NEVRO CORP
Form 10-Q
November 07, 2016
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2016

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
Commission File Number: 001-36715

Nevro Corp.

(Exact name of registrant as specified in its charter)

Delaware	56-2568057
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

1800 Bridge Parkway

Redwood City, CA

(Address of principal executive offices)

94065

(Zip Code)

(650) 251-0005

(Registrant’s telephone number, including area code)

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See 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

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

As of October 31, 2016 there were 28,765,282 shares of the registrant’s common stock, par value $0.001 per share, outstanding.

Nevro Corp.

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PART I—FINANCIAL INFORMATION

Item 1. Condensed Consolidated Financial Statements

Nevro Corp.

Condensed Consolidated Balance Sheets

(unaudited)

(in thousands, except share and per share data)

	September 30, 2016	December 31, 2015
Assets		
Current assets		
Cash and cash equivalents	$ 42,733	$ 87,036
Short-term investments	245,226	106,634
Accounts receivable, net of allowance for doubtful accounts of $678 and $122 at September 30, 2016 and December 31, 2015, respectively	40,837	22,522
Inventories	73,367	62,430
Prepaid expenses and other current assets	6,776	4,009
Total current assets	408,939	282,631
Property and equipment, net	7,607	5,794
Other assets	2,409	1,852
Restricted cash	906	906
Total assets	$ 419,861	$ 291,183
Liabilities and stockholders' equity		
Current liabilities		
Accounts payable	$ 13,105	$ 21,887
Accrued liabilities	21,383	14,381
Other current liabilities	77	121
Total current liabilities	34,565	36,389
Long-term debt	136,496	19,740
Other long-term liabilities	1,071	462
Total liabilities	172,132	56,591
Commitments and contingencies (Note 5)		
Stockholders' equity		
Preferred stock, $0.001 par value, 10,000,000 shares authorized at September 30, 2016 and December 31, 2015; zero shares issued and outstanding at September 30, 2016 and December 31, 2015	—	—
Common stock, $0.001 par value, 290,000,000 shares authorized at September 30, 2016 and December 31, 2015; 28,611,806 and 28,143,573 shares issued and	29	28

outstanding at September 30, 2016 and December 31, 2015, respectively		
Additional paid-in capital	459,978	424,147
Accumulated other comprehensive loss	(917)	(175)
Accumulated deficit	(211,361)	(189,408)
Total stockholders' equity	247,729	234,592
Total liabilities and stockholders' equity	$ 419,861	$ 291,183

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

Nevro Corp.

Condensed Consolidated Statements of Operations and Comprehensive Loss

(unaudited)

(in thousands, except share and per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Revenue	$60,922	$15,402	$157,973	$36,482
Cost of revenue	19,235	5,968	53,741	15,349
Gross profit	41,687	9,434	104,232	21,133
Operating expenses				
Research and development	7,923	5,247	22,453	15,508
Sales, general and administrative	35,636	21,896	98,591	54,848
Total operating expenses	43,559	27,143	121,044	70,356
Loss from operations	(1,872)	(17,709)	(16,812)	(49,223)
Interest income	556	185	1,066	399
Interest expense	(2,381)	(739)	(3,995)	(2,093)
Other income (expense), net	259	(922)	96	(1,757)
Loss on extinguishment of debt	—	—	(1,268)	—
Loss before income taxes	(3,438)	(19,185)	(20,913)	(52,674)
Provision for income taxes	448	269	1,040	566
Net loss	(3,886)	(19,454)	(21,953)	(53,240)
Other comprehensive loss:				
Changes in foreign currency translation adjustment	(100)	(188)	(446)	(191)
Changes in unrealized losses on short-term investments, net	(507)	(89)	(296)	(4)
Net change in other comprehensive loss	(607)	(277)	(742)	(195)
Comprehensive Loss	$(4,493)	$(19,731)	$(22,695)	$(53,435)
Net loss per share, basic and diluted	$(0.14)	$(0.70)	$(0.77)	$(2.04)
Weighted average number of common shares used to compute basic and diluted net loss per share	28,542,760	27,861,523	28,373,430	26,102,679

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

Nevro Corp.

Condensed Consolidated Statements of Cash Flows

(unaudited)

(in thousands)

	Nine Months Ended September 30,	
	2016	2015
Cash flows from operating activities		
Net loss	$(21,953)	$(53,240)
Adjustments to reconcile net loss to net cash used in operating activities		
Depreciation and amortization	1,234	287
Stock-based compensation expense	10,428	5,083
Accretion of discount on short-term investments	(148)	(324)
Non-cash loss on extinguishment of debt	1,156	—
Payment of original issue discount	(1,500)	—
Provision for doubtful accounts	562	58
Write-down of inventory	2,759	2,071
Non-cash interest expense	2,037	179
Unrealized losses on foreign currency transactions	939	—
Changes in operating assets and liabilities		
Accounts receivable	(19,249)	(4,338)
Inventories	(13,997)	(29,542)
Prepaid expenses and other current assets	(2,837)	(646)
Other assets	(557)	(1,483)
Accounts payable	(8,928)	7,994
Accrued liabilities	6,583	3,851
Other long-term liabilities	610	41
Net cash used in operating activities	(42,861)	(70,009)
Cash flows from investing activities		
Purchases of short-term investments	(266,839)	(127,924)
Proceeds from maturity of short-term investments	128,100	144,772
Changes in restricted cash	—	(606)
Purchases of property and equipment	(2,414)	(4,310)
Net cash provided by (used in) investing activities	(141,153)	11,932
Cash flows from financing activities		
Proceeds from issuance of common stock in underwritten public offering	—	118,440
Proceeds from issuance of convertible notes	172,500	—
Convertible notes initial issuance discount and debt issuance costs	(6,171)	—
Proceeds from issuance of warrants	33,120	—
Purchase of convertible note hedges	(45,092)	—
Repayment of debt	(19,500)	—
Proceeds from issuance of common stock from stock option exercises	5,234	2,145
Net cash provided by financing activities	140,091	120,585
Effect of exchange rate changes on cash and cash equivalents	(380)	(237)
Net increase (decrease) in cash and cash equivalents	(44,303)	62,271

Cash and cash equivalents		
Cash and cash equivalents at beginning of period	87,036	25,287
Cash and cash equivalents at end of period	$42,733	$87,558
Significant non-cash transactions		
Purchases of property and equipment in accounts payable	$1,385	$1,016
Vesting of early-exercised stock options	$40	$39

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

Nevro Corp.

Notes to Condensed Consolidated Financial Statements

(unaudited)

1. Formation and Business of the Company

Nevro Corp. (the Company) was incorporated in Minnesota on March 10, 2006 to manufacture and market innovative active implantable medical devices for the treatment of neurological disorders initially focusing on the treatment of chronic pain. Subsequently, the Company was reincorporated in Delaware on October 4, 2006 and relocated to California.

Since inception, the Company has incurred net losses and negative cash flows from operations. During the year ended December 31, 2015, the Company incurred a net loss of $67.4 million and used $100.4 million of cash in operations. For the nine months ended September 30, 2016, the Company incurred a net loss of $22.0 million and used $42.9 million of cash in operations. At September 30, 2016 and December 31, 2015, the Company had an accumulated deficit of $211.4 million and $189.4 million, respectively. The Company has financed operations to date primarily through private placements of equity securities, borrowings under a debt agreement, the issuance of common stock in its November 2014 initial public offering, its June 2015 underwritten public offering and its June 2016 underwritten public offering of convertible senior notes due 2021. The Company's ability to continue to meet its obligations and to achieve its business objectives for the foreseeable future is dependent upon, amongst other things, generating sufficient revenues and its ability to continue to control expenses. Failure to increase sales of its products, manage discretionary expenditures or raise additional financing, if required, may adversely impact the Company's ability to achieve its intended business objectives.

The accompanying interim condensed consolidated financial statements as of September 30, 2016 and for the nine months ended September 30, 2016 and 2015, and the related interim information contained within the notes to the financial statements, are unaudited. The unaudited interim condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States (U.S. GAAP) for interim financial information and on the same basis as the audited financial statements filed included on the Company's Annual Report on Form 10-K (Annual Report) filed with the Securities and Exchange Commission (SEC) on February 29, 2016. In the opinion of management, the accompanying unaudited interim condensed consolidated financial statements contain all adjustments (consisting of normal recurring adjustments) necessary to state fairly the Company's financial position as of September 30, 2016, and the results of its operations and cash flows for the nine months ended September 30, 2016 and 2015. All such adjustments are of a normal and recurring nature. The interim financial data as of September 30, 2016 is not necessarily indicative of the results to be expected for the year ending December 31, 2016, or for any future period.

The accompanying condensed consolidated financial statements and related financial information should be read in conjunction with the audited consolidated financial statements and the related notes thereto for the year ended December 31, 2015 included in the Annual Report.

2. Summary of Significant Accounting Policies

Basis of Presentation

These condensed consolidated financial statements have been prepared in accordance with U.S. GAAP. The condensed consolidated financial statements include the Company's accounts and those of its wholly-owned subsidiaries. All intercompany accounts and transactions have been eliminated.

Segments

The chief operating decision maker for the Company is the Chief Executive Officer. The Chief Executive Officer reviews financial information presented on a consolidated basis, accompanied by information about revenue by geographic region, for purposes of allocating resources and evaluating financial performance. The Company has one business activity and there are no segment managers who are held accountable for operations, operating results or plans for levels or components below the consolidated unit level. Accordingly, the Company has determined that it has a single reportable and operating segment structure. The Company and its Chief Executive Officer evaluate performance based primarily on revenue in the geographic locations in which the Company operates.

Historically, the Company derived most of its revenue from sales to customers in Australia and Europe. In May 2015, the U.S. Food and Drug Administration (FDA) approved the Company's premarket approval (PMA) application to market Senza in the United States and the Company launched sales in the United States in 2015. Revenue by geography is based on the billing address of the

customer. The following table sets forth, by geographic area, those countries with revenue accounting for more than 10% of the total revenue in any of the periods presented:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
United States	78 %	29 %	74 %	12 %
Australia	*	24 %	*	27 %
United Kingdom	*	15 %	*	17 %
Germany	*	14 %	*	17 %

* Represents less than 10%

Long-lived assets located outside the United States are not material; therefore, disclosures have been limited to revenue.

Foreign Currency Translation

The Company's consolidated financial statements are prepared in U.S. dollars (USD). Its foreign subsidiaries use their local currency as their functional currency and maintain their records in the local currency. Accordingly, the assets and liabilities of these subsidiaries are translated into USD using the current exchange rates in effect at the balance sheet date and equity accounts are translated into USD using historical rates. Revenues and expenses are translated using the monthly average exchange rates during the period when the transaction occurs. The resulting foreign currency translation adjustments from this process are recorded in accumulated other comprehensive income (loss) on the consolidated balance sheets.

Unrealized foreign exchange gains and losses from the remeasurement of assets and liabilities denominated in currencies other than the functional currency of the reporting entity are recorded in other income (expense), net. Additionally, realized gains and losses resulting from transactions denominated in currencies other than the local currency are recorded in other income (expense), net in the condensed consolidated statements of operations. The Company recorded net unrealized and net realized foreign currency transaction gains (losses) during the periods presented as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net unrealized foreign currency gains (losses)	$615	$293	$(663)	$958
Net realized foreign currency gains (losses)	(310)	(1,170)	918	(2,576)

As the Company's international operations grow, its risks associated with fluctuations in currency rates will become greater, and the Company will continue to reassess its approach to managing this risk. In addition, currency fluctuations or a weakening USD can increase the costs of the Company's international expansion. To date, the Company has not entered into any foreign currency hedging contracts. Based on its current international structure, the

Company does not plan on engaging in hedging activities in the near future.

Use of Estimates

The preparation of financial statements in accordance with U.S. GAAP requires management to make estimates and assumptions that affect the amounts reported in the condensed consolidated financial statements and accompanying notes. Significant accounting estimates and management judgments reflected in the condensed consolidated financial statements include items such as allowances for doubtful accounts; clinical accruals; stock-based compensation; depreciation and amortization periods; inventory valuation; and valuation of investments and deferred tax assets, including valuation allowances. Estimates are based on historical experience, where applicable, and other assumptions believed to be reasonable by the management. Actual results may differ from those estimates under different assumptions or conditions.

Concentration of Credit Risk and Other Risks and Uncertainties

Financial instruments that potentially subject the Company to a concentration of credit risk consist of cash, cash equivalents and investments. The majority of the Company’s cash is held by one financial institution in the United States in excess of federally insured limits. The Company maintained investments in money market funds that were not federally insured during the periods ended September 30, 2016 and December 31, 2015. The Company also held cash in foreign banks of approximately $4.0 million at September 30, 2016 and $5.2 million at December 31, 2015 that was not federally insured. The Company has not experienced any losses on its deposits of cash and cash equivalents.

Through December 31, 2014, all of the Company's revenue had been derived from sales of its products in international markets, principally Australia and Europe. In May 2015, the Company launched sales in the United States upon receiving FDA approval to market and sell its products in the United States. In the international markets in which the Company participates, the Company uses both a direct sales force and distributors to sell its products, while in the United States the Company utilizes a direct sales force. The Company performs ongoing credit evaluations of its direct customers and distributors, does not require collateral, and maintains allowances for potential credit losses on customer accounts when deemed necessary.

During the three and nine months ended September 30, 2016 and 2015, no single customer accounted for more than 10% of the Company's revenue. As of September 30, 2016 and December 31, 2015, no single customer accounted for more than 10% of the accounts receivable balance.

The Company is subject to risks common to medical device companies, including, but not limited to, new technological innovations, dependence on key personnel, protection of proprietary technology, compliance with government regulations, product liability, manufacturing quality and scaling, continued reimbursement from third-party payors, uncertainty of market acceptance of products and the need to obtain additional financing. The Company is dependent on third-party manufacturers and suppliers, in some cases sole- or single-source suppliers.

There can be no assurance that the Company's products or services will continue to be accepted in its existing marketplaces, nor can there be any assurance that any future products or services can be developed or manufactured at an acceptable cost and with appropriate performance characteristics, or that such products or services will be successfully marketed, if at all.

The Company may choose to raise additional funds to further enhance its research and development efforts, for product expansion opportunities or to acquire a new business or products that are complementary to its business. There can be no assurance that such financing will be available or will be at terms acceptable by the Company.

Fair Value of Financial Instruments

The carrying amounts of certain of the Company's financial instruments, including cash equivalents, short-term investments, accounts receivable, accounts payable and accrued liabilities, approximate fair value due to their relatively short maturities.

Cash and Cash Equivalents

The Company considers all highly-liquid investments purchased with an original maturity of three months or less at the date of purchase to be cash equivalents. Cash and cash equivalents include money market funds in the amount of $24.2 million and $36.6 million as of September 30, 2016 and December 31, 2015, respectively. At September 30, 2016 and December 31, 2015, the Company's cash equivalents were held at institutions in the United States and include deposits in a money market fund which was unrestricted as to withdrawal or use.

Restricted Cash

Restricted cash as of September 30, 2016 and December 31, 2015 consists of a letter of credit of $0.6 million representing collateral for the Company's Redwood City, California building lease pursuant to an agreement dated March 5, 2015 and certificates of deposit of $0.3 million collateralizing payment of charges related to the Company's credit cards.

Investment Securities

The Company classifies its investment securities as available-for-sale. Those investments with maturities of less than 12 months at the date of purchase are considered short-term investments. Those investments with maturities greater than 12 months at the date of purchase are considered long-term investments. The Company's investment securities classified as available-for-sale are recorded at fair value. Unrealized gains and losses, deemed temporary in nature, are reported as a separate component of accumulated comprehensive income (loss).

A decline in the fair value of any security below cost that is deemed other than temporary results in a charge to earnings and the corresponding establishment of a new cost basis for the security. Premiums (discounts) are amortized (accreted) over the life of the related security as an adjustment to yield using the straight-line interest method. Dividend and interest income are recognized when earned. Realized gains and losses are included in earnings and are derived using the specific identification method for determining the cost of securities sold.

Inventories

Inventories are stated at the lower of cost to purchase or manufacture the inventory or the market value of such inventory. Cost is determined using the standard cost method which approximates the first-in, first-out basis. Market value is determined as the lower of replacement cost or net realizable value. The Company regularly reviews inventory quantities in consideration of actual loss experiences, projected future demand and remaining shelf life to record a provision for excess and obsolete inventory when appropriate.

The Company writes down inventory that has become obsolete, inventory that has a cost basis in excess of its expected net realizable value, and inventory that is in excess of expected requirements. The estimate of excess quantities is subjective and primarily dependent on the Company's estimates of future demand for a particular product. If the estimate of future demand is inaccurate based on actual sales, the Company may increase the write down for excess inventory for that component and record a charge to inventory impairment in the accompanying consolidated statements of operations and comprehensive loss. The Company periodically evaluates the carrying value of inventory on hand for potential excess amounts over demand using the same lower of cost or market approach that has been used to value inventory. The Company also periodically evaluates inventory quantities in consideration of actual loss experience. In addition, the Company determines at times that there may be certain inventory that does not meet its product requirements. As a result of these evaluations, the Company recognized total write downs of $1.1 million and $0.5 million for its inventories for the three months ended September 30, 2016 and 2015, respectively, and $2.8 million and $2.1 million for the nine months ended September 30, 2016 and 2015, respectively. The Company's estimation of the future demand for a particular component of the Senza product may vary and may result in changes in estimates of inventory values in any particular period.

Shipping and Handling Costs

Shipping and handling costs are expensed as incurred and are included in cost of revenue.

Revenue Recognition

The Company recognizes revenue when all of the following criteria are met:

- persuasive evidence of an arrangement exists;
- the sales price is fixed or determinable;
- collection of the relevant receivable is reasonably assured at the time of sale; and
- delivery has occurred or services have been rendered.

For a majority of sales, where the Company's sales representative delivers its product at the point of implantation at hospitals or medical facilities, the Company recognizes revenue upon completion of the procedure and authorization, which represents satisfaction of the required revenue recognition criteria. For the remaining sales, which are sent from the Company's distribution centers directly to hospitals and medical facilities, as well as distributor sales, where product is ordered in advance of an implantation procedure and a valid purchase order has been received, the Company recognizes revenue at the time of shipment of the product, which represents the point in time when the customer has taken ownership and assumed the risk of loss and the required revenue recognition criteria are satisfied. The Company's customers are obligated to pay within specified terms regardless of when or if they ever sell or use the products. The Company does not offer rights of return or price protection and it has no post-delivery obligations.

The Company has a limited one to five year warranty to most customers in the markets in which it operates. Estimated warranty obligations are recorded at the time of sale, and warranty costs have not been material to date.

Property and Equipment

Property and equipment are stated at cost less accumulated depreciation and amortization. Depreciation of property and equipment, other than leasehold improvements, is computed using the straight-line method over the assets' estimated useful lives of three to five years. Leasehold improvements are amortized on a straight-line basis over the shorter of the estimated useful life of the asset or the life of the lease. Upon retirement or sale, the cost and related accumulated depreciation are removed from the consolidated balance sheet and the resulting gain or loss, if any, is reflected in operations. Maintenance and repairs are charged to operations as incurred.

Impairment of Long-Lived Assets

The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset might not be recoverable. When such an event occurs, management determines whether there has been impairment

by comparing the anticipated undiscounted future net cash flows to the related asset group's carrying value. If an asset is considered impaired, the asset is written down to fair value, which is based either on discounted cash flows or appraised value, depending on the nature of the asset. There were no impairment charges or changes in estimated useful lives recorded through September 30, 2016.

Income Taxes

During the three and nine months ended September 30, 2016 and 2015, the Company calculated its interim tax provision to record taxes incurred on a discrete basis due to the variability of taxable income in the jurisdictions in which it operates. Additionally, the Company records income taxes using the asset and liability method, which requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been recognized in the Company's condensed consolidated financial statements or income tax returns. In estimating future tax consequences, expected future events other than enactments or changes in the tax law or rates are considered. Valuation allowances are provided when necessary to reduce deferred tax assets to the amount expected to be realized. The provision for income taxes for the three and nine months ended September 30, 2016 and 2015 is primarily comprised of foreign taxes based upon income earned during the period with no tax benefit recorded for the loss jurisdictions.

The Company operates in various tax jurisdictions and is subject to audit by various tax authorities. To date, taxes paid have been predominantly due to income taxes in foreign jurisdictions in which the Company conducts business. The Company provides for tax contingencies whenever it is deemed probable that a tax asset has been impaired or a tax liability has been incurred for events such as tax claims or changes in tax laws. Tax contingencies are based upon their technical merits, relative tax law and the specific facts and circumstances as of each reporting period. Changes in facts and circumstances could result in material changes to the amounts recorded for such tax contingencies.

The Company records uncertain tax positions on the basis of a two-step process whereby (1) a determination is made as to whether it is more likely than not that the tax positions will be sustained based on the technical merits of the position and (2) for those tax positions that meet the more-likely-than-not recognition threshold, the Company recognizes the largest amount of tax benefit that is greater than 50% likely to be realized upon ultimate settlement with the related tax authority. The Company's policy is to recognize interest and penalties related to income taxes as a component of income tax expense. No interest or penalties related to income taxes have been recognized in the statements of operations and comprehensive loss for the three and nine months ended September 30, 2016 and 2015.

Comprehensive Income (Loss)

Comprehensive income (loss) represents all changes in the stockholders' equity except those resulting from and distributions to stockholders. The Company's changes in unrealized gains and losses on available-for-sale investment securities and foreign currency translation adjustments represent the components of other comprehensive income (loss) that are excluded from the reported net loss and have been presented in the consolidated statements of operations and comprehensive loss.

Research and Development

Research and development costs, including new product development, regulatory compliance and clinical research, are charged to operations as incurred in the consolidated statements of operations and comprehensive loss. Such costs include personnel-related costs, including stock-based compensation, supplies, services, depreciation, allocated facilities and information services, clinical trial and related clinical manufacturing expenses, fees paid to investigative sites and other indirect costs.

Stock-Based Compensation

The Company accounts for stock-based compensation arrangements with employees in accordance with Accounting Standards Codification (ASC) 718, Compensation - Stock Compensation. ASC 718 requires the recognition of compensation expense, using a fair value-based method, for costs related to all share-based payments including stock options.

The Company's determination of the fair value of stock options on the date of grant utilizes the Black-Scholes option-pricing model and is impacted by its common stock price as well as changes in assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to, expected term that options will remain outstanding, expected common stock price volatility over the term of the option awards, risk-free interest rates and expected dividends.

The fair value is recognized over the period during which an optionee is required to provide services in exchange for the option award, known as the requisite service period (usually the vesting period) on a straight-line basis. Stock-based compensation expense recognized at fair value includes the impact of estimated forfeitures. The Company estimates future forfeitures at the date of grant and revises the estimates, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

Equity instruments issued to non-employees are recorded at their fair value on the measurement date and are subject to periodic adjustments as the underlying equity instruments vest. The fair value of options granted to consultants is expensed when vested. The non-employee stock-based compensation expense was not material for all periods presented.

Estimating the fair value of equity-settled awards as of the grant date using valuation models, such as the Black-Scholes option pricing model, is affected by assumptions regarding a number of complex variables. Changes in the assumptions can materially affect the fair value and ultimately how much stock-based compensation expense is recognized. These inputs are subjective and generally require significant analysis and judgment to develop. For all stock options granted to date, the Company estimated the volatility data based on a study of publicly traded industry peer companies. For purposes of identifying these peer companies, the Company considered the industry, stage of development, size and financial leverage of potential comparable companies. The risk-free interest rate is based on the yield available on U.S. Treasury zero-coupon issues similar in duration to the expected term of the equity-settled award.

The Company accounts for stock-based compensation for the restricted stock units at their fair value, based on the closing market price of the Company's common stock on the grant date. These costs are recognized on a straight-line basis over the requisite service period, which is generally the vesting term of four years.

The Company also issues stock options and restricted stock units with vesting based upon completion of performance goals. The fair value for these performance based awards is recognized over the period during which the goals are to be achieved. Stock-based compensation expense recognized at fair value includes the impact of estimated probability that the goals would be achieved, which is assessed prior to the requisite service period for the specific goals.

The Company recognizes a benefit from stock-based compensation as additional paid-in capital if an incremental tax benefit is realized by following the with-and-without approach.

Net Loss per Share of Common Stock

Basic net loss per common share is calculated by dividing the net loss by the weighted average number of common shares outstanding during the period, without consideration for potentially dilutive securities. Diluted net loss per share is computed by dividing the net loss by the weighted average number of common shares and potentially dilutive securities outstanding for the period. For purposes of the diluted net loss per share calculation, the Company's restricted stock units and common stock options are considered to be potentially dilutive securities. Because the Company has reported a net loss in all periods presented, diluted net loss per common share is the same as basic net loss per common share for those periods.

Recent Accounting Pronouncements

In July 2015, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2015-11, Inventory (Topic 330): Simplifying the Measurement of Inventory, which permits companies to measure inventory at the lower of cost and realizable value. ASU 2015-11 applies to all business entities and is effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2016. Early adoption is permitted. The Company has not determined the potential effects of ASU 2015-11 on its consolidated financial statements.

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606), which supersedes the revenue recognition requirements in ASC 605, Revenue Recognition. This ASU is based on the principle that revenue is recognized to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The ASU also requires additional disclosure about the nature, amount, timing and uncertainty of revenue and cash flows arising from

customer contracts, including significant judgments and changes in judgments and assets recognized from costs incurred to obtain or fulfill a contract. In August 2015, FASB issued ASU No. 2015-14, Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date, which effectively delayed the adoption date by one year, to an effective date for public entities for annual and interim periods beginning after December 15, 2017. In April 2016, FASB issued ASU No. 2016-10, Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing, which clarifies the aspects of Topic 606 that relates to identifying performance obligations and licensing implementation guidance. In May 2016, the FASB issued ASU No. 2016-12, Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients, related to disclosures of remaining performance obligations, as well as other amendments to guidance on collectability, non-cash consideration and the presentation of sales and other similar taxes collected from customers. The effective dates of ASU 2016-10 and ASU 2016-12 are the same as that of ASU 2014-09. The Company has not determined the potential effects of the guidance on its consolidated financial statements, nor has it selected the transition method.

In August 2014, the FASB issued ASU No. 2014-15, Disclosure of Uncertainties About an Entity’s Ability to Continue as a Going Concern. The new standard provides guidance around management’s responsibility to evaluate whether there is substantial

doubt about an entity's ability to continue as a going concern and to provide related footnote disclosures. The new standard is effective for fiscal years, and interim periods within those fiscal years, ending after December 15, 2016. Early adoption is permitted. The adoption of this standard is not expected to have a material impact on the Company's consolidated financial statements.

In January 2016, the FASB issued ASU 2016-01, Recognition and Measurement of Financial Assets and Financial Liabilities, which addresses certain aspects of recognition, measurement, presentation and disclosure of financial instruments. ASU 2016-01 is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2017. The Company has not determined the potential effects of this ASU on its consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842). This update requires an entity to recognize assets and liabilities for leases with lease terms of more than 12 months on the balance sheet. ASU 2016-02 is effective for public entities for fiscal years beginning after December 15, 2018. The Company has not determined the potential effects of the guidance on its consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-09, Compensation-Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting. This update simplifies the accounting for employee share-based payment transactions, including the accounting for income taxes, forfeitures and statutory tax withholding requirements, as well as classification in the statement of cash flows. ASU 2016-09 is effective for public entities for annual periods beginning after December 15, 2016. The Company has not determined the potential effects of the guidance on its consolidated financial statements.

In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. This update changes the accounting for recognizing impairments of financial assets, such that credit losses for certain types of financial instruments will be estimated based on expected losses. The update also modifies the impairment models for available-for-sale debt securities and for purchased financial assets with credit deterioration since their origination. ASU 2016-13 is effective for public entities for annual periods beginning after December 15, 2019. Early adoption is permitted after December 15, 2018. The Company has not determined the potential effects of this ASU on its consolidated financial statements.

In August, 2016, the FASB issued ASU No. 2016-15, Classification of Certain Cash Receipts and Cash Payments (a consensus of the Emerging Issues Task Force). The update clarifies the classification of certain cash receipts and cash payments in the statement of cash flows, including debt prepayment or extinguishment costs, settlement of contingent consideration arising from a business combination, insurance settlement proceeds and distributions from certain equity method investees. ASU 2016-15 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. Early adoption is permitted. The Company has not determined the potential effects of the guidance on its consolidated financial statements.

In October 2016, the FASB issued ASU No. 2016-16, Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other than Inventory. This update is intended to reduce the complexity and diversity in practice related to the tax consequences of certain types of intra-entity asset transfers. Under this ASU, a selling entity is required to recognize a current tax expense or benefit upon the transfer of the asset. Similarly, the purchasing entity is required to recognize a deferred tax asset or liability, as well as the related deferred tax benefit or expense, upon receipt of the asset. This ASU does not apply to intra-entity transfers of inventory, where the income tax consequences from the sale of inventory from one member of a consolidated entity to another will continue to be deferred until the inventory is sold to a third party. ASU 2016-16 is effective for public entities for annual periods beginning after December 15, 2017, and interim periods within those annual periods. Early adoption is permitted. The Company has not determined the potential effects of the guidance on its consolidated financial statements.

3. Fair Value Measurements

Fair value is defined as the exchange price that would be received for an asset or an exit price 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. Valuation techniques used to measure fair value must maximize the use of observable inputs and minimize the use of unobservable inputs.

The fair value hierarchy defines a three-level valuation hierarchy for disclosure of fair value measurements as follows:

- Level 1—Observable inputs, such as quoted prices in active markets for identical assets or liabilities.
- Level 2—Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, 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.
- Level 3—Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

Cash Equivalents and Short-Term Investments

The Company's cash equivalents are comprised of investments in money market funds that are classified as Level 1 of the fair value hierarchy and commercial paper and corporate notes that are classified as Level 2 in the fair value hierarchy. To value its money market funds, the Company values the funds at $1 stable net asset value, which is the market pricing convention for identical assets that the Company has the ability to access. The Company's short-term investments are comprised of commercial paper and U.S. government agency obligations. All short-term investments have been classified within Level 1 or Level 2 of the fair value hierarchy because of the sufficient observable inputs for revaluation. The Company's Level 2 investments are valued using third-party pricing sources. The pricing services utilize industry-standard valuation models, including both income and market-based approaches, for which all significant inputs are observable, either directly or indirectly, to estimate fair value. These inputs include reported trades of and broker/dealer quotes on the same or similar investments, issuer credit spreads, benchmark investments, prepayment/default projections based on historical data and other observable inputs. The following table sets forth the Company's financial instruments that were measured at fair value on a recurring basis by level within the fair value hierarchy (in thousands):

Balance as of September 30, 2016	Level 1	Level 2	Level 3	Total
Assets:				
Money market funds (i)	$24,185	$—	$ —	$24,185
Commercial paper (iii)	—	171,258	—	171,258
Corporate notes (iii)	—	73,969	—	73,969
Total assets	$24,185	$245,227	$ —	$269,412

Balance as of December 31, 2015	Level 1	Level 2	Level 3	Total
Assets:				
Money market funds (i)	$36,559	$—	$ —	$36,559
Commercial paper (ii)	—	129,206	—	129,206
Treasury bonds (iii)	10,617	—	—	10,617
Total assets	$47,176	$129,206	$ —	$176,382

(i) Included in cash and cash equivalents on the condensed consolidated balance sheets.
(ii) Included in either cash and cash equivalents or short-term investments on the condensed consolidated balance sheets.
(iii) Included in short-term investments on the condensed consolidated balance sheets.

Convertible Senior Notes

As of September 30, 2016, the fair value of the 1.75% convertible senior notes due 2021 was $225.1 million. The fair value was determined on the basis of market prices observable for similar instruments and is considered Level 2 in the fair value hierarchy (See Note 6).

4. Balance Sheet Components

Investments

The fair value of the Company's cash equivalents and short-term investments approximates their respective carrying amounts due to their short-term maturity. The following is a summary of the gross unrealized gains and unrealized losses on the Company's investment securities, excluding investments in money market funds (in thousands):

	September 30, 2016			
	Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Aggregate Fair Value
Investment Securities				
Commercial paper	$171,352	$ 9	$ (103)	$171,258
Corporate notes	74,039	2	(72)	73,969
Total securities	$245,391	$ 11	$ (175)	$245,227

	December 31, 2015			
	Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Aggregate Fair Value
Investment Securities				
Commercial paper (i)	$129,075	$ 131	$ —	$129,206
Treasury bonds	10,616	1	—	10,617
Total securities	$139,691	$ 132	$ —	$139,823

(i) Included $33.2 million of commercial paper that is classified as cash and cash equivalents on the consolidated balance sheet.

Realized gains or losses and other-than-temporary impairments, if any, on available-for-sale securities are reported in other income (expense), net as incurred. The cost of securities sold is determined based on the specific identification method. The Company has not recorded any realized gains or losses on its investments during the periods presented.

The contractual maturities of the Company’s investment securities were all within one year as of September 30, 2016 and December 31, 2015.

Inventories (in thousands)

	September 30, 2016	December 31, 2015
Raw materials	$ 32,132	$ 37,096
Finished goods	41,235	25,334
Total inventories	$ 73,367	$ 62,430

Property and Equipment, Net (in thousands)

	September 30, 2016	December 31, 2015
Laboratory equipment	$ 1,718	$ 921
Computer equipment and software	2,329	1,836
Furniture and fixtures	2,050	1,752
Leasehold improvements	1,213	1,188
Construction in process	2,233	799
Total	9,543	6,496
Less: Accumulated depreciation and amortization	(1,936)	(702)
Property and equipment, net	$ 7,607	$ 5,794

The Company recognized depreciation and amortization expense on property and equipment as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Depreciation and amortization expense	$ 465	$ 157	$ 1,234	$ 287

Accrued Liabilities (in thousands)

	September 30, 2016	December 31, 2015
Accrued payroll and related expenses	$ 14,260	$ 9,857
Accrued professional fees	745	583
Accrued taxes	2,033	2,044
Accrued clinical and research expenses	642	405
Accrued interest	897	—
Accrued other	2,806	1,492
Total accrued liabilities	$ 21,383	$ 14,381

5. Commitments and Contingencies

Operating Leases

The Company entered into a non-cancellable operating lease effective May 1, 2010 for facilities in Menlo Park, California as amended in 2012 to extend the period of the lease until May 31, 2015. In March 2015, the Company again extended the lease through September 30, 2015, at which time the lease terminated. In August 2014, the Company entered into a new facility lease for warehouse space beginning on August 21, 2014 through May 31, 2015. In March 2015, the Company extended the warehouse lease through February 2017 under which it is obligated to pay approximately $0.3 million in lease payments over the remaining term of the lease.

In March 2015, the Company entered into a lease agreement for approximately 50,000 square feet of office space located in Redwood City, California for a period beginning on June 30, 2015 and ending in May 2022, with initial annual payments of approximately $2.0 million, increasing to $2.4 million annually during the final year of the lease term.

The Company recognized rent expense during the periods indicated as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Rent expense	$ 593	$ 851	$ 1,800	$ 1,260

Contingencies

From time to time, the Company may have certain contingent liabilities that arise in the ordinary course of business activities related to, for example, employment matters and patent issues. The Company accrues a liability for such matters when it is probable that future expenditures will be made and such expenditures can be reasonably estimated. There are no matters which the Company has determined are reasonably possible of materially affecting the Company’s financial position or results of operations.

Indemnification

The Company enters into standard indemnification arrangements in the ordinary course of business. Pursuant to these arrangements, the Company indemnifies, holds harmless and agrees to reimburse the indemnified parties for losses suffered or incurred by the indemnified party, in connection with any trade secret, copyright, patent or other intellectual property infringement claim by any third-party with respect to the Company's technology. The term of these indemnification agreements is generally perpetual. The maximum potential amount of future payments the Company could be required to make under these agreements is not determinable because it involves claims that may be made against the Company in the future, but have not yet been made.

The Company has entered into indemnification agreements with its directors and officers that may require the Company to indemnify its directors and officers against liabilities that may arise by reason of their status or service as directors or officers, other than liabilities arising from willful misconduct of the individual. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited; however, the Company has director and officer insurance coverage that reduces the Company's exposure and enables the Company to recover a portion of any future amounts paid. The Company believes the estimated fair value of these indemnification agreements in excess of applicable insurance coverage is minimal.

The Company has not incurred costs to defend lawsuits or settle claims related to these indemnification agreements. No liability associated with such indemnifications has been recorded to date.

License Agreement

In March 2006, the Company entered into an amended and restated license agreement with the Mayo Foundation for Medical Education and Research (Mayo), and Venturi Group LLC (VGL), which provides the Company access to certain know-how and licensed patents owned by Mayo and VGL for treatment of central, autonomic and peripheral nervous system disorders, including pain, using devices to modulate nerve signaling. The licenses granted are exclusive and the Company has the right to sub-license. The agreement will terminate upon the last to expire patent application, unless terminated earlier. The agreement can be terminated any time by Mayo or VGL.

Per the terms of the license, the Company is required to pay royalties based on the greater of earned royalties or a minimum royalty. The earned royalty is based on a percentage of net sales of licensed products either by the Company or the sub-licensee. The minimum royalty payment is based on royalty periods as defined in the agreement.

In March 2011, the Company entered into a Phase II License Agreement with Mayo which provides the Company access to the certain know-how and licensed patents owned by Mayo. The licenses granted are exclusive and the Company has the right to sub-license.

Per terms of the license, the Company is required to:

- Pay a retainer fee of $40,000 per annum starting March 2011 and ending on February 2013; and
- Pay royalties based on the greater of earned royalties or a minimum royalty. The earned royalties are based on a percentage of net sales of licensed products either by the Company or the sub-licensee. The minimum annual royalty payment is $200,000.

The Company recognized royalty expense during the periods indicated as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Royalty expense	$ 606	$ 153	$ 1,571	$ 363

6. Long-term Debt

1.75% Convertible Senior Notes and Convertible Note Hedge and Warrant Transactions

In June 2016, the Company issued $150.0 million aggregate principal amount of 1.75% convertible senior notes due 2021 in a registered underwritten public offering and an additional $22.5 million aggregate principal amount of such notes pursuant to the exercise in full of the over-allotment options of the underwriters (the 2021 Notes). The interest rates are fixed at 1.75% per annum and are payable semi-annually in arrears on June 1 and December 1 of each year, commencing on December 1, 2016. The total net proceeds from the debt offering, after deducting initial purchase discounts and debt issuance costs, were approximately $166.2 million.

Each $1,000 principal amount of the 2021 Notes will initially be convertible into 10.3770 shares of the Company's common stock, which is equivalent to an initial conversion price of approximately $96.37 per share, subject to adjustment upon the occurrence of specified events. The 2021 Notes will be convertible at the option of the holders at any time prior to the close of business on the business day immediately preceding December 1, 2020, only under the following circumstances: (1) during any calendar quarter commencing after the calendar quarter ending on September 30, 2016 (and only during such calendar quarter), if the last reported sale price of the Company's common stock for at least 20 trading days (whether or not consecutive) during a period of 30 consecutive trading days ending on the last trading day of the immediately preceding calendar quarter is greater than or equal to 130% of the conversion price on each applicable trading day; (2) during the five business day period after any ten consecutive trading day period (the measurement period) in which the trading price (as defined in the indenture to the 2021 Notes) per $1,000 principal amount of notes for each trading day of the measurement period was less than 98% of the product of the last reported sale price of the Company's common stock and the conversion rate on each such trading day; or (3) upon the occurrence of specified corporate events. On or after December 1, 2020 until the close of business on the second scheduled trading day immediately preceding the maturity date, holders may convert their 2021 Notes at any time, regardless of the foregoing circumstances. Upon conversion, the Company will pay or deliver, as the case may be, cash, shares of the Company's common stock or a combination of cash and shares of the Company's common stock, at the Company's election. If the Company undergoes a fundamental change prior to the maturity date, holders of the notes may require the Company to repurchase for cash all or any portion of their notes at a repurchase price equal to 100% of the principal amount of the notes to be repurchased, plus accrued and unpaid interest to, but excluding, the fundamental change repurchase date. In addition, if specific corporate events occur prior to the applicable maturity date, the Company will increase

the conversion rate for a holder who elects to convert their notes in connection with such a corporate event in certain circumstances. It is the Company's current intent and policy to settle conversions through combination settlement with a specified dollar amount per $1,000 principal amount of notes of $1,000. During the three months ended September 30, 2016, the conditions allowing holders of the 2021 Notes to convert have not been met. The 2021 Notes are therefore not convertible during the three months ended September 30, 2016 and are classified as long-term debt. Should the sale price condition be met in a future quarter, the 2021 Notes will be convertible at the holders' option during the immediately following quarter. As of September 30, 2016, the if-converted value of the 2021 Notes did not exceed the principal value of those notes.

In accounting for the issuance of the convertible senior notes, the Company separated the 2021 Notes into liability and equity components. The carrying amount of the liability component was calculated by measuring the fair value of a similar debt instrument that does not have an associated convertible feature. The carrying amount of the equity component representing the conversion option was $32.9 million and was determined by deducting the fair value of the liability component from the par value of the 2021 Notes. The equity component is not remeasured as long as it continues to meet the conditions for equity classification. The excess of the principal amount of the liability component over its carrying amount ("debt discount") is amortized to interest expense over the term of the 2021 Notes expense at an effective interest rate of 6.29% over the contractual terms of the notes.

In accounting for the debt issuance costs of $6.2 million related to the 2021 Notes, the Company allocated the total amount incurred to the liability and equity components of the 2021 Notes based on their relative values. Issuance costs attributable to the liability component were $5.0 million and will be amortized to interest expense using the effective interest method over the contractual terms of the 2021 Notes. Issuance costs attributable to the equity component were netted with the equity component in stockholders' equity.

The net carrying amount of the liability component of the 2021 Notes was as follows (in thousands):

	September 30, 2016
Principal	$ 172,500
Unamortized discount	(31,236)
Unamortized issuance cost	(4,768)
Net carrying amount	$ 136,496

The net carrying amount of the equity component of the 2021 Notes was as follows (in thousands):

	September 30, 2016
Debt discount related to value of conversion option	$ 32,945
Debt issuance cost	(1,179)
Net carrying amount	$ 31,766

The following table sets forth the interest expense recognized related to the 2021 Notes (in thousands):

	Three Months Ended September 30, 2016	Nine Months Ended September 30, 2016
Contractual interest expense	$ 755	$ 898
Amortization of debt discount	1,438	1,710
Amortization of debt issuance costs	188	223
Total interest expense related to the 2021 Notes	$ 2,381	$ 2,831

In connection with the offering of the 2021 Notes, the Company entered into convertible note hedge transactions with certain bank counterparties in which the Company has the option to purchase initially (subject to adjustment for certain specified events) a total of approximately 1.8 million shares of the Company's common stock at a price of approximately $96.37 per share. The total cost of the convertible note hedge transactions was $45.1 million. In addition, the Company sold warrants to certain bank counterparties whereby the holders of the warrants have the option to purchase initially (subject to adjustment for certain specified events) a total of approximately 1.8 million shares of the Company's common stock at a price of $127.28 per share. The Company received $33.1 million in cash proceeds from the sale of these warrants. Taken together, the purchase of the convertible note hedges and the sale of warrants are intended to offset any actual dilution from the conversion of these notes and to effectively increase the overall conversion price from $96.37 to $127.28 per share. As these transactions meet certain accounting criteria, the convertible note hedges and warrants are recorded in stockholders' equity and are not accounted for as derivatives. The net cost of $12.0 million incurred in connection with the convertible note hedge and warrant transactions was recorded as a reduction to additional paid-in capital on the consolidated balance sheet.

Capital Royalty Term Loan

On October 24, 2014, the Company entered into a credit facility (the "credit facility") with Capital Royalty Partners and certain of its affiliates (the "lenders") under which, subject to certain conditions, the Company could enter into three term loan agreements totaling $50.0 million with the lenders on or before September 30, 2015. In June 2016, the Company paid the outstanding principal and repayment fees totaling $21.0 million to the lenders, and the credit facility terminated and is now no longer in effect. Under the credit facility, each term loan was to be paid over 24 quarterly payment periods, with the first payment due on the last day of the calendar quarter during the period for which the term loan was made. The first twelve quarterly payments would be interest only payments, and the last twelve quarterly payments would be equal installments in which interest and principal amounts were paid. Interest would be calculated at a fixed rate of 11.5% per annum. During the interest only period for the first twelve quarterly payments under each term loan, the Company could elect to make the 11.5% interest payment by making a cash payment for the 8.0% per annum of interest and making a payment in kind for the remaining amount, for which the 3.5% per annum of interest would be added to the outstanding principal amount of the loans. The Company chose not to elect the payment in kind option. The final payment would also include an additional amount for closing and repayment fees equivalent to 5% of the term loan agreement. The Company entered into the first term loan for $20.0 million on December 12, 2014, and incurred closing fees of $0.5 million. Under the original agreement, the Company was eligible to enter into a second term loan for a principal amount of $10.0 million on or prior to March 31, 2015 and a third term loan for a principal amount of $20.0 million on or prior to September 30, 2015, in each case, upon meeting certain conditions. In March 2015, the Company entered into a First Amendment under its credit facility with Capital Royalty Partners to extend the draw-down deadline of the second draw from March 31, 2015 to June 29, 2015. In June 2015, the Company entered into a Second Amendment to extend the draw-down deadline of the second draw from June 29, 2015 to September 30, 2015. The Company met the deadline to satisfy certain conditions precedent on or prior to September 30, 2015, such that the interest only period on the first draw was extended so that the outstanding principal amount of the term loans would be payable in a single installment at maturity (the 24th quarterly payment date after the first borrowing). The Company's obligations under the credit facility were collateralized by substantially all of its assets, including its intellectual property.

7. Net Loss Per Share

The following table summarizes the computation of basic and diluted net loss per share (in thousands, except share and per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net loss, basic and diluted	$(3,886)	$(19,454)	$(21,953)	$(53,240)
Weighted average shares outstanding	28,547,789	27,881,302	28,382,147	26,126,145
Less: weighted average shares subject to repurchase	(5,029)	(19,779)	(8,717)	(23,466)
Weighted average shares used to compute basic and diluted net loss per share	28,542,760	27,861,523	28,373,430	26,102,679
Net loss per share, basic and diluted	$(0.14)	$(0.70)	$(0.77)	$(2.04)

Basic net loss per share is computed by dividing the net loss by the weighted average number of common shares outstanding for the period. Diluted net loss per share is computed by dividing the net loss by the weighted average number of common shares and dilutive common stock equivalents outstanding for the period, if inclusion of these is dilutive. Since the Company expects to settle the principal amount of its outstanding convertible senior notes in cash, the Company uses the treasury stock method for calculating any potential dilutive effect of the conversion spread on diluted net income per share, if applicable. The conversion spread will have a dilutive impact on diluted net income per share of common stock when the average market price of the Company's common stock for a given period exceeds the conversion price of $96.37 per share for the 2021 Notes. Because the Company has reported a net loss for all periods presented, diluted net loss per common share is the same as basic net loss per common share for those periods. The following potentially dilutive securities outstanding at the end of the periods presented have been excluded from the computation of diluted shares outstanding, as the effect would be anti-dilutive:

	September 30,	
	2016	2015
Unreleased restricted stock	276,081	—
Options to purchase common stock	2,928,391	2,907,246
Total	3,204,472	2,907,246

8. Employee Benefit Plans

401(k) Plan

In 2007, the Company adopted a 401(k) plan for its employees whereby eligible employees may contribute up to the maximum amount permitted by the Internal Revenue Code. In June 2016, the Company adopted a policy to match a portion of employee contributions for all qualified employees participating in the 401(k) plan.

Employee Stock Purchase Plan

Concurrent with the effectiveness of the Company's registration statement on Form S-1 in November 2014, the Company's 2014 Employee Stock Purchase Plan (ESPP) became effective. The ESPP allows eligible employees to purchase shares of the Company's Class A common stock at a discount through payroll deductions of up to 15% of their eligible compensation, subject to any plan limitations. The ESPP generally provides for six-month offering periods, and at the end of each offering period, employees are able to purchase shares at 85% of the lower of the fair market value of the Company's Class A common stock on the first trading day of the offering period or on the last trading day of the offering period.

Shares of common stock issued under the ESPP were zero and 42,613 for the three and nine months ended September 30, 2016, respectively. No shares of common stock were issued under the ESPP for the three and nine months ended September 30, 2015. Shares available for future purchase under the ESPP were 650,984 at September 30, 2016.

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

You should read the following management's discussion and analysis of our financial condition and results of operations in conjunction with our unaudited condensed consolidated financial statements and notes thereto included in Part I, Item 1 of this Quarterly Report on Form 10-Q (Quarterly Report) and with our audited consolidated financial statements and notes thereto for the year ended December 31, 2015, included in our Annual Report on Form 10-K filed with the U.S. Securities and Exchange Commission (SEC) on February 29, 2016.

Special note regarding forward-looking statements

This report contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those discussed in the forward-looking statements. The statements contained in this report that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the Securities Act), and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act). Forward-looking statements are often identified by the use of words such as, but not limited to, "anticipate," "believe," "can," "continue," "could," "estimate," "expect," "intend," "may," "plan," "project," "seek," "should," "strategy," "t and similar expressions or variations intended to identify forward-looking statements. These statements are based on the beliefs and assumptions of our management based on information currently available to management. Such forward-looking statements are subject to risks, uncertainties and other important factors that could cause actual results and the timing of certain events to differ materially from future results expressed or implied by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those identified below and those discussed in the section titled "Risk Factors" included under Part II, Item 1A below. Furthermore, such forward-looking statements speak only as of the date of this report. Except as required by law, we undertake no obligation to update any forward-looking statements to reflect events or circumstances after the date of such statements.

Overview

We are a medical device company that has developed and commercialized an innovative neuromodulation platform for the treatment of chronic pain. Our Senza system is the only spinal cord stimulation (SCS) system that delivers our proprietary HF10 therapy. On May 8, 2015, our premarket approval (PMA) application for our Senza SCS system (Senza) was approved by the U.S. Food and Drug Administration (FDA). Accordingly, we began U.S. commercialization of the Senza system in May 2015. In order to maintain our PMA approval in the United States, we need to comply with applicable laws and regulations from the FDA and other relevant regulatory agencies. The Senza system received a CE Mark in 2010, and commercialization commenced in Europe in 2010 and Australia in 2011 where the system is reimbursed under existing SCS codes. We market our products to physicians in Europe and Australia and sell to hospitals and outpatient surgery centers through both a direct sales organization and distributors. Beginning in 2010, we established our international sales organizations to support our product launch outside of the United States.

In the second quarter of 2015, we recorded our first commercial sales of Senza in the United States. During 2015, revenue in the United States increased from $53,000 in the second quarter to $4.5 million in the third quarter and $19.8 million in the fourth quarter. Revenue from international sales was $9.7 million, $11.3 million, $10.9 million and $13.3 million for the first, second, third

and fourth quarters of fiscal year 2015, respectively. Our total revenue was $9.7 million, $11.4 million, $15.4 million and $33.1 million for the first, second, third and fourth quarters of fiscal year 2015, respectively. During 2016, revenue in the United States was $29.5 million, $40.6 million and $47.2 million for the first, second and third quarter of the fiscal year, respectively. Revenue from international sales was $12.2 million, $14.8 million and $13.7 million for the first, second and third quarter of fiscal year 2016, respectively. Our total revenue was $41.7 million, $55.4 million and $60.9 million for the first, second and third quarter of fiscal year 2016, respectively.

Our commercial efforts are supported by the results of our SENZA-RCT U.S. pivotal study, which demonstrated the superiority of HF10 therapy over traditional SCS therapies for treating both back and leg pain. While SCS therapy is indicated and reimbursed for treating back and leg pain, it has limited efficacy in back pain and is utilized primarily for treating leg pain, which has limited its market adoption. In our pivotal study, HF10 therapy was demonstrated to provide significant and sustained back pain relief in addition to leg pain relief. We believe we are positioned to transform and grow the approximately $1.7 billion existing global SCS market under current reimbursement by treating back pain in addition to leg pain without causing paresthesia.

Since our inception, we have financed our operations primarily through equity and debt financings and borrowings under a debt facility. Our accumulated deficit as of September 30, 2016 was $211.4 million. A significant amount of our capital resources has been used to support the development of Senza and our HF10 therapy, including, our pivotal clinical trial, SENZA-RCT, and we have also made a significant investment building our U.S. commercial infrastructure and sales force to support our commercialization efforts in the United States. We intend to continue to make significant investments in our U.S. commercial infrastructure, as well as in research and development (R&D) to develop Senza to treat other chronic pain indications, including conducting clinical trials to support our future regulatory submissions. In order to further enhance our research and development efforts, pursue product expansion opportunities or acquire a new business or products that are complementary to our business, we may choose to raise additional funds, which may include future equity and debt financings.

We rely on third-party suppliers for all of the components of Senza and for the assembly of the system. Many of these suppliers are currently single-source suppliers. During 2015 and 2016, we entered into several supply agreements in an effort to reinforce our supply chain. We are also required to maintain high levels of inventory, and, as a result, we are subject to the risk of inventory obsolescence and expiration, which may lead to inventory impairment charges. In particular, we have substantially increased our levels of inventory in order to meet our estimated demand in the United States and, as a result, incur significant expenditures associated with such increases in our inventory. Additionally, as compared to direct manufacturers, our dependence on third-party manufacturers exposes us to greater lead times increasing our risk of inventory obsolesce.

On November 5, 2014, our registration statement on Form S-1 relating to the initial public offering (IPO) of common stock became effective. The IPO closed in November 2014 at which time we issued 8,050,000 shares of our common stock, which included 1,050,000 shares issued pursuant to the exercise in full by the underwriters of their option to purchase additional shares. We received cash proceeds of approximately $131.6 million from the IPO, net of underwriting discounts and commissions and offering costs paid by us. In June 2015, we completed an underwritten public offering of our common stock, which included shares of our common stock held by certain of our stockholders, at which time we issued 2,470,587 shares of common stock, including 705,882 shares issued pursuant to the exercise in full by the underwriters of their option to purchase additional shares. We received cash proceeds of approximately $118.4 million, net of underwriting discounts and commissions and offering costs paid by us.

In June 2016, we issued $150.0 million aggregate principal amount of 1.75% convertible senior notes due 2021 in a registered underwritten public offering and an additional $22.5 million aggregate principal amount of such notes pursuant to the exercise in full of the over-allotment options of the underwriters (the 2021 Notes). The interest rates are fixed at 1.75% per annum and are payable semi-annually in arrears on June 1 and December 1 of each year, commencing on December 1, 2016. The total net proceeds from the debt offering, after deducting transaction costs, were approximately $166.2 million. In connection with the offering of the 2021 Notes, we entered into convertible

note hedge transactions whereby we have the option to purchase initially (subject to adjustment for certain specified events) a total of approximately 1.8 million shares of our common stock at a price of approximately $96.37 per share. The total cost of the convertible note hedge transactions was $45.1 million. In addition, we also sold warrants whereby the holders of the warrants have the option to purchase initially (subject to adjustment for certain specified events) a total of approximately 1.8 million shares of our common stock at a price of $127.28 per share. We received $33.1 million in cash proceeds from the sale of these warrants.

Important Factors Affecting our Results of Operations

We believe that the following factors have impacted and we expect will continue to impact our results of operations.

Significant Investment in U.S. Sales Organization

We are continuing to make significant investments in building our U.S. commercial infrastructure and sales force and in recruiting and training our sales representatives for U.S. commercialization. This is a lengthy process that requires recruiting appropriate sales representatives, establishing a commercial infrastructure in the United States and training our sales representatives, and will require significant investment by us. Following initial training for Senza, our sales representatives typically require lead time in the field to grow their network of accounts and produce sales results. Successfully recruiting and training a sufficient number of productive sales representatives is required to achieve growth at the rate we expect.

Importance of Physician Awareness and Acceptance of Senza

We continue to invest in programs to educate physicians who treat chronic pain about the advantages of Senza. This requires significant commitment by our marketing team and sales organization, and can vary depending upon the physician's practice specialization, personal preferences and geographic location. We are competing with well-established companies in our industry that have strong existing relationships with many of these physicians. Educating physicians about the advantages of Senza, and influencing these physicians to use Senza to treat chronic pain, is required to grow our revenue.

Access to Hospital Facilities

In the United States, in order for physicians to use Senza, the hospital facilities where these physicians treat patients typically will require us to enter into purchasing contracts. This process can be lengthy and time-consuming and requires extensive negotiations and management time. In Europe, we may be required to engage in a contract bidding process in order to sell Senza, which processes are only open at certain periods of time, and we may not be successful in the bidding process.

Reimbursement and Coverage Decisions by Third-Party Payors

Healthcare providers in the United States generally rely on third-party payors to cover and reimburse all or part of the cost of Senza and the related implant procedure for patients, principally federal Medicare, state Medicaid and private health insurance plans. The revenue we are able to generate from sales of Senza depends in large part on the availability of reimbursement from such payors. While we currently have a favorable reimbursement decision from federal Medicare, decisions of coverage and reimbursement for Senza and the related implant procedure from private health insurance providers can vary. In general, these decisions require that such payors perform analyses to determine if the procedure is medically necessary and if our technology is covered under their existing coverage policy. These payors may deny reimbursement if they determine that the device or procedure was not used in accordance with the payor's coverage policy, is subject to individual plan benefit limitations or is investigational and/or experimental. A significant component of our commercial efforts include working with private payors to ensure positive coverage and reimbursement decisions for Senza. While favorable reimbursement decisions from federal Medicare and certain commercial payors, such as Aetna, Cigna, Humana and Kaiser, have facilitated our increase in revenue to date, certain regional Blue Cross Blue Shield plans, have denied coverage for Senza on the basis that high-frequency neuromodulation is investigational and/or experimental. We continue to engage in efforts to convince such payors of the advantages of HF10 therapy and while we have overturned some investigational/experimental designations such as Blue Cross Blue Shield Highmark and Blue Cross Blue Shield of Alabama, there can be no assurances that we are successful in overturning negative coverage decisions by private health insurance plans. A significant number of negative coverage and reimbursement decisions by private insurers may impair our ability or delay our ability to grow our revenue.

Inventory Buildup and Supply Chain Management

Our Senza product consists of a substantial number of individual components and, in order to market and sell Senza effectively, we must maintain high levels of inventory. In particular, as we continue with our commercial launch of Senza in the United States and continue to add additional suppliers to fortify our supply chain, we are substantially increasing our levels of inventory. As a result, we are incurring significant expenditures associated with the increases in our inventory, which will include satisfying certain minimum purchase obligations, as demand for Senza in the United States is developing. There may also be times in which we determine that our inventory does not meet our product requirements, as was the case in the nine months ended September 30, 2016 and the year ended December 31, 2015, wherein we recorded a write down of inventory of $1.7 million and $2.1 million, respectively, for inventory that did not meet our product requirements. Further, the manufacturing process for Senza requires lengthy lead times, during which components may become obsolete. We may also over- or under-estimate the amount needed of a given component, in which case we may expend extra resources or be constrained in the amount of end product that we can produce. These factors subject us to the risk of inventory obsolescence and expiration, which may lead to inventory impairment charges.

Investment in Research and Clinical Trials

We intend to continue investing in research and development to expand into new indications and chronic pain conditions for Senza, as well as develop product enhancements to improve outcomes and enhance the physician and patient experience. In the future, we expect to initiate clinical trials to support the development of Senza and HF10 therapy for the treatment of other chronic pain conditions. We believe that our continuing clinical research and regulatory efforts will continue to drive adoption of Senza. While research and development and clinical testing are time consuming and costly, we believe that clinical data demonstrating efficacy, safety and cost effectiveness is critical to increasing the adoption of HF10 therapy.

We Do Not Expect Our Revenue Growth Rate in International Markets to Continue at Historic Rates

Our revenue from international markets has increased from $18.2 million for the year ended December 31, 2012 to $45.3 million for the year ended December 31, 2015. Revenue increased as a result of our sales of Senza in Europe and Australia; however, we do not expect to continue this rate of revenue growth in these international markets given our existing penetration in these markets. Despite our growth in international markets, international revenue was negatively impacted by the appreciation of the U.S. dollar. Due to governmental reimbursements constraints in the European SCS market limiting the number of annual SCS implants and our current penetration in these markets, we expect to grow less rapidly in the future than we have in the past in this market.

Critical Accounting Policies, Significant Judgments and Use of Estimates

Our management’s discussion and analysis of financial condition and results of operations are based upon our unaudited consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. On an ongoing basis, we evaluate our critical accounting policies and estimates. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable in the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions and conditions. Our significant accounting policies are more fully described in Note 2 of the accompanying unaudited condensed consolidated financial statements. There have been no significant or material changes in our critical accounting policies during the three months ended September 30, 2016.

Components of Results of Operations

Revenue

Our revenue is generated from sales to two types of customers: hospitals and outpatient medical facilities served through a direct sales force and third-party distributors. Sales to hospitals and medical facilities represent the majority of our revenue. Product sales to hospitals and medical facilities are billed to, and paid by, the hospitals as part of their normal payment processes, with payment received by us in the form of an electronic transfer, check or credit card payment. Product sales to distributors are billed to and paid by the distributors as part of their normal payment processes, with payment received by us in the form of an electronic transfer.

Revenue from sales of Senza fluctuate based on the selling price of the system, as the sales price of a system varies among jurisdictions, and based on the mix of sales by jurisdiction. In addition, our revenue may fluctuate based on the ratio of trials to permanent implants. Our revenue from international sales can also be significantly impacted by fluctuations in foreign currency exchange rates, as our sales are denominated in the local currency in the countries in which we sell our products.

We expect our revenue to fluctuate from quarter to quarter due to a variety of factors, including seasonality, and the impact of the buying patterns and implant volumes of our hospitals and medical facilities, and third-party distributors. In addition, in the second quarter of 2015, we commenced commercial sales of Senza in the United States and recorded revenue of approximately $24.4 million in fiscal 2015 and $117.3 million in the nine months ended September 30, 2016 for sales in the United States. We anticipate that our total revenue will increase as we continue our commercial launch in the United States.

Cost of Revenue

We utilize contract manufactures for the production of Senza. Cost of revenue consists primarily of acquisition costs of the components of Senza, allocated manufacturing overhead, royalty payments, scrap and inventory obsolescence, as well as distribution-related expenses, such as logistics and shipping costs, net of costs charged to customers.

We calculate gross margin as revenue less cost of revenue divided by revenue. Our gross margin has been and will continue to be affected by a variety of factors, primarily by our costs to have our products manufactured for us, the ratio of trials to permanent implants, the period of time between a trial and the related permanent implant and, to a lesser extent, the percentage of products we

sell to distributors as compared to those sold directly to hospitals and medical facilities as our gross margin is typically higher on products we sell directly as compared to products we sell through distributors. While costs are primarily incurred in U.S. dollars, international revenue may be impacted by the appreciation or depreciation of the U.S. dollar, which may impact our overall gross margin. We expect our gross margin to be positively affected over time to the extent we are successful in reducing manufacturing costs as our sales volume increases. However, our gross margin may fluctuate from period to period.

Operating Expenses

Our operating expenses consist of research and development (R&D), and sales, general and administrative expense (SG&A). Personnel costs are the most significant component of operating expenses and consist of salaries, benefits, stock-based compensation and sales commissions. We expect operating expenses to increase in absolute dollars, as we continue to invest to grow our business.

Research and Development. R&D costs are expensed as incurred. R&D expense consists primarily of personnel costs, including salary, employee benefits and stock-based compensation expenses for our R&D employees. R&D expense also includes costs associated with product design efforts, development prototypes, testing, clinical trial programs and regulatory activities, contractors and consultants, equipment and software to support our development, facilities and information technology. We expect R&D expense to increase in absolute dollars as we continue to develop product enhancements to Senza and develop our HF10 therapy to treat other chronic pain indications, including conducting additional clinical studies. Our R&D expenses may fluctuate from period to period due to the timing and extent of our R&D and clinical trial expenses.

Sales, General and Administrative. SG&A expense consists primarily of personnel costs, including salary, employee benefits and stock-based compensation expenses for our sales and marketing personnel, including sales commissions, and for administrative personnel that support our general operations, such as information technology, executive management, financial accounting, customer services and human resources personnel. We expense commissions at the time of the sale. SG&A expense also includes costs attributable to marketing, as well as travel, intellectual property and other legal fees, financial audit fees, insurance, fees for other consulting services, depreciation and facilities.

In the last two years, we significantly increased the size of our sales presence internationally and increased marketing spending to generate sales opportunities. Additionally, we have made substantial investments in our U.S. commercial infrastructure to support our commercialization efforts in the U.S. We expect SG&A expenses to continue to significantly increase as we build up our sales and marketing personnel to support commercialization of Senza in the United States, continue to increase the size of our sales and marketing organizations and increase our international presence and develop and assist our channel partners.

For the nine months ended September 30, 2016, our administrative expenses increased compared to the same period in the prior year. We expect our administrative expenses will continue to increase as we increase our headcount and expand our facility and information technology to support our growing operations as a public company. Additionally, we anticipate increased expenses related to audit, legal, regulatory and tax-related services associated with maintaining compliance with exchange listing and SEC requirements, including compliance under the Sarbanes-Oxley Act of 2002 (the Sarbanes-Oxley Act) as a large accelerated filer, director and officer insurance premiums and investor relations costs associated with being a public company. Our SG&A expense may fluctuate from period to period due to the seasonality of our revenue and the timing and extent of our SG&A expense.

Interest Income and Interest Expense

Interest income consists primarily of interest income earned on our investments and interest expense consists of interest paid on our outstanding debt and the amortization of debt discount and debt issuance costs.

Other Income (Expense), Net

Other income (expense), net, consists primarily of foreign currency transaction gains and losses and the gains and losses from the remeasurement of foreign-denominated balances to the U.S. dollar.

Provision for Income Taxes

The provision for income taxes is calculated on a discrete basis due to the variability of taxable income in the jurisdictions in which we operate. The provision for income taxes consists primarily of income taxes in foreign jurisdictions in which we conduct business. We maintain a full valuation allowance for our deferred tax assets including net operating loss carryforwards and R&D credits and other tax credits.

Consolidated Results of Operations

Comparison of the three months ended September 30, 2016 and 2015

Revenue, Cost of Revenue, Gross Profit and Gross Margin

	Three Months Ended September 30,		
	2016	2015	Change
(in thousands)			
Revenue	$60,922	$15,402	$45,520
Cost of revenue	19,235	5,968	13,267
Gross profit	$41,687	$9,434	$32,253
Gross margin	68 %	61 %	7 %

Revenue. Revenue increased to $60.9 million in the three months ended September 30, 2016 from $15.4 million in the three months ended September 30, 2015, an increase of $45.5 million, or 296%. The revenue increase was primarily due to $47.2 million of sales of the Senza system in the United States in the three months ended September 30, 2016, compared to $4.5 million in the three months ended September 30, 2015, our first full quarter of commercialization of Senza in the United States, as well as continued adoption of the Senza system in international markets where it has historically been sold.

Cost of Revenue, Gross Profit and Gross Margin. Cost of revenue increased to $19.2 million in the three months ended September 30, 2016 from $6.0 million in the three months ended September 30, 2015, an increase of $13.3 million, or 222%. This was primarily due to an $11.3 million increase in the costs of manufactured product components as sales volumes increased in the most recent period, as well as an increase of $1.0 million related to product accessories used as part of ramping our operational infrastructure in response to our continued U.S. product launch. Gross profit increased to $41.7 million in the three months ended September 30, 2016 from $9.4 million in the three months ended September 30, 2015, an increase of $32.3 million, or 341%. Gross profit as a percentage of revenue, or gross margin, increased to 68% in the three months ended September 30, 2016, compared to 61% in the three months ended September 30, 2015. The gross margin increase is partly attributed to a smaller charge in the current year, as a percentage of revenue, related to the write-down of inventory. We additionally had a decrease in the underlying cost of components sold.

Operating Expenses

	Three Months Ended September 30,				
	2016		2015		
	Amount	% of Total Revenue	Amount	% of Total Revenue	Change Amount
(in thousands)					
Operating expenses:					

Research and development	$7,923	13	%	$5,247	34	%