

SAFEGUARD SCIENTIFICS INC

Form 10-Q

April 27, 2011

Table of Contents

SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549
FORM 10-Q
Quarterly Report Pursuant to Section 13 or 15(d)
of the Securities Exchange Act of 1934
For the Quarter Ended March 31, 2011
Commission File Number 1-5620
Safeguard Scientifics, Inc.
(Exact name of registrant as specified in its charter)

Pennsylvania

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

23-1609753

(I.R.S. Employer ID No.)

435 Devon Park Drive

Building 800

Wayne, PA

(Address of principal executive offices)

19087

(Zip Code)

(610) 293-0600

Registrant's telephone number, including area code

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

(Do not check if a smaller reporting company)

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

Number of shares outstanding as of April 26, 2011
Common Stock 20,681,234

SAFEGUARD SCIENTIFICS, INC.
QUARTERLY REPORT ON FORM 10-Q
INDEX

	Page
<u>PART I FINANCIAL INFORMATION</u>	
<u>Item 1 Financial Statements:</u>	
<u>Consolidated Balance Sheets (unaudited) March 31, 2011 and December 31, 2010</u>	3
<u>Consolidated Statements of Operations (unaudited) Three Months Ended March 31, 2011 and 2010</u>	4
<u>Consolidated Statements of Cash Flows (unaudited) Three Months Ended March 31, 2011 and 2010</u>	5
<u>Consolidated Statement of Changes in Equity (unaudited) Three Months Ended March 31, 2011</u>	6
<u>Notes to Consolidated Financial Statements (unaudited)</u>	7-23
<u>Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	24-41
<u>Item 3 Quantitative and Qualitative Disclosures About Market Risk</u>	42
<u>Item 4 Controls and Procedures</u>	43
<u>PART II OTHER INFORMATION</u>	
<u>Item 1A Risk Factors</u>	44
<u>Item 6 Exhibits</u>	45
<u>Signatures</u>	46
<u>Exhibit 31.1</u>	
<u>Exhibit 31.2</u>	
<u>Exhibit 32.1</u>	
<u>Exhibit 32.2</u>	

Table of Contents

**SAFEGUARD SCIENTIFICS, INC.
CONSOLIDATED BALANCE SHEETS**

	March 31, 2011	December 31, 2010	
			(As Revised, See Note 13)
			(In thousands except per share data) (Unaudited)
ASSETS			
Current Assets:			
Cash and cash equivalents	\$ 95,406	\$ 183,419	
Cash held in escrow	6,433	6,434	
Marketable securities	57,219	42,411	
Restricted cash equivalents	5,023	4,893	
Prepaid expenses and other current assets	750	785	
Total current assets	164,831	237,942	
Property and equipment, net	263	295	
Ownership interests in and advances to partner companies	71,604	60,256	
Available-for-sale securities	22,151	25,447	
Long-term marketable securities	21,346		
Long-term restricted cash equivalents	9,505	11,881	
Other	666	724	
Total Assets	\$ 290,366	\$ 336,545	
LIABILITIES AND EQUITY			
Current Liabilities:			
Convertible senior debentures current	\$	\$ 31,289	
Accounts payable	261	493	
Accrued compensation and benefits	1,705	4,168	
Accrued expenses and other current liabilities	3,542	4,223	
Total current liabilities	5,508	40,173	
Other long-term liabilities	4,267	5,311	
Convertible senior debentures non-current	45,220	44,630	
Commitments and contingencies			
Equity:			
Preferred stock, \$0.10 par value; 1,000 shares authorized			
Common stock, \$0.10 par value; 83,333 shares authorized; 20,666 and 20,630 shares issued and outstanding in 2011 and 2010, respectively	2,067	2,063	
Additional paid-in capital	807,765	806,859	
Accumulated deficit	(584,317)	(575,307)	
Accumulated other comprehensive income	9,856	12,816	
Total equity	235,371	246,431	

Total Liabilities and Equity	\$ 290,366	\$ 336,545
------------------------------	------------	------------

See Notes to Consolidated Financial Statements.

Table of Contents

SAFEGUARD SCIENTIFICS, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS

	Three Months Ended March 31,	
	2011	2010
	(As Revised, See Note 13)	
	(In thousands except per share data)	
	(Unaudited)	
General and administrative expense	\$ 4,884	\$ 4,833
Operating loss	(4,884)	(4,833)
Other income (loss), net	(292)	(11,297)
Interest income	367	97
Interest expense	(1,636)	(730)
Equity loss	(2,565)	(5,088)
Net loss before income taxes	(9,010)	(21,851)
Income tax benefit		
Net loss	\$ (9,010)	\$ (21,851)
Net loss per share:		
Basic	\$ (0.44)	\$ (1.07)
Diluted	\$ (0.46)	\$ (1.07)
Average shares used in computing basic and diluted loss per share:	20,678	20,392

See Notes to Consolidated Financial Statements.

Table of Contents

SAFEGUARD SCIENTIFICS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Three Months Ended March 31,	
	2011	2010
	(In thousands)	
	(Unaudited)	
Cash Flows from Operating Activities:		
Net cash used in operating activities	\$ (7,285)	\$ (6,341)
Cash Flows from Investing Activities:		
Investment in restricted cash equivalents for interest on convertible senior debentures		(19,009)
Proceeds from sales of and distributions from companies and funds	95	2,755
Advances to partner companies		(2,025)
Acquisitions of ownership interests in partner companies and funds	(14,073)	(4,812)
Increase in marketable securities	(55,635)	(11,305)
Decrease in marketable securities	19,481	10,768
Proceeds from sale of discontinued operations, net	1	477
Other, net	107	
Net cash used in investing activities	(50,024)	(23,151)
Cash Flows from Financing Activities:		
Costs on exchange of convertible senior debentures		(150)
Repurchase of convertible senior debentures	(30,848)	
Issuance of Company common stock, net	144	472
Net cash (used in) provided by financing activities	(30,704)	322
Net Decrease in Cash and Cash Equivalents	(88,013)	(29,170)
Cash and Cash Equivalents at beginning of period	183,419	67,347
Cash and Cash Equivalents at end of period	\$ 95,406	\$ 38,177

See Notes to Consolidated Financial Statements.

Table of Contents

SAFEGUARD SCIENTIFICS, INC.
CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

	Total	Accumulated deficit	Accumulated other comprehensive income (loss) (In thousands) (unaudited)	Common stock Shares	Amount	Additional paid-in capital
Balance December 31, 2010 (As Revised, See Note 13)	\$ 246,431	\$ (575,307)	\$ 12,816	20,630	\$ 2,063	\$ 806,859
Net loss	(9,010)	(9,010)				
Stock options exercised, net	144			36	4	140
Issuance of restricted stock, net	39					39
Stock-based compensation expense	727					727
Other comprehensive loss	(2,960)		(2,960)			
Balance March 31, 2011	\$ 235,371	\$ (584,317)	\$ 9,856	20,666	\$ 2,067	\$ 807,765

See Notes to Consolidated Financial Statements.

Table of Contents

**SAFEGUARD SCIENTIFICS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

1. GENERAL

The accompanying unaudited interim Consolidated Financial Statements of Safeguard Scientifics, Inc. (the Company) were prepared in accordance with accounting principles generally accepted in the United States of America and the interim financial statement rules and regulations of the SEC. In the opinion of management, these statements include all adjustments (consisting only of normal recurring adjustments) necessary for a fair presentation of the Consolidated Financial Statements. The interim operating results are not necessarily indicative of the results for a full year or for any interim period. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations relating to interim financial statements. The Consolidated Financial Statements included in this Form 10-Q should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations included elsewhere in this Form 10-Q and included together with the Company's Consolidated Financial Statements and Notes thereto included in the Company's 2010 Annual Report on Form 10-K.

2. BASIS OF PRESENTATION

The Company's Consolidated Financial Statements included the accounts of Clariant Inc. (Clariant) in continuing operations through May 14, 2009, the date of its deconsolidation. Clariant was acquired by GE Healthcare in December 2010. The Company had elected to apply the fair value option to account for its retained interest in Clariant upon deconsolidation. Unrealized gains and losses on the mark-to-market of its holdings in Clariant and realized gains and losses on the sale of any of its holdings in Clariant were recognized in Other income (loss), net in the Consolidated Statement of Operations for all periods subsequent to the date that Clariant was deconsolidated through the date of its disposition.

The Company's ownership interests in Tengion, Inc. (Tengion) and NuPathe, Inc. (NuPathe) are accounted for as available-for-sale securities following Tengion's and NuPathe's completion of initial public offerings in April 2010 and August 2010, respectively. Available-for-sale securities are carried at fair value, based on quoted market prices, with the unrealized gains and losses, net of tax, reported as a separate component of equity. Unrealized losses are charged against net income (loss) when a decline in the fair value is determined to be other than temporary.

In February 2011, the Company increased its ownership interest in MediaMath, Inc. (MediaMath) to 22.4%, a threshold at which the Company believes it exercises significant influence. Accordingly, the Company adopted the equity method of accounting for its holdings in MediaMath. The Company has adjusted the financial statements for all prior periods presented to retrospectively apply the equity method of accounting for its holdings in MediaMath since the initial date of acquisition in July 2009 (see Note 13).

Table of Contents**SAFEGUARD SCIENTIFICS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****3. OWNERSHIP INTERESTS IN AND ADVANCES TO PARTNER COMPANIES**

The following summarizes the carrying value of the Company's ownership interests in and advances to partner companies and private equity funds.

	March 31, 2011	December 31, 2010
	(In thousands) (Unaudited)	
Equity Method:		
Partner companies	\$ 63,027	\$ 50,561
Private equity funds	2,141	2,265
	65,168	52,826
Cost Method:		
Private equity funds	2,951	2,908
	2,951	2,908
Advances to partner companies	3,485	4,522
	\$ 71,604	\$ 60,256
Available-for-sale securities	\$ 22,151	\$ 25,447

The Company recognized an impairment charge of \$1.4 million related to SafeCentral, Inc. in the three months ended March 31, 2011 which is reflected in Equity loss in the Consolidated Statement of Operations. The Company reduced its carrying value in SafeCentral to \$0.8 million due to modifications to the strategic direction of the business and changes in executive management at SafeCentral.

The Company recognized an impairment charge of \$0.3 million for the three months ended March 31, 2011, which is reflected in Other income (loss), net, in the Consolidated Statements of Operations, representing the unrealized loss on the mark-to-market of its ownership interest in Tengion, which was previously recorded as a separate component of equity. Following the impairment charge, the Company's adjusted cost basis in Tengion was \$1.5 million. The Company determined that the decline in the value of its public holdings in Tengion was other than temporary. The Company also recognized impairment charges on its holdings in Tengion of \$2.1 million and \$1.1 million in the first and third quarters of 2010 respectively.

For the three months ended March 31, 2010, the Company recognized an unrealized loss of \$0.9 million on the mark-to-market of its holdings in Clariant which was included in Other income (loss), net in the Consolidated Statements of Operations.

Table of Contents**SAFEGUARD SCIENTIFICS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following unaudited summarized financial information for Clariant for the three months ended December 31, 2009 has been compiled from the unaudited financial statements of Clariant. The results of Clariant for periods prior to its sale in December 2010 are reported on a one quarter lag.

	Three Months Ended December 31, 2009 (In thousands) (unaudited)
Results of Operations:	
Revenue	\$ 23,252
Operating loss	\$ (2,315)
Net loss from continuing operations	\$ (2,690)

4. ACQUISITION OF INTERESTS IN PARTNER COMPANIES

In February 2011, the Company deployed an additional \$9.0 million in MediaMath. In conjunction with this funding, the Company's voting interest in MediaMath increased from 17.3% to 22.4%, a threshold at which the Company believes it exercises significant influence. Accordingly, the Company adopted the equity method of accounting for its holdings in MediaMath. See Note 13 regarding the change in accounting treatment for the Company's holdings in MediaMath from the cost method to the equity method. The Company previously had acquired an interest in MediaMath in July 2009 for \$6.7 million. MediaMath is an online media trading company that enables advertising agencies and their advertisers to optimize their ad spending across various exchanges through its proprietary algorithmic bidding platform and data integration technology. The difference between the Company's cost and its interest in the underlying net assets of MediaMath was allocated to intangible assets and goodwill as reflected in the carrying value in Ownership interests in and advances to partner companies on the Consolidated Balance Sheets. In February 2011, the Company acquired a 30.7% ownership interest in ThingWorx, Inc. (ThingWorx) for \$5.0 million. ThingWorx offers a platform designed to accelerate the development of applications connecting people, systems and devices. The Company accounts for its holdings in ThingWorx under the equity method. The difference between the Company's cost and its interest in the underlying net assets of ThingWorx was allocated to intangible assets and goodwill as reflected in the carrying value in Ownership interests in and advances to partner companies on the Consolidated Balance Sheets.

5. FAIR VALUE MEASUREMENTS

The Company categorizes its financial instruments into a three-level fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). If the inputs used to measure fair value fall within different levels of the hierarchy, the category level is based on the lowest priority level input that is significant to the fair value measurement of the instrument. Financial assets recorded at fair value on the Company's Consolidated Balance Sheets are categorized as follows:

- Level 1 Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.
- Level 2 Include other inputs that are directly or indirectly observable in the marketplace.
- Level 3 Unobservable inputs which are supported by little or no market activity.

The fair value hierarchy also requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

Table of Contents**SAFEGUARD SCIENTIFICS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following table provides the assets and liabilities measured at fair value on a recurring basis as of March 31, 2011 and December 31, 2010:

	Carrying Value	Fair Value Measurement at March 31, 2011		
		Level 1	Level 2	Level 3
		(in thousands)		
		(unaudited)		
Cash and cash equivalents	\$ 95,406	\$ 95,406	\$	\$
Cash held in escrow	\$ 6,433	\$ 6,433	\$	\$
Restricted cash equivalents	\$ 14,528	\$ 14,528	\$	\$
Available-for-sale securities	\$ 22,151	\$ 22,151	\$	\$
Marketable securities held-to-maturity:				
Commercial paper	\$ 30,560	\$ 30,560	\$	\$
U.S. Treasury Bills	29,608	29,608		
Government agency bonds	10,051	10,051		
Certificates of deposit	8,346	8,346		
	\$ 78,565	\$ 78,565	\$	\$
		Fair Value Measurement at December 31, 2010		
		(in thousands)		
		(unaudited)		
Cash and cash equivalents	\$ 183,419	\$ 183,419	\$	\$
Cash held in escrow	\$ 6,434	\$ 6,434	\$	\$
Restricted cash equivalents	\$ 16,774	\$ 16,774	\$	\$
Available-for-sale securities	\$ 25,447	\$ 25,447	\$	\$
Marketable securities held-to-maturity:				
Commercial paper	\$ 27,362	\$ 27,362	\$	\$
U.S. Treasury Bills	12,053	12,053		
Certificates of deposit	2,996	2,996		
	\$ 42,411	\$ 42,411	\$	\$

Table of Contents

SAFEGUARD SCIENTIFICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

As of March 31, 2011, \$57.2 million of marketable securities had contractual maturities which were less than one year and \$21.4 million of marketable securities had contractual maturities greater than one year. Held-to-maturity securities are carried at amortized cost, which, due to the short-term maturity of these instruments, approximates fair value using quoted prices in active markets for identical assets or liabilities defined as Level 1 inputs under the fair value hierarchy.

The Company's holdings in Clariant during the three months ended March 31, 2010 were measured at fair value using quoted prices for Clariant's common stock as traded on the NASDAQ Capital Market, which is considered a Level 1 input under the valuation hierarchy.

The Company recognized an impairment charge of \$1.4 million related to SafeCentral in the three months ended March 31, 2011 measured as the amount by which SafeCentral's carrying value exceeded its estimated fair value. The fair market value of SafeCentral was determined to be \$0.8 million at March 31, 2011 based on Level 3 inputs as defined above.

The Company accounts for its holdings in NuPathe as available-for-sale securities. As of March 31, 2011, the Company's adjusted cost basis in available-for-sale securities of NuPathe was \$10.8 million. As of March 31, 2011 the Company's holdings of available-for-sale securities in NuPathe had generated an unrealized gain of \$9.9 million. The value of the Company's holdings in NuPathe was measured by reference to quoted prices for NuPathe's common stock as traded on the NASDAQ Capital Market, which is considered a Level 1 input under the valuation hierarchy.

The Company accounts for its holdings in Tengion as available-for-sale securities. The Company recognized an impairment charge of \$0.3 million in the three months ended March 31, 2011, representing the loss on the mark-to-market of its ownership interest in Tengion which was previously recorded as a separate component of equity. As of March 31, 2011, the Company's adjusted cost basis in available-for-sale securities of Tengion was \$1.5 million. The value of the Company's holdings in Tengion was measured by reference to quoted prices for Tengion's common stock as traded on the NASDAQ Capital Market, which is considered a Level 1 input under the valuation hierarchy.

Table of Contents**SAFEGUARD SCIENTIFICS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****6. COMPREHENSIVE INCOME (LOSS)**

Comprehensive income (loss) is the change in equity of a business enterprise from transactions and other events and circumstances from non-owner sources. Excluding net income (loss), the Company's sources of comprehensive income (loss) were from changes in fair value of available-for-sale securities.

The following summarizes the components of comprehensive income (loss):

	Three Months ended March 31,	
	2011	2010
	(In thousands)	
	(unaudited)	
Net loss	\$ (9,010)	\$ (21,851)
Other comprehensive income (loss), before taxes:		
Unrealized net loss on available-for-sale securities	(3,296)	
Reclassification adjustment for other than temporary impairment of available-for-sale securities included in net income (loss)	336	
Total comprehensive loss	\$ (11,970)	\$ (21,851)

The Company accounts for its holdings in NuPathe and Tengion as available-for-sale securities. The Company recorded an unrealized net loss of \$3.3 million associated with available-for-sale securities as a separate component of equity in the three months ended March 31, 2011. The Company reclassified \$0.3 million in unrealized losses associated with Tengion in the three months ended March 31, 2011 as a result of management's determination that the security was impaired on an other than temporary basis.

7. CONVERTIBLE DEBENTURES AND CREDIT ARRANGEMENTS

The carrying values of the Company's convertible senior debentures were as follows:

	March 31,	December 31,
	2011	2010
	(In thousands)	
	(Unaudited)	
Convertible senior debentures due 2024	\$ 441	\$ 31,289
Convertible senior debentures due 2014	44,779	44,630
	45,220	75,919
Less: current portion		(31,289)
Convertible senior debentures - non-current	\$ 45,220	\$ 44,630

Table of Contents

SAFEGUARD SCIENTIFICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Convertible Senior Debentures due 2024

In 2004, the Company issued an aggregate of \$150 million in face value of convertible senior debentures with a stated maturity date of March 15, 2024 (the 2024 Debentures). The Company has \$0.4 million of the 2024 Debentures outstanding at March 31, 2011. On March 21, 2011, the Company repurchased \$30.8 million of the 2024 Debentures as required by the 2024 Debenture holders. Interest on the 2024 Debentures is payable semi-annually. At the debentures holders' option, the 2024 Debentures are convertible into the Company's common stock through March 14, 2024, subject to certain conditions. The adjusted conversion rate of the debentures is \$43.3044 of principal amount per share. The closing price of the Company's common stock at March 31, 2011 was \$20.35. The remaining 2024 Debentures holders have the right to require the Company to repurchase the 2024 Debentures on March 20, 2014 or March 20, 2019 at a repurchase price equal to 100% of their face amount, plus accrued and unpaid interest. Subject to certain conditions, the Company has the right to redeem all or some of the 2024 Debentures.

At March 31, 2011, the fair value of the \$0.4 million outstanding 2024 Debentures approximated their carrying value based on quoted market prices as of such date.

Convertible Senior Debentures due 2014

In March 2010, the Company issued an aggregate of \$46.9 million in face value of convertible senior debentures with a stated maturity of March 15, 2014 (the 2014 Debentures). Interest on the 2014 Debentures is payable semi-annually on March 15 and September 15. In the first quarter of 2010, as required under the terms of the 2014 Debentures, the Company placed approximately \$19.0 million in a restricted escrow account to make all scheduled interest payments on the 2014 Debentures through their maturity. In the three months ended March 31, 2011, interest payments of \$2.4 million were made out of the restricted escrow account and are considered non-cash investing activities.

Including accrued interest, a total of \$14.5 million was reflected in Restricted cash equivalents on the Consolidated Balance Sheet at March 31, 2011, of which \$5.0 million was classified as a current asset.

At the debentures holders' option, the 2014 Debentures are convertible into the Company's common stock at anytime after March 15, 2013; and, prior to March 15, 2013, under any of the following conditions:

- during any fiscal quarter commencing after June 30, 2010 if the closing sale price per share of Company common stock is greater than or equal to 120% of the conversion price for at least 20 trading days during the period of 30 trading days ending on the last day of the preceding fiscal quarter;

- during the five day period immediately following any 10 consecutive trading day period in which the trading price per \$1,000 principal amount of 2014 Debentures for each trading day of such period was less than 100% of the product of the closing sale price per share of Company common stock multiplied by the conversion rate on each such trading day;

- If a fundamental change (as defined) occurs, including sale of all or substantially all of the Company's common stock or assets, liquidation, dissolution or a change in control.