consolidated
		(in thousands)		
Net revenues	$517	$14,290	$-	$14,807
Operating income (loss)	$(3,122)	$3,316	$(2,295)	$(2,101)
Total assets	$7,852	$87,671	$273,671	$369,194
Accounts receivable	$494	$11,092	$-	$11,586
Property and equipment, net	$5,857	$39,517	$-	$45,374

The operating loss for the sports-related reporting segment includes a write-down of goodwill, property and equipment, and inventory aggregating $1,981.

14. Net (Loss) Income Per Share

Basic net (loss) income per share is computed by dividing net (loss) income by the weighted-average number of common shares outstanding during the period. Diluted net (loss) income per share gives effect to all potentially dilutive common shares outstanding during the period, which include certain stock-based awards, calculated using the treasury stock method, and convertible notes that are potentially dilutive at certain earnings levels, and are computed using the if-converted method. As disclosed in Note 1, all share information for the prior year period has been adjusted to reflect the Reverse/Forward Split.

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A reconciliation of the numerator and denominator of the basic and diluted net (loss) income per share attributable to Steel Excel computations was as follows:

	Three-Month Period Ended:	
	March 31, 2012	April 1, 2011
	(in thousands), except per share amounts	
Numerators (basic and diluted)		
Net (loss) income	$(1,888)	$1,817
Denominators		
Basic weighted-average shares outstanding	10,891	10,880
Effect of dilutive securities:		
Stock-based awards	-	8
Diluted weighted-average shares outstanding	10,891	10,888
Net (loss) income per share:		
Basic	$(0.17)	$0.17
Diluted	$(0.17)	$0.17

Diluted net loss per share for the three-month period ended March 31, 2012 was based only on the weighted-average number of shares outstanding during that period, as inclusion of any common stock equivalents would have been antidilutive. Certain potential common shares were excluded from the diluted computation for the three-month period ended April 1, 2011 because their inclusion would have been anti-dilutive. The potential common shares excluded for the three-month periods March 31, 2012 and April 1, 2011 were as follows:

	Three-Month Period Ended:	
	March 31, 2012	April 1, 2011
	(in thousands)	
Outstanding stock options	87	23
Outstanding restricted stock	17	8
3.4% Convertible senior subordinated notes	3	3

15. Related Party Transactions

As of March 31, 2012, Steel Partners Holdings, L.P., SPH Group LLC, SPH Group Holdings LLC, and Steel Partners Holdings GP Inc. (collectively, "Steel Partners") beneficially owned approximately 40% of the Company's outstanding common stock. Jack L. Howard, John J. Quicke, and Warren G. Lichtenstein are directors of the Company and each such person is deemed to be an affiliate of Steel Partners under the rules of the Securities Exchange Act of 1934, as amended. Each of the three directors is compensated with cash compensation and equity awards or equity-based awards in amounts that are consistent with the Company's Non-employee Director Compensation Policy. In addition, Mr. Quicke currently serves as the Interim President and CEO of the Company and is compensated $30,000 per month in connection with this role, which is in addition to the compensation he receives as a non-employee board member. Mr. Quicke also serves as the CEO of other affiliates of Steel Partners.

Pursuant to a management services agreement between the Company and SP Corporate Services LLC ("SP Corporate"), the Company used $0.1 million of various services during the three-month period ended March 31, 2012. SP Corporate is an affiliate of Steel Partners.

See Note 16 below for discussion of a pending acquisition of a company majority-owned by Steel Partners.

16. Subsequent Events

On April 30, 2012, the Company entered into a definitive share acquisition agreement (the “Agreement”) to acquire Sun Well Service, Inc. (“Sun Well”), an operating subsidiary of BNS Holding, Inc. (“BNS”). Steel Partners owns approximately 85% of BNS. Sun Well is a provider of premium well services to oil and gas exploration and production companies operating in the Williston Basin in North Dakota and Montana. Sun Well will be included in the Company’s oilfield services reporting segment.

Pursuant to the terms of the Agreement, the Company will acquire all of the capital stock of SWH, Inc., the parent company of Sun Well, for an acquisition price of $85 million less net debt (debt outstanding less cash), subject to certain adjustments. The acquisition price will be paid through the issuance of up to 2,200,000 shares of the Company’s common stock (valued at $30 per share) and cash. The acquisition is contingent upon BNS stockholder approval, among other things, and is expected to close by the end of the June 30, 2012 quarter.

As a result of the acquisition, Steel Partners will beneficially own slightly over 50% of the Company’s outstanding common stock.

The Company and BNS each appointed a special committee of independent directors to consider and negotiate this transaction because of the interest of Steel Partners in each company.

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

This Quarterly Report on Form 10-Q contains forward-looking statements that involve risks and uncertainties. The statements contained in this document that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, or the Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act, including, without limitation, statements regarding our expectations, beliefs, intentions or strategies regarding our business, including, but not limited to, our ability to consolidate and manage our newly acquired businesses; failure to achieve expected cost savings and other synergies from our newly acquired businesses; our ability to identify suitable acquisition candidates or business and investment opportunities; our ability to realize the benefits of our net tax operating losses; the possibility of being deemed an investment company under the Investment Company Act of 1940, as amended, which may make it difficult for us to complete future business combinations or acquisitions; the potential need to record additional impairment charges for long-lived assets or marketable securities based on current market conditions; fluctuations in demand for our services; operating risks inherent in the oilfield services industry; environmental and other health and safety laws and regulations, including those relating to climate change; general economic conditions and our expected liquidity in future periods. We may identify these statements by the use of words such as “anticipate,” “believe,” “continue,” “could,” “estimate,” “expect,” “intend,” “may,” “might,” “pl “predict,” “project,” “should,” “will,” “would” and other similar expressions. All forward-looking statements included in this document are based on information available to us on the date hereof, and we assume no obligation to update any such forward-looking statements, except as may otherwise be required by law.

Our actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors, including those set forth in the “Risk Factors” section in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011. In evaluating our business, current and prospective investors should consider carefully these factors in addition to the other information set forth in this report.

While management believes that the discussion and analysis in this report is adequate for a fair presentation of the information presented, we recommend that you read this discussion and analysis in conjunction with our Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

Reverse/Forward Stock Split

At the close of business on October 3, 2011, we effected a reverse split (the “Reverse Split”) immediately followed by a forward split (the “Forward Split” and together with the Reverse Split, the “Reverse/Forward Split”). At our 2011 annual stockholders meeting, our stockholders approved a proposal authorizing the Board of Directors (the “Board”) to effect the reverse/forward stock split at exchange ratios determined by the Board within certain specified ranges.

The exchange ratio for the Reverse Split was 1-for-500 and the exchange ratio for the Forward Split was 50-for-1. As a result of the Reverse Split, stockholders holding less than 500 shares (the "Cashed Out Stockholders") were entitled to a cash payment for all of their shares. All remaining stockholders following the Forward Split (the "Remaining Stockholders") were also entitled to a cash payment for any fractional shares that they would otherwise have received. The cash payment that each Cashed Out Stockholder or Remaining Stockholder was entitled to receive was based upon such stockholder's pro rata share of the total net proceeds received in the sale of the aggregated fractional shares by the Company's transfer agent at prevailing prices on the open market.

All shares outstanding and per share information for the previous financial periods being reported have been adjusted to reflect the Reverse/Forward Split.

Overview

We are primarily focused on capital redeployment and identification of new business operations in which we can utilize our existing working capital and maximize the use of our net tax operating losses ("NOLs") in the future. The identification of new business operations includes, but is not limited to, the oilfield services, sports, training, education, entertainment, and lifestyle businesses. During the fiscal year ended December 31, 2011, we acquired two sports-related businesses and one oilfield services business. We currently operate in these two reportable segments, but may add others in the future depending upon acquisition opportunities to further redeploy our working capital.

On February 9, 2012, we acquired the business and assets of Eagle Well Services, Inc., which now operates as Well Services Ltd. ("Well Services"), a leader in the oilfield service industry serving customers in the Bakken basin of North Dakota and Montana. The purchase price was $48.1 million in cash. Well Services is included in our oilfield services reporting segment.

On April 30, 2012, we entered into a definitive share acquisition agreement (the "Agreement") to acquire Sun Well Service, Inc. ("Sun Well"), an operating subsidiary of BNS Holding, Inc. ("BNS"). Sun Well is a provider of premium well services to oil and gas exploration and production companies operating in the Williston Basin in North Dakota and Montana. Sun Well will be included in our oilfield services reporting segment.

Pursuant to the terms of the Agreement, we will acquire all of the capital stock of SWH, Inc., the parent company of Sun Well, for an acquisition price of $85 million less net debt (debt outstanding less cash), subject to certain adjustments. The acquisition price will be paid through the issuance of up to 2,200,000 shares of our common stock (valued at $30 per share) and cash. Affiliates of Steel Partners Holdings L.P. ("Steel Partners") currently own approximately 40% of our outstanding common stock and 85% of BNS. The acquisition is contingent upon BNS stockholder approval, among other things, and is expected to close by the end of the June 30, 2012 quarter.

As a result of the acquisition, Steel Partners will beneficially own slightly over 50% of our outstanding common stock. We and BNS each appointed a special committee of independent directors to consider and negotiate this transaction because of the interest of Steel Partners in each company.

Results of Operations

Since we completed the wind down of our Aristos Business in September 2010, we did not have operating businesses in the three-month period ended April 1, 2011. Therefore, there are no comparisons for net revenues, cost of revenues, and gross margin.

Revenues and Gross Margin

Revenues for the three-month period ended March 31, 2012 were $14.8 million, with a gross margin of $5.7 million (38.5% as a percentage of revenues). Our sports-related reporting segment had revenues of $0.5 million, with a gross margin of $0.2 million, while our oilfield services reporting segment had revenues of $14.3 million, with a gross margin of $5.5 million.

Operating Expenses

Operating expenses now consist of selling, general and administrative expenses only as our current operations do not include research and development. Total operating expenses for the three-month period ended March 31, 2012 were $7.8 million, with the sports-related and oilfield services reporting segments aggregating $3.3 million and $2.1 million, respectively. The sports-related operating expenses included write-downs of goodwill, inventory, and property and equipment for The Show, which aggregated $2.0 million. The Show is not meeting forecasted projections, with no expectation to perform as represented when acquired on August 15, 2011.

Interest and Other Income (Expense), Net

For the three-month period ended March 31, 2012, we have net interest and other expense of $0.2 million compared to net interest and other income of $5.3 million for the same period of fiscal 2011. This is primarily the result of our realizing foreign currency translation gains from substantial liquidation of certain of our foreign subsidiaries that aggregated $3.8 million in the three-month period ended April 1, 2011, compared to $49,000 for the three-month period ended March 31, 2012. In addition, a change in our investments to more liquid assets resulted in our interest income being reduced to $0.3 million in the three-month period ended March 31, 2012, compared to $1.4 million in the same period of fiscal 2011. In addition, the three-month period ended March 31, 2012 included a write-off of a $0.5 million loan to The Show. As The Show is not expected to meet forecasted projections, we do not anticipate it will be able to make repayment of the loan.

Income Taxes

Income tax provisions for interim periods are based on the Company's estimated annual income tax rate for entities that were profitable. Entities that had operating losses with no tax benefit were excluded. The estimated annual tax for the three-month periods ended March 31, 2012 and April 1, 2011 include foreign taxes related to the Company's foreign subsidiaries and certain state minimum taxes. Interest is accrued on prior years' tax disputes and refund claims as a discrete item each period. Although the Company believes its tax estimates are reasonable, the ultimate tax outcome may materially differ from the tax amounts recorded in its Financial Statements and may cause a higher effective tax rate that could materially affect its income tax provision, results of operations or cash flows in the period or periods for which such determination is made.

The Company recorded a tax expense of $0.1 million for the three-month period ended March 31, 2012. This is primarily the result of two discrete tax expenses of which one is related to the amortization of indefinite lived intangible assets, and the other is related to mark-to-market adjustments to the value of available-for-sale securities. For the three-month period ended April 1, 2011, the Company recorded a tax provision of $1.1 million as it realized certain currency translation gains due to substantial liquidation of certain of its foreign subsidiaries during the period. This was offset by income tax benefits from losses incurred in other foreign jurisdictions and the reversal of foreign taxes reserves.

The Company continues to monitor the status of its NOLs, which may be used to offset future taxable income. If the Company underwent an ownership change, the NOLs would be subject to an annual limit on the amount of the taxable income that may be offset by its NOLs generated prior to the ownership change and additionally, the Company may be unable to use a significant portion of its NOLs to offset taxable income. The Company has adopted a tax benefits preservation plan with the intention of reducing the likelihood of an ownership change. However, the Company cannot ensure that this plan will be effective in deterring all transfers of the Company's common stock that could result in such an ownership change. Additionally, if stockholders holding a majority of the Company's outstanding shares of common stock do not approve the plan prior to the final adjournment of the Company's 2012 Annual Meeting of Stockholders, the plan will expire. For details regarding the Company's NOL carryforwards prior to the three-month period ended March 31, 2012, please refer to Note 14 of the Notes to Financial Statements included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

As of March 31, 2012, the Company's total gross unrecognized tax benefits were $29.9 million, of which $9.2 million, if recognized, would affect the effective tax rate. There have been no material changes to the Company's total gross unrecognized tax benefits from December 31, 2011.

The Company is subject to U.S. federal income tax as well as income taxes in many U.S. states and foreign jurisdictions in which the Company operates or formerly operated. As of March 31, 2012, fiscal years 2004 onward remained open to examination by the U.S. taxing authorities and fiscal years 1999 onward remained open to examination in various foreign jurisdictions. U.S. tax attributes generated in fiscal years 1999 onward also remain subject to adjustment in subsequent audits when they are utilized.

The calculation of unrecognized tax benefits involves dealing with uncertainties in the application of complex global tax regulations. Management regularly assesses the Company's tax positions in light of legislative, bilateral tax treaty, regulatory and judicial developments in the countries in which the Company conducts or formerly conducted business. Management believes that it is not reasonably possible that the gross unrecognized tax benefits will change significantly within the next 12 months; however, tax audits remain open and the outcome of any tax audits are inherently uncertain, which could change this judgment in any given quarter.

Liquidity and Capital Resources

Key Components of Cash Flows

Working Capital: Our principal source of liquidity is cash, cash equivalents, and marketable securities on hand. We focus on managing the critical components of working capital, which include payables and short-term debt. Our working capital at March 31, 2012 and December 31, 2011 was $275.4 million and $324.1 million, respectively. The decrease in working capital of $48.7 million at March 31, 2012 compared to December 31, 2011 was primarily attributable to the acquisition of the business and assets of Well Services for $48.1 million on February 9, 2012.

Operating Activities: Net cash used by operating activities was $3.5 million in the three-month period ended March 31, 2012, compared to $1.5 million in the same period of fiscal 2011. This difference is primarily the result of the $2.5 million gain on the release of foreign currency translation in the fiscal 2011 period. In addition, we have more operating assets and liabilities in the current period compared to the fiscal 2011 period due to our return to operating businesses with our sports-related and oilfield services reporting segments, which did not exist in the corresponding three-month period of fiscal 2011.

Investing Activities: Net cash provided by investing activities decreased to $40.5 million for the three-month period ended March 31, 2012, compared to $54.4 million for the same period of fiscal 2011. Purchases of marketable securities used cash of $198.6 million and $98.3 million for the fiscal 2012 and 2011 periods, respectively. Sales of marketable securities provided cash of $261.3 million and $114.0 million for the fiscal 2012 and 2011 periods, respectively. However, this was partially offset in the fiscal 2012 period by the acquisition of the business and assets of Well Services for $48.1 million. We continue to manage our cash through interest-bearing accounts.

Financing Activities: We had no financing activities for both three-month periods ended March 31, 2012 and April 1, 2011.

Liquidity Requirements

At March 31, 2012, we had $269.4 in cash, cash equivalents and marketable securities, of which approximately $1.7 million was held by our foreign subsidiaries whose functional currency is the local currency. Our available-for-sale securities included short-term deposits, corporate obligations, United States government securities, and government agencies, and were recorded on our Condensed Balance Sheets at fair market value, with their related unrealized gain or loss reflected as a component of "Accumulated other comprehensive income, net of taxes" in shareholders' equity.

In the three-month periods ended March 31, 2012 and April 1, 2011, we did not recognize a material loss on our securities as the unrealized losses incurred were not deemed to be other-than-temporary. We hold our marketable securities as available-for-sale and mark them to market. We expect to realize the full value of all our marketable securities upon maturity or sale, as we have the intent and ability to hold the securities until the full value is realized. However, we cannot provide any assurance that our invested cash, cash equivalents and marketable securities will not be impacted by adverse conditions in the financial markets, which may require us to record an impairment charge that could adversely impact our financial results.

In addition, we maintain our cash, cash equivalents and marketable securities with certain financial institutions, in which our balances exceed the limits that are insured by the Federal Deposit Insurance Corporation. If the underlying financial institutions fail or other adverse conditions occur in the financial markets, our cash balances may be impacted.

In the future, we may make additional acquisitions of businesses, and we may be required to use a significant portion of our available cash balances for such acquisitions or for working capital needs thereafter. Net accounts receivable were $11.5 million and $4.7 million at March 31, 2012 and December 31, 2011, respectively. The increase of $6.8 million is primarily due to the recent acquisition of Well Services and increased revenues from our other oilfield services business, Rogue Pressure Services, LLC. We believe our receivables are ultimately collectible or recoverable, net of certain reserves, and that aggregate allowances for doubtful accounts are adequate.

We have invested in technology companies through two venture capital funds, Pacven Walden Ventures V Funds and APV Technology Partners II, L.P. At March 31, 2012 and December 31, 2011, the carrying value of such investments aggregated $1.1 million for both periods, which were based on quarterly statements we receive from each of the funds. The statements are generally received one quarter in arrears, as more timely valuations are not practical. The statements reflect the net asset value, which we use to determine the fair value for these investments, which (a) do not have a readily determinable fair value and (b) either have the attributes of an investment company or prepare their financial statements consistent with the measurement principles of an investment company. The assumptions we use due to lack of observable inputs may impact the fair value of these equity investments in future periods. While we have seen some improvement in global economic conditions, any adverse changes in equity investments and current market conditions may require us to record an impairment charge against all or a portion of these equity investments in the future.

We believe that our cash balances will be sufficient to satisfy our anticipated cash needs for working capital and capital expenditures for at least the next 12 months. The consummation of multiple acquisitions in fiscal 2011 and the anticipation of additional acquisitions in the future, prevailing economic conditions and/or financial, business and other factors beyond our control could adversely affect our estimates of our future cash requirements. As such, we could be required to fund our cash requirements by alternative financing. In these instances, we may seek to raise such additional funds through public or private equity or debt financings or from other sources. As a result, we may not be able to obtain adequate or favorable equity financing, if needed, due in part to our shares of common stock currently trading on the OTCQB Market. Any equity financing we obtain may dilute existing ownership interests, and any debt financing could contain covenants that impose limitations on the conduct of our business. There can be no assurance that additional financing, if needed, would be available on terms acceptable to us or at all.

Commitments and Contingencies

Legal Proceedings

The information contained under the heading, "Legal Proceedings," set forth under Part II, Item 1 of this Quarterly Report on Form 10-Q is incorporated herein by reference.

Contractual Obligations

Through our recent acquisitions, we assumed leases of property with the following non-cancelable obligations:

	Amount (in thousands)
For the year ended December 31:	
2012 (remaining nine months)	$452
2013	457
2014	431
2015	431
2016	425
	$2,196

Recent Accounting Pronouncements

Effective January 1, 2012, we adopted the provisions of Accounting Standards Update, or ASU, No. 2011-05, Comprehensive Income (Topic 220) Presentation of Comprehensive Income, or ASU No. 2011-05, and began presenting the total of comprehensive income, the components of net income and the components of other comprehensive income in two separate but consecutive statements. The provisions of ASU No. 2011-05 are required to be adopted retroactively. As this guidance provides only presentation requirements, the adoption of this standard did not impact our results of operations, cash flows, or financial position.

There were no additional accounting pronouncements recently issued in the three-month period ended March 31, 2012, which are applicable to us or may be considered material to us. For a complete discussion of the impact of recent accounting pronouncements, please refer to Note 2 of the Notes to Consolidated Financial Statements included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

Critical Accounting Policies

Our critical accounting policies have not changed from those presented in the Management's Discussion and Analysis of Financial Condition and Results of Operations – Critical Accounting Policies in our Annual Report on Form 10-K for our fiscal year ended December 31, 2011.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

For financial market risks related to changes in interest rates, equity price, and foreign currency exchange rates, reference is made to "Item 7A Quantitative and Qualitative Disclosures about Market Risk" contained in Part II of our Annual Report on Form 10-K for our fiscal year ended December 31, 2011. Our exposure to market risk has not changed materially since December 31, 2011.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Under the supervision and with the participation of our management, including our Interim Chief Executive Officer, or Interim CEO, and our Chief Financial Officer, or CFO, we conducted an evaluation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act), as of the end of the period covered by this Quarterly Report on Form10-Q. Based upon that evaluation, our Interim CEO and our CFO have concluded that the design and operation of our disclosure controls and procedures were effective to provide reasonable assurance that the information required to be disclosed by us in reports that we file or submit under the Exchange Act (i) is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission, or SEC, rules and forms and (ii) is accumulated and communicated to our management, including our Interim CEO and CFO, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

There has been no change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that occurred during the three-month period ended March 31, 2012, which was the period covered by this Quarterly Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Inherent Limitations on Effectiveness of Controls

A control system, no matter how well conceived and operated, can only provide reasonable assurance that the objectives of the control system are met. Because of these inherent limitations, no evaluation of our disclosure controls and procedures or our internal control over financial reporting will provide absolute assurance that misstatements due to error or fraud will not occur.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

From time to time, we may be a party in legal actions in various U.S. and foreign jurisdictions, arising from the normal course of business. In the opinion of management, such legal actions are not expected to have a material adverse effect on our financial condition or results of operations.

Item 1A. Risk Factors

Our business faces significant risks. The risks described in "Item 1A. Risk Factors" in our Annual Report on Form 10-K for our fiscal year ended December 31, 2011, may not be the only risks we face. Additional risks that we do not yet know of or that we currently think are immaterial may also impair our results of operations and financial condition. If any of the events or circumstances described in our Annual Report on Form 10-K for our fiscal year ended December 31, 2011 actually occurs, our business, financial condition, or results of operations could suffer, and the trading price of our common stock could decline.

Item 6. Exhibits

31.1*	Certification of the Principal Executive Officer, John J. Quicke, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2*	Certification of the Principal Financial Officer, Mark. A. Zorko, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1*	Certifications of the Principal Executive Officer, John J. Quicke, and the Principal Financial Officer, Mark A. Zorko, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS**	XBRL Instance Document.
101.SCH**	XBRL Taxonomy Extension Schema Document.
101.CAL**	XBRL Taxonomy Extension Calculation Linkbase Document.
101.DEF**	XBRL Taxonomy Extension Definition Linkbase Document.
101.LAB**	XBRL Taxonomy Extension Label Linkbase Document.
101.PRE**	XBRL Taxonomy Extension Presentation Linkbase Document.

* Filed herewith.
** Furnished with this Form 10-Q. In accordance with Rule 406T of Regulation S-T, the interactive data files on Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for the purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under these sections.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned hereunto duly authorized.

Steel Excel Inc.

By:	/s/ John J. Quicke John J. Quicke Interim President and Chief Executive Officer (principal executive officer)	Date: May 10, 2012
By:	/s/ Mark A. Zorko Mark A. Zorko Chief Financial Officer (principal financial officer)	Date: May 10, 2012

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