BIOLASE TECHNOLOGY INC
Form S-3/A
September 29, 2003
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**As filed with the Securities and Exchange Commission on September 29, 2003**

**Registration No. 333-106260**

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# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

## Amendment No. 3

## to

## FORM S-3

## REGISTRATION STATEMENT

## UNDER

## THE SECURITIES ACT OF 1933

# BIOLASE TECHNOLOGY, INC.

*(Exact Name of Registrant as Specified in Its Charter)*

| | |
|---|---|
| **Delaware** | **87-0442441** |
| *(State or Other Jurisdiction* | *(I.R.S. Employer* |
| *of Incorporation or Organization)* | *Identification Number)* |

**981 Calle Amanecer**

**San Clemente, California 92673**

**(949) 361-1200**

*(Address, Including Zip Code, and Telephone Number, Including Area Code, of Registrant s Principal Executive Offices)*

**Jeffrey W. Jones**

**President and Chief Executive Officer**

**BioLase Technology, Inc.**

**981 Calle Amanecer**

**San Clemente, California 92673**

**(949) 361-1200**

*(Name, Address, Including Zip Code, and Telephone Number, Including Area Code, of Agent For Service)*

*Copies to:*

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**San Diego, California 92122**

**(858) 450-8400**

**Approximate date of commencement of proposed sale to the public:** As soon as practicable after the effective date of this registration statement.

If the only securities being registered on this form are being offered pursuant to dividend or interest reinvestment plans, please check the following box. ¨

If any of the securities being registered on this form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, other than securities offered only in connection with dividend or interest reinvestment plans, check the following box. ¨

If this form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. ¨________

If this form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. ¨________

If delivery of the prospectus is expected to be made pursuant to Rule 434, please check the following box. ¨

**CALCULATION OF REGISTRATION FEE**

| Title of Each Class of Securities to be Registered | Amount to be Registered | Proposed Maximum Offering Price Per Share(1) | Proposed Maximum Aggregate Offering Price(1) | Amount of Registration Fee |
|---|---|---|---|---|
| Common Stock, $.001 par value per share(2) | 3,228,625 shares(3) | $12.48 | $40,293,240 | $3,260(4) |

(1) Estimated based upon the average of the high and low sales prices of the registrant s common stock on September 25, 2003, as reported by the Nasdaq National Market, solely for the purpose of calculating the registration fee pursuant to Rule 457(c) promulgated under the Securities Act of 1933, as amended.
(2) Includes associated preferred stock purchase rights issuable under the Rights Agreement dated December 31, 1998.

(3) Includes 421,125 shares that the underwriters have the option to purchase to cover over-allotments, if any.
(4) A portion of the registration fee in the amount of $2,903 was previously paid at the time of the initial filing of the registration statement on June 19, 2003.

**The registrant hereby amends this registration statement on such date or dates as may be necessary to delay its effective date until the registrant shall file a further amendment which specifically states that this registration statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933, as amended, or until this registration statement shall become effective on such date as the Commission, acting pursuant to said Section 8(a), may determine.**

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**The information in this preliminary prospectus is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission becomes effective. This preliminary prospectus is not an offer to sell nor does it seek an offer to buy these securities in any jurisdiction where the offer or sale is not permitted.**

**SUBJECT TO COMPLETION, DATED SEPTEMBER 29, 2003**

**PRELIMINARY PROSPECTUS**

# 2,807,500 Shares

# Common Stock

We are offering 2,500,000 shares of our common stock and one of our stockholders is offering 307,500 shares of our common stock. We will not receive any proceeds from the sale of shares by the selling stockholder. Our common stock is traded on the Nasdaq National Market under the symbol BLTI. On September 19, 2003, the last reported sale price of our common stock on the Nasdaq National Market was $12.85 per share.

**Investing in our common stock involves risks. See Risk Factors beginning on page 5.**

| | Per Share | Total |
|---|---|---|
| Public Offering Price | $ | $ |
| Underwriting Discounts | $ | $ |
| Proceeds, before expenses, to BioLase Technology, Inc. | $ | $ |
| Proceed, before expenses, to the selling stockholder | $ | $ |

The underwriters have the right to purchase up to 421,125 additional shares of common stock from us to cover over-allotments, if any.

The Securities and Exchange Commission and state securities regulators have not approved or disapproved of these securities or determined if this prospectus is truthful or complete. It is illegal for any person to tell you otherwise.

Needham & Company, Inc.

William Blair & Company

Oppenheimer & Co. Inc.

The date of this prospectus is , 2003.

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You should rely only on the information contained in this prospectus. We have not, and the underwriters have not, authorized anyone to provide you with information different from that contained in this prospectus. We are not, and the underwriters are not, making an offer to sell or seeking offers to buy, these securities in any jurisdiction where the offer or sale is not permitted. The information contained in this prospectus is accurate only as of the date of this prospectus, regardless of the time of delivery of this prospectus or any sale of these securities.

In this prospectus, BioLase, BLTI, we, us, our, or our company refer to BioLase Technology, Inc. and its subsidiaries and predecessors, collectively. BioLase®, Waterlase®, Millennium®, Laserbrush®, Lazersmile®, Flavorflow®, Hydrolase® and Vetlase® are our registered trademarks, and LaserSmile is our unregistered trademark. All other trademarks, servicemarks or trade names referred to in this prospectus are the property of their respective owners.

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## PROSPECTUS SUMMARY

*This summary highlights our business and other selected information contained elsewhere in this prospectus. This summary does not contain all of the information that you should consider before making an investment decision. You should read the entire prospectus carefully, including Risk Factors, our consolidated financial statements and notes to these statements and other information incorporated by reference in this prospectus, before deciding to invest.*

### BioLase Technology, Inc.

We are the world s leading dental laser company. We design, manufacture and market proprietary dental laser systems that allow dentists, oral surgeons and other specialists to perform a broad range of common dental procedures. Our systems provide superior performance for many types of dental procedures, with less pain and faster recovery times than are generally achieved with high-speed drills and other dental instruments. We have clearance from the U.S. Food and Drug Administration to market our laser systems in the United States. We also have approvals to sell our laser systems in Canada, the European Union and other international markets. Since 1998, we have sold more than 2,000 laser systems in over 20 countries. Our revenues in 2002 increased 65% from 2001, to $27.3 million, and in the first six months of 2003 grew to $19.6 million, an increase of 59% over the same period last year.

Our primary product, the Waterlase system, is the best selling dental laser system. The Waterlase uses a patented combination of water and laser to precisely cut hard tissue, such as bone and teeth, and soft tissue, such as gums. We also offer the LaserSmile system, which uses a laser to perform soft tissue and cosmetic procedures, including tooth whitening. In May 2003, we acquired the American Dental Laser product line of American Medical Technologies, Inc., including the Diolase and Pulsemaster systems, which can be used for common soft tissue procedures. These systems, together with our Waterlase and LaserSmile, offer a broad product line with a range of features and price points. We also manufacture and sell accessories and disposables for our laser systems, such as handpieces, laser tips and tooth whitening gel.

According to the American Dental Association, there are over 160,000 practicing dentists in the United States. The World Federation of Dentistry, an international dental organization, estimates that there are at least 700,000 dentists worldwide. Although the use of lasers in dentistry is growing, only a small percentage of dentists currently use lasers. We believe this represents a significant opportunity for us to increase the sales of our laser systems worldwide.

Traditional dental instruments, such as high speed drills used on hard tissue and scalpels, scissors and other cutting instruments used on soft tissue, cause discomfort, require anesthesia and result in unintended trauma to dental structure. Alternatives to traditional instruments in most cases are not suitable for performing a wide range of hard and soft tissue procedures. We believe these limitations create a significant opportunity for our laser systems, which can often perform common hard and soft tissue dental procedures more effectively and comfortably.

Our goal is to establish our laser systems as essential tools in dentistry for most common dental procedures. Our systems complement traditional tools, such as dental drills, which perform functions our systems do not address, such as cutting metal fillings and certain polishing and grinding functions. While our systems are more expensive than competing instruments, we believe that the superior performance of our systems, and the potential return on investment our systems offer practitioners, will enable us to increase our leading market position.

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**The BioLase Solution**

We have developed our laser systems for the dental market to perform many common hard and soft tissue dental procedures, such as cavity preparations, root canals and cutting and reshaping gums. We believe our laser systems are positioned to become the preferred instruments for many dental procedures.

Our laser systems benefit practitioners by:

- reducing the need for anesthesia, which can decrease the time required for each procedure;
- allowing general dentists to perform more complex surgical and cosmetic procedures that they may have previously referred to specialists or simply not performed;
- improving patient retention and increasing the demand for elective procedures; and
- reducing trauma, swelling and general discomfort.

Our laser systems benefit patients by:

- improving comfort and reducing trauma for many common procedures;
- eliminating or reducing the need for anesthesia in many cases, and the associated pain of injections and numbness;
- enabling multiple procedures to be performed in one visit; and
- making many elective procedures more comfortable and convenient.

**Business Strategy**

Our objectives are to increase our leadership position and expand our penetration in the dental laser market. Our strategy consists of the following key elements:

- increasing awareness of our laser systems among dental practitioners and patients;

- expanding our sales and distribution capabilities in the United States and abroad;
- expanding our products and applications in dentistry;
- continuing to provide high quality manufacturing and customer service; and
- strengthening and defending our technology leadership in the dental laser market.

**Key Strengths**

We believe we can strengthen our leading position in the dental laser market because of the following advantages over our competitors:

- our Waterlase is the only commercially available dental laser that uses water and a unique crystal laser optimized for dental applications;
- our Waterlase system is the best selling dental laser system;
- we have established relationships with leading dental practitioners and academic leaders worldwide who help us increase awareness of our systems among dental professionals; and
- we have a strong patent portfolio covering a broad range of dental technologies.

**Additional Information**

We are a Delaware corporation. Our principal executive office is at 981 Calle Amanecer, San Clemente, California 92673, and our telephone number is (949) 361-1200. Our corporate web site is *www.Biolase.com.* The information on our web site is not part of this prospectus.

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**The Offering**

| | |
|---|---|
| Common stock offered by us | 2,500,000 shares |
| Common stock offered by selling stockholder | 307,500 shares |
| Common stock outstanding after the offering | 24,039,571 shares |
| Use of proceeds | For general corporate purposes, working capital, potential repayment of debt, of which approximately $3 million is currently outstanding, capital expenditures and potential acquisitions. We will not receive any proceeds from the sale of shares by the selling stockholder. |
| Nasdaq National Market symbol | BLTI |

The number of shares of common stock outstanding after this offering is based on 21,539,571 shares outstanding as of September 19, 2003, and excludes 3,654,244 shares consisting of:

3,004,704 shares issuable upon exercise of outstanding options at a weighted average exercise price of $4.47 per share; and

649,540 additional shares of common stock reserved for future grant or issuance under our equity incentive compensation plans.

Unless otherwise indicated, all information in this prospectus assumes no exercise by the underwriters of their over-allotment option to purchase up to 421,125 additional shares of common stock from us. Shares purchased by the underwriters to cover over-allotments, if any, will be offered for sale under this prospectus.

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**Summary Consolidated Financial Data**

**(in thousands, except per share data)**

The following tables set forth summary consolidated financial data for the periods indicated. You should read the data set forth below in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations and our consolidated financial statements and related notes included elsewhere in this prospectus. We derived the consolidated statements of operations data for the years ended December 31, 2000, 2001 and 2002 from our audited financial statements included elsewhere in this prospectus. We derived the selected financial data with respect to the consolidated statements of operations data for the six months ended June 30, 2002 and 2003, and with respect to the balance sheet data at June 30, 2003, from unaudited financial statements included elsewhere in this prospectus. The data set forth below reflects the recent restatement of our financial statements to account for a change in the timing of revenue recognition, as more fully explained in Management s Discussion and Analysis of Financial Condition and Results of Operation and Note 2 to the consolidated financial statements included elsewhere in this prospectus.

| | Fiscal Years Ended December 31, (Restated) | | | Six Months Ended June 30, | |
|---|---|---|---|---|---|
| | 2000 | 2001 | 2002 | 2002 (Restated) | 2003 |
| **Consolidated Statements of Operations Data:** | | | | | |
| Net sales | $ 9,495 | $ 16,546 | $ 27,257 | $ 12,275 | $ 19,557 |
| Cost of sales | 4,816 | 6,938 | 10,485 | 4,827 | 7,362 |
| Gross profit | 4,679 | 9,608 | 16,772 | 7,448 | 12,195 |
| Other income | | 79 | 63 | 32 | 32 |
| Operating expenses: | | | | | |
| Sales and marketing | 4,211 | 7,314 | 10,729 | 4,637 | 7,233 |
| General and administrative | 1,841 | 2,011 | 3,010 | 1,332 | 1,880 |
| Engineering and development | 2,288 | 1,520 | 1,684 | 788 | 1,033 |
| Total operating expenses | 8,340 | 10,845 | 15,423 | 6,757 | 10,146 |
| Income (loss) from operations | (3,661) | (1,158) | 1,412 | 723 | 2,081 |
| Non-operating income (loss) | (94) | (123) | 86 | 61 | 112 |
| Income (loss) before cumulative effect of change in accounting principle | (3,755) | (1,281) | 1,498 | 784 | 2,193 |
| Cumulative effect of change in accounting principle | (34) | | | | |
| Net income (loss) | $ (3,789) | $ (1,281) | $ 1,498 | $ 784 | $ 2,193 |
| Income (loss) per share before cumulative effect of change in accounting principle: | | | | | |
| Basic | $ (0.20) | $ (0.07) | $ 0.08 | $ 0.04 | $ 0.11 |
| Diluted | $ (0.20) | $ (0.07) | $ 0.07 | $ 0.04 | $ 0.10 |
| Cumulative effect of change in accounting principle per share: | | | | | |
| Basic | $ 0.00 | $ | $ | $ | $ |
| Diluted | $ 0.00 | $ | $ | $ | $ |

| | | | | | |
|---|---|---|---|---|---|
| Net income (loss) per share: | | | | | |
| Basic | $ (0.20) | $ (0.07) | $ 0.08 | $ 0.04 | $ 0.11 |
| Diluted | $ (0.20) | $ (0.07) | $ 0.07 | $ 0.04 | $ 0.10 |
| Shares used in computing net income (loss) per share | | | | | |
| Basic | 19,171 | 19,510 | 19,929 | 19,910 | 20,781 |
| Diluted | 19,171 | 19,510 | 21,303 | 21,454 | 22,691 |

The following table presents our consolidated balance sheet data as of June 30, 2003, which we derived from our unaudited financial statements included elsewhere in this prospectus. The as adjusted for the offering data gives effect to the sale of 2,500,000 shares of common stock by us in this offering at an assumed public offering price of $12.85 per share, which was the last reported sales price of our common stock on September 19, 2003, and after deducting underwriting discounts and commissions, and estimated offering expenses payable by us.

| | June 30, 2003 | |
|---|---|---|
| | **Actual** | **As Adjusted for Offering** |
| **Consolidated Balance Sheet Data:** | | |
| Cash and cash equivalents | $ 6,646 | $ 35,883 |
| Working capital | 4,869 | 34,106 |
| Total assets | 25,605 | 54,842 |
| Total debt | 3,124 | 3,124 |
| Stockholders equity | 12,446 | 41,683 |

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## RISK FACTORS

*Investing in our common stock involves a high degree of risk. You should carefully consider the following risks and all the other information in this prospectus before making an investment decision about our common stock. While the risks described below are the ones we believe are most important for you to consider, these risks are not the only ones that we face. If any of the following risks actually occurs, our business, operating results or financial condition could suffer, the trading price of our common stock could decline and you could lose all or part of your investment.*

### Risks Relating to Our Business

**Our quarterly sales and operating results may fluctuate in future periods and we may fail to meet expectations, which may cause the price of our common stock to decline.**

Our quarterly sales and operating results have fluctuated and are likely to continue to vary from quarter to quarter due to a number of factors, many of which are not within our control. If our quarterly sales or operating results fall below the expectations of investors or securities analysts, the price of our common stock could decline substantially. Factors that might cause quarterly fluctuations in our sales and operating results include the following:

- variation in demand for our products, including variation due to seasonality;
- our ability to research, develop, introduce, market and gain market acceptance of new products and product enhancements in a timely manner;
- our ability to control costs;
- the size, timing, rescheduling or cancellation of significant customer orders;
- the introduction of new products by competitors;
- long sales cycles and fluctuations in sales cycles;
- the availability and reliability of components used to manufacture our products;
- changes in our pricing policies or those of our suppliers and competitors, as well as increased price competition in general;
- the mix of our domestic and international sales, and the risks and uncertainties associated with our international business;

- costs associated with any future acquisitions of technologies and businesses;
- limitations on our ability to use net operating loss carryforwards under the provisions of Internal Revenue Code Section 382 and similar provisions under applicable state laws;
- developments concerning the protection of our proprietary rights; and
- general global economic and political conditions, including international conflicts and acts of terrorism.

A significant amount of our sales in any quarter may consist of sales through distributors. Sales from distributors accounted for approximately 17% of our revenue in 2002, and no single distributor accounted for more than 10% of our sales in any given quarter. As a result, the timing of orders by distributors may impact our quarter-to-quarter results. The loss of or a substantial reduction in orders from distributors could seriously harm our business, financial condition and results of operations. Additionally, the amount of expenses we incur, in part, depends on our expectations regarding future sales. In particular, we expect to continue incurring substantial expenses relating to the marketing and promotion of our products. Since many of our costs are fixed in the short term, if we have a shortfall in sales, we may be unable to reduce expenses quickly enough to avoid losses. Accordingly, you should not rely on quarter-to-quarter comparisons of our operating results as an indication of our future performance.

**Dentists and patients may be slow to adopt laser technologies, which could limit the market acceptance of our products.**

Our dental laser systems represent relatively new technologies in the dental market. Currently, only a small percentage of dentists use lasers to perform dental procedures. Our future success will depend on our ability to increase demand for our products by demonstrating to a broad spectrum of dentists and patients the potential performance advantages of our laser systems over traditional methods of treatment and over competitive laser systems. Dentists have historically been and may continue to be slow to adopt new technologies on a widespread basis. Factors that may inhibit adoption of laser technologies by dentists include cost, and concerns about the safety, efficacy and reliability of lasers. Economic pressure may make dentists reluctant to purchase substantial capital equipment or invest in new technologies. Patient acceptance will depend in part on the recommendations of dentists and specialists as well as other factors, including without limitation, the relative effectiveness, safety, reliability and comfort of our systems as compared with those of other instruments and methods for performing dental procedures. The failure of dental lasers to achieve broad market acceptance would have an adverse effect on our business, financial condition and results of operations. We cannot assure you that we will have sufficient resources to continue to successfully market our products to achieve broad market acceptance.

**We may have difficulty managing our growth.**

We have been experiencing significant growth in the scope of our operations and the number of our employees. This growth has placed significant demands on our management as well as our financial and operational resources. In order to achieve our business objectives, we anticipate that we will need to continue to grow. If this growth occurs, it will continue to place additional significant demands on our management and our financial and operational resources, and will require that we continue to develop and improve our operational, financial and other internal controls both in the United States and internationally. In particular, our growth has and, if it continues, will increase the challenges involved in implementing appropriate operational and financial systems, expanding manufacturing capacity and scaling up production, expanding our sales and marketing infrastructure and capabilities, providing adequate training and supervision to maintain high quality standards, and preserving our culture and values. The main challenge associated with our growth has been, and we believe will continue to be, our ability to recruit skilled sales, manufacturing and management personnel. Our inability to scale our business appropriately or otherwise adapt to growth would cause our business, financial condition and results of operations to suffer.

**If we are unable to protect our intellectual property rights, our competitive position could be harmed or we could be required to incur expenses to enforce our rights.**

Our future success will depend, in part, on our ability to obtain and maintain patent protection for our products and technology, to preserve our trade secrets and to operate without infringing the intellectual property of others. In part, we rely on patents to establish and maintain proprietary rights in our technology and products. While we hold a number of issued patents and have other patent applications pending on our products and technology, we cannot assure you that any additional patents will be issued, that the scope of any patent protection will exclude competition or that any of our patents will be held valid if subsequently challenged. Other companies also may independently develop similar products, duplicate our products or design products that circumvent our patents. Additionally, the laws of foreign countries may not protect our products or intellectual property rights to the same extent as do the laws of the United States.

We face substantial uncertainty regarding the impact that other parties intellectual property positions will have on the markets for dental and other medical lasers. Competitors may claim that we have infringed their current or future intellectual property rights. The medical technology industry has in the past been characterized by a substantial amount of litigation and related administrative proceedings regarding patents and intellectual property rights. We may not prevail in any future intellectual property infringement litigation given the complex technical issues and inherent uncertainties in litigation. Any claims, with or without merit, could be time-consuming and distracting to management, result in costly litigation, cause product shipment delays, or

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require us to enter into royalty or licensing agreements. Additionally, if an intellectual property claim against us is successful, we might not be able to obtain a license on acceptable terms or license a substitute technology or redesign our products to avoid infringement. Any of the foregoing adverse events could seriously harm our business, financial condition and results of operations.

**We are a party to two related patent infringement lawsuits involving patents relating to our core technology, which if determined adversely to us, could have a significant negative effect on our earnings.**

We are currently involved in two patent related lawsuits with Diodem, LLC, a California limited liability company, which was founded by Collete Cozean, the former chief executive officer of Premier Laser Systems, Inc. On May 2, 2003, we initiated a civil action in the U.S. District Court for the Central District of California against Diodem, in which we are seeking a judicial declaration against Diodem that technology used in our laser systems does not infringe four patents owned by Diodem. Diodem claims to have acquired the patents from Premier Laser Systems, Inc., which filed for bankruptcy protection in March 2000. On May 5, 2003, Diodem added us as a party to an infringement lawsuit it had previously filed in the U.S. District Court for the Central District of California. Diodem alleges that our technology, including the technology used in our Waterlase system, infringes four patents it acquired from Premier. Diodem s infringement suit seeks treble damages, a preliminary and permanent injunction from further alleged infringement, attorneys fees and other unspecified damages. Both of these lawsuits are in their preliminary stages, and may proceed for an extended period of time. There can be no assurance that our technology will not be found to infringe any of Diodem s patents at issue in these proceedings or that we will not be liable for some or all of the damages alleged by Diodem or subject to some or all of the relief requested by Diodem.

In addition, these lawsuits could result in significant expenses and diversion of management s time and other resources. If Diodem successfully asserts an infringement claim against us in its infringement lawsuit, our operations may be severely impacted, especially to the extent that it affects our right to use the technology incorporated in our Waterlase system, which accounted for approximately 77% of our revenue in 2002 and approximately 82% of our revenue for the six months ended June 30, 2003. Diodem s infringement proceeding could also result in significant limitations on our ability to manufacture, market and sell our products, including our Waterlase system, as well as delays and costs associated with redesigning our products and payments of license fees, monetary damages and other payments. Additionally, we may be enjoined from incorporating certain technology into our products, all of which could significantly impede our operations, increase operating expenses, reduce our revenue and cause us to incur losses.

**We depend on a limited number of suppliers and if we cannot secure alternate suppliers, the amount of sales in any period could be adversely affected.**

We purchase certain materials and components included in our Waterlase system and other products from a limited group of suppliers using purchase orders, and we have no written supply contracts with our key suppliers. Our business depends in part on our ability to obtain timely deliveries of materials and components in acceptable quality and quantities from our suppliers. The introduction of our LaserSmile system in 2001 was delayed due to an interruption in the supply of components for the system, however, we have not otherwise experienced material delays in the supply of components. Certain components of our products, particularly specialized components used in our lasers, are currently available only from a single source or limited sources. For example, the crystal, fiber and handpieces used in our Waterlase system, which accounted for approximately 77% of our revenue in 2002 and approximately 82% of our revenue for the six months ended June 30, 2003, are each supplied by a separate single supplier. We have not experienced material delays from these suppliers, and we have identified and tested alternative suppliers for each of these three components. However, an unexpected interruption in a single source supplier could create manufacturing delays, and disrupt sales and cash flow as we sought to replace the supplier, which we estimate could take up to three months. Such an interruption could cause our business, financial condition and results of operations to suffer.

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**We have significant international sales and are subject to risks associated with operating in international markets.**

International sales comprise a significant portion of our net sales and we intend to continue to pursue and expand our international business activities. International sales accounted for approximately 23% of our revenue in 2002 and approximately 21% of our revenue for the six months ended June 30, 2003. Political and economic conditions outside the United States could make it difficult for us to increase our international sales or to operate abroad. International operations, including our facility in Germany, are subject to many inherent risks, including:

- adverse changes in tariffs;
- political, social and economic instability and increased security concerns;
- fluctuations in currency exchange rates;
- longer collection periods and difficulties in collecting receivables from foreign entities;
- exposure to different legal standards;
- ineffectiveness of international distributors;
- reduced protection for our intellectual property in some countries;
- burdens of complying with a variety of foreign laws;
- import and export license requirements and restrictions of the United States and each other country in which we operate;
- trade restrictions;
- the imposition of governmental controls;
- unexpected changes in regulatory or certification requirements;
- difficulties in staffing and managing international manufacturing and sales operations; and
- potentially adverse tax consequences and the complexities of foreign value added tax systems.

We believe that international sales will continue to represent a significant portion of our net sales, and we intend to further expand our international operations. Our sales in Europe are denominated principally in Euros, while our sales in other international markets are in dollars. As a result, an increase in the relative value of the dollar against the Euro would lead to less income from sales denominated in Euros, unless we increase prices, which may not be possible due to competitive conditions in Europe. We realized a gain of $108,000 on foreign currency transactions for the six month period ended June 30, 2003, due to a decrease in the value of the dollar relative to the value of the Euro. We could experience losses from European transactions if the relative value of the dollar were to increase in the future. We do not currently engage in any transactions as a hedge against risks of loss due to foreign currency fluctuations, although we may consider doing so in the future. We also expect that sales of products manufactured at our facility in Germany will account for an increasing percentage of our revenue, which will further increase our exposure to the above-described risks associated with our international operations. Sales of products manufactured at our German facility accounted for 9% of our revenue in 2002 and approximately 22% of our revenue for the six months ended June 30, 2003. Since expenses relating to our manufacturing operations in Germany are paid in Euros, an increase in the value of the Euro relative to the dollar would increase the expenses associated with our German manufacturing operations and reduce our earnings. In addition, we may experience difficulties associated with managing our operations remotely and complying with German regulatory and legal requirements for maintaining our manufacturing operations in that country. Any of these factors may adversely affect our future international sales and manufacturing operations and, consequently, negatively impact our business, financial condition and operating results. Despite these risks, we believe the market for our products outside the United States justifies our effort to expand our international operations.

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**If we are unable to meet customer demand or comply with quality regulations, our sales will suffer.**

We manufacture our products at our California and German production facilities. In order to achieve our business objectives, we will need to significantly expand our manufacturing capabilities to produce the systems and accessories necessary to meet demand. We intend to finance the cost of expansion through operating income, funds available under our bank credit line and a portion of the proceeds from this offering. We may encounter difficulties in scaling-up production of our products, including problems involving production capacity and yields, quality control and assurance, component supply and shortages of qualified personnel. In addition, our manufacturing facilities are subject to periodic inspections by the U.S. Food and Drug Administration, state agencies and foreign regulatory agencies. Our success will depend in part upon our ability to manufacture our products in compliance with the U.S. Food and Drug Administration s Quality System regulations and other regulatory requirements. Our business will suffer if we do not succeed in manufacturing our products on a timely basis and with acceptable manufacturing costs while at the same time maintaining good quality control and complying with applicable regulatory requirements.

**Any failure to significantly expand sales of our products will negatively impact our business.**

We currently handle a majority of the marketing, distribution and sales of our laser systems. In order to achieve our business objectives, we will need to significantly expand our marketing and sales efforts on a nationwide and global basis. We will face significant challenges and risks in expanding, training, managing and retaining our sales and marketing teams, including managing geographically dispersed efforts. In addition, we use third party distributors to sell our products in a number of countries outside the United States, and are dependent on the sales and marketing efforts of these third party distributors. These distributors may not commit the necessary resources to effectively market and sell our products. If we are unable to expand our sales and marketing capabilities, we may not be able to effectively commercialize our products.

**Acquisitions could have unintended negative consequences, which could harm our business.**

As part of our business strategy, we may acquire one or more businesses, products or technologies. Most recently, in May 2003, we acquired the American Dental Laser product line and related dental laser assets of American Medical Technologies, Inc., including the Diolase and Pulsemaster systems, and related inventory, patents and other intellectual property rights. We are currently in the process of integrating the assets relating to the American Dental Laser product line into our operations. We must effectively integrate the American Dental Laser product line into our operations in order to achieve profitability from it. The pro forma income statement for the year ended December 31, 2002 included in this prospectus shows a net loss when the seller s historical losses from operating this product line are combined with our operations for 2002. However, we believe we can integrate the acquired assets into our sales and manufacturing infrastructure with minimal increase to our operating expenses because we acquired principally patents, brand names, customer lists and other intangibles and we did not assume the seller s personnel, facilities or other overhead.

Acquisitions could require significant capital infusions and could involve many risks, including, but not limited to, the following:

- we may encounter difficulties in assimilating and integrating the operations, products and workforce of the acquired companies;
- acquisitions may negatively impact our results of operations because they may require large one-time charges or could result in increased debt or contingent liabilities, adverse tax consequences, substantial depreciation or deferred compensation charges, or the amortization or write down of amounts related to deferred compensation, goodwill and other intangible assets;

acquisitions may be dilutive to our existing stockholders;

acquisitions may disrupt our ongoing business and distract our management; and

key personnel of the acquired company may decide not to work for us.

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We cannot assure you that we will be able to identify or consummate any future acquisitions on acceptable terms, or at all. If we do pursue any acquisitions, it is possible that we may not realize the anticipated benefits from such acquisitions or that the market will not positively view such acquisitions.

**We may be unable to comply with covenants contained in our credit agreement, which could result in the impairment of our working capital and alter our ability to operate our business.**

In May 2003, we secured a new credit facility through Bank of the West. At September 19, 2003, the outstanding principal balance on this credit facility was $1.8 million. To maintain the right to borrow under this credit facility and avoid a default under our credit agreement with Bank of the West, we are required to satisfy certain financial tests and comply with certain operating covenants contained in that agreement. Our ability to satisfy required financial ratios and tests can be affected by events beyond our control, including prevailing economic, financial and industry conditions, and we cannot assure you that we will continue to meet those ratios and tests in the future. A breach of any of these covenants, ratios or tests could result in a default under our credit agreement. If we default, our lender will no longer be obligated to extend credit to us and could elect to declare all amounts outstanding under the credit agreement, together with accrued interest, to be immediately due and payable. If we were unable to repay those amounts, our lender could proceed against the collateral granted to it to secure that indebtedness, which includes our intellectual property. The results of such action would have a significant negative impact on our results of operations and financial condition. Due to the restatement of our financial statements, we were not in compliance with three covenants under the credit facility at June 30, 2003. The bank waived our non-compliance with these covenants as of June 30, 2003, so that we are not in default under the credit facility. We cannot assure you that we will regain compliance as of the next evaluation date for determining compliance with financial covenants on September 30, 2003.

**Material increases in interest rates may harm our sales.**

We currently sell our products primarily to dentists in general practice. These dentists often purchase our products with funds they secure through various financing arrangements with third party financial institutions, including credit facilities and short term loans. If interest rates increase, these financing arrangements will be more expensive to our dental customers, which would effectively increase the price of our products to our customers and, thereby, may decrease overall demand for our products. Any reduction in the sales of our products would cause our business to suffer.

**We may not be able to compete successfully against our current and future competitors.**

We compete with a number of foreign and domestic companies that market traditional dental products, such as dental drills, as well as other companies that market laser technologies in the dental and medical markets that we address, including companies such as Hoya ConBio, a subsidiary of Hoya Photonics, a large Japanese manufacturer primarily of optics and crystals, OpusDent Ltd., a subsidiary of Lumenis, Ka Vo, Deka Dental Corporation and Fotona d.d. Some of our competitors have greater financial, technical, marketing or other resources than us, which may allow them to respond more quickly to new or emerging technologies and to devote greater resources to the acquisition or development and introduction of enhanced products than we can. In addition, the rapid technological changes occurring in the healthcare industry are expected to lead to the entry of new competitors, especially as dental and medical lasers gain increasing market acceptance. Our ability to anticipate technological changes and to introduce enhanced products on a timely basis will be a significant factor in our ability to grow and remain competitive. New competitors or technological changes in laser products and methods could cause commoditization of such products, require price discounting or otherwise adversely affect our gross margins.

**Rapid changes in technology could harm the demand for our products or result in significant additional costs.**

The markets in which our laser systems compete are subject to rapid technological change, evolving industry standards, changes in the regulatory environment, frequent new device introductions and evolving dental

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and surgical techniques. These changes could render our products uncompetitive or obsolete. The success of our existing and future products is dependent on the differentiation of our products from those of our competitors, the timely introduction of new products and the perceived benefit to the customer in terms of improved patient satisfaction and return on investment. The process of developing new medical devices is inherently complex and requires regulatory approvals or clearances that can be expensive, time consuming and uncertain. We cannot assure you that we will successfully identify new product opportunities, be financially or otherwise capable of completing the research and development required to bring new products to market in a timely manner or that products and technologies developed by others will not render our products obsolete.

**The failure to attract and retain key personnel could adversely affect our business.**

Our future success depends in part on the continued service of certain key personnel, including our Chief Executive Officer, our Executive Vice President responsible for sales, our Vice President of Research and Development and our Chief Financial Officer. We do not have employment agreements with any of our key employees, other than an employment agreement with our Chief Executive Officer, which expires in January 2004, and an employment agreement with our Executive Vice President responsible for sales, which can be terminated at will by the executive or by us.

Our success will also depend in large part on our ability to continue to attract, retain and motivate qualified engineering and other highly skilled technical personnel. Competition for certain employees, particularly development engineers, is intense despite the effects of the economic slowdown. We may be unable to continue to attract and retain sufficient numbers of such highly skilled employees. Our inability to attract and retain additional key employees or the loss of one or more of our current key employees could adversely affect our business, financial condition and results of operations.

**Product liability claims against us could be costly and could harm our reputation.**

The sale of dental and medical devices involves the inherent risk of product liability claims against us. We currently maintain product liability insurance on a per occurrence basis with a limit of $11 million per occurrence and $12 million in the aggregate for all occurrences. The insurance is subject to various standard coverage exclusions, including damage to the product itself, losses from recall of our product and losses covered by other forms of insurance such as workers compensation. There is no assurance that we will be able to obtain such insurance in the future on terms acceptable to us, or at all. We do not know whether claims against us with respect to our products, if any, would be successfully defended or whether our insurance would be sufficient to cover liabilities resulting from such claims. Any claims successfully brought against us would cause our business to suffer.

**We are exposed to risks associated with the recent worldwide economic slowdown and related uncertainties.**

Concerns about decreased consumer and investor confidence, reduced corporate profits and capital spending, and recent international conflicts and terrorist and military activity have resulted in a downturn in the equity markets and a slowdown in economic conditions, both domestically and internationally, and have caused concern about the strength or longevity of an economic recovery. These unfavorable conditions could ultimately cause a slowdown in customer orders or cause customer order cancellations. In addition, recent political and social turmoil related to international conflicts and terrorist acts may put further pressure on economic conditions in the United States and abroad. Unstable political, social and economic conditions make it difficult for our customers, our suppliers and us to accurately forecast and plan future business activities. If such conditions continue or worsen, our business, financial condition and results of operations could suffer.

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**We may not be able to secure additional financing to meet our future capital needs.**

We expect to expend significant capital to further develop our products, increase awareness of our laser systems and our brand names and to expand our operating and management infrastructure as we increase sales in the United States and abroad. We may use capital more rapidly than currently anticipated. Additionally, we may incur higher operating expenses and generate lower revenue than currently expected, and we may be required to depend on external financing to satisfy our operating and capital needs, including the repayment of our debt obligations. We may be unable to secure additional debt or equity financing on terms acceptable to us, or at all, at the time when we need such funding. If we do raise funds by issuing additional equity or convertible debt securities, the ownership percentages of existing stockholders would be reduced, and the securities that we issue may have rights, preferences or privileges senior to those of the holders of our common stock or may be issued at a discount to the market price of our common stock which would result in dilution to our existing stockholders. If we raise additional funds by issuing debt, we may be subject to debt covenants, such as the debt covenants under our secured credit facility, which could place limitations on our operations including our ability to declare and pay dividends. Our inability to raise additional funds on a timely basis would make it difficult for us to achieve our business objectives and would have a negative impact on our business, financial condition and results of operations.

**We have adopted anti-takeover defenses that could delay or prevent an acquisition of our company and may affect the price of our common stock.**

Certain provisions of our certificate of incorporation and stockholder rights plan could make it difficult for any party to acquire us, even though an acquisition might be beneficial to our stockholders. These provisions could limit the price that investors might be willing to pay in the future for shares of our common stock.

In December 1998, we adopted a stockholder rights plan pursuant to which one preferred stock purchase right is distributed to our stockholders for each share of our common stock held by them. In connection with the stockholder rights plan, the Board of Directors may issue up to 500,000 shares of Series B Junior Participating Cumulative Preferred Stock. If any party acquires 15% or more of our outstanding common stock, the holders of these rights will be able to purchase the underlying junior participating preferred stock as a way to discourage, delay or prevent a change in control of our company.

In addition, under our certificate of incorporation, the Board of Directors has the power to authorize the issuance of up to 500,000 shares of preferred stock and to determine the price, rights, preferences, privileges and restrictions, including voting rights, of those shares without further vote or action by the stockholders. Accordingly, our Board of Directors may issue preferred stock with terms that could have preference over and adversely affect the rights of holders of our common stock.

The issuance of any preferred stock may:

- delay, defer or prevent a change in control of BioLase;
- discourage bids for the common stock at a premium over the market price of our common stock;
- adversely affect the voting and other rights of the holders of our common stock; and

discourage acquisition proposals or tender offers for our shares.

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## Risks Relating to Our Industry

**Changes in government regulation or the inability to obtain or maintain necessary government approvals could harm our business.**

Our products are subject to extensive government regulation, both in the United States and in other countries. To clinically test, manufacture and market products for human use, we must comply with regulations and safety standards set by the U.S. Food and Drug Administration and comparable state and foreign agencies. Regulations adopted by the U.S. Food and Drug Administration are wide ranging and govern, among other things, product design, development, manufacture and testing, labeling, storage, advertising and sales. Generally, products must meet regulatory standards as safe and effective for their intended use before being marketed for human applications. The clearance process is expensive, time-consuming and uncertain. Failure to comply with applicable regulatory requirements of the U.S. Food and Drug Administration can result in an enforcement action which may include a variety of sanctions, including fines, injunctions, civil penalties, recall or seizure of our products, operating restrictions, partial suspension or total shutdown of production and criminal prosecution. The failure to receive or maintain requisite approvals for the use of our products or processes, or significant delays in obtaining such approvals, could prevent us from developing, manufacturing and marketing products and services necessary for us to remain competitive. In addition, unanticipated changes in existing regulatory requirements or the adoption of new requirements could impose significant costs and burdens on us, which could increase our operating expenses, reduce our revenue and profits, and result in operating losses.

**If our customers cannot obtain third party reimbursement for their use of our products, they may be less inclined to purchase our products.**

Our products are generally purchased by dental or medical professionals who have various billing practices and patient mixes. Such practices range from primarily private pay to those who rely heavily on third party payors, such as private insurance or government programs. In the United States, third party payors review and frequently challenge the prices charged for medical services. In many foreign countries, the prices for dental services are predetermined through government regulation. Payors may deny coverage and reimbursement if they determine that the procedure was not medically necessary, such as a cosmetic procedure, or that the device used in the procedure was investigational. We believe that most of the procedures being performed with our current products generally are reimbursable, with the exception of cosmetic applications such as tooth whitening. For the portion of dentists who rely heavily on third party reimbursement, the inability to obtain reimbursement for services using our products could deter them from purchasing or using our products. We cannot predict the effect of future healthcare reforms or changes in financing for health and dental plans. Any such changes could have an adverse effect on the ability of a dental or medical professional to generate a return on investment using our current or future products. Such changes could act as disincentives for capital investments by dental and medical professionals and could have a negative impact on our business, financial condition and results of operations.

## Risks Relating to This Offering

**Our common stock price has been volatile, which could result in substantial losses for stockholders.**

Our common stock is currently traded on the Nasdaq National Market and the Nasdaq Europe Market. While our average daily trading volume for the 52-week period ending September 19, 2003 was approximately 469,301 shares, we have in the past experienced, and may in the future experience, more limited daily trading volume. The trading price of our common stock has been and may continue to be volatile. The closing sale prices of our common stock, as reported by the Nasdaq National Market, have ranged from $3.50 to $16.03 for the 52-week period ending September 19, 2003. The market for technology companies, in particular, has at various times experienced extreme volatility that often has been unrelated to the operating performance of particular

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companies. These broad market and industry fluctuations may significantly affect the trading price of our common stock, regardless of our actual operating performance. The trading price of our common stock could be affected by a number of factors, including, but not limited to, changes in expectations of our future performance, changes in estimates by securities analysts (or failure to meet such estimates), quarterly fluctuations in our sales and financial results and a variety of risk factors, including the ones described elsewhere in this prospectus. Periods of volatility in the market price of a company s securities sometimes result in securities class action litigation. If this were to happen to us, such litigation would be expensive and would divert management s attention. In addition, if we needed to raise equity funds under adverse conditions, it would be difficult to sell a significant amount of our stock without causing a significant decline in the trading price of our stock.

**Our shares may be delisted if our stock price drops below $5.00 per share or if we otherwise fail to comply with applicable listing requirements.**

We are required to maintain a stock price of approximately $5.00 per share in order to maintain our listing on the Nasdaq National Market. If our stock price drops below approximately $5.00 per share for an extended period of time or we are otherwise unable to satisfy the continued listing requirements of the Nasdaq National Market, our shares could be delisted from the Nasdaq National Market and the marketability, liquidity and price of our common stock would be adversely affected.

**Investors will experience immediate and substantial dilution in net tangible book value per share of common stock purchased in this offering.**

Our net tangible book value at June 30, 2003, was approximately $6.9 million, or approximately $0.32 per share of common stock, without giving effect to any exercise of options then outstanding. Our net tangible book value per share has been determined by dividing the net tangible book value, total tangible assets less total liabilities, by the number of shares of common stock outstanding at June 30, 2003. After giving effect to the sale of 2,500,000 shares of our common stock in this offering at the public offering price of $12.85 per share, which was the last reported sales price of our common stock on the Nasdaq National Market on September 19, 2003, and after deduction of the underwriting discount and estimated offering expenses, our net tangible book value immediately after the offering will be approximately $36.1 million or $1.50 per share. Accordingly, the offering price of our common stock will be substantially higher than the net tangible book value per share of our existing capital stock. As a result, if you purchase common stock in this offering, you will incur immediate and substantial dilution of $11.35 in net tangible book value per share of common stock, based on the public offering price of $12.85 per share. You also could experience additional dilution upon the exercise of outstanding stock options.

**Our management will have broad discretion over the use of the capital resources made available by this offering and you may not agree with the way they are used.**

While we currently intend to use the net proceeds of this offering for general corporate purposes, working capital, potential repayment of debt, capital expenditures and potential future acquisitions or other investments, we may subsequently choose to use it for different purposes or not at all. The effect of the offering will be to increase capital resources available to our management, and our management may allocate these capital resources as it determines is necessary. You will be relying on the judgment of our management with regard to the use of the capital resources generated by this offering.

**Our stock price may decline if additional shares are sold in the market after the offering.**

Future sales of substantial amounts of shares of our common stock by our existing stockholders in the public market, or the perception that these sales could occur, may cause the market price of our common stock to decline. In addition, we may be required to issue additional shares upon exercise of previously granted options that are currently outstanding. Our directors and executive officers have agreed to enter into lock up agreements with the

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underwriters, in which they will agree to refrain from selling their shares for a period of 120 days after this offering. Increased sales of our common stock in the market after exercise of currently outstanding options or expiration of the lock-up agreements could exert significant downward pressure on our stock price. These sales also might make it more difficult for us to sell equity or equity-related securities in the future at a time and price we deem appropriate.

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## FORWARD-LOOKING STATEMENTS

This prospectus contains forward-looking statements, including statements concerning the future of our industry, product and service development, business strategy, the possibility of future acquisitions, and continued acceptance and growth of our products. These statements may be identified by the use of forward-looking terminology such as may, will, expect, anticipate, estimate, continue or other similar wor These statements may discuss future expectations, contain projections of results of operations or of financial condition or include other forward-looking information. You should not place undue reliance on any forward-looking statements. When considering any forward-looking statements, you should keep in mind the risk factors and other cautionary statements in this prospectus. The risk factors noted above and other factors noted throughout this prospectus could cause our actual results to differ significantly from the results contained in any forward-looking statement. Except as required by Federal securities laws, we are under no obligation to update any forward-looking statements, whether as a result of new information, future events or otherwise.

In this prospectus, we rely on and refer to information, statistics and forecasts regarding the markets in which we compete. We obtained this information and these statistics and forecasts from various sources and publications that are not produced for the purposes of securities offerings or economic analysis. We have not independently verified the data and make no representation as to the accuracy of the data we have included.

## USE OF PROCEEDS

The net proceeds to us from the sale of the 2,500,000 shares of common stock offered by us under this prospectus will be approximately $29,237,000 based on an assumed public offering price of $12.85 per share, which was the last reported sales price of our common stock on the Nasdaq National Market on September 19, 2003, and after deducting estimated underwriting discounts and commissions, and expenses payable by us. We will not receive any proceeds from the sale of 307,500 shares by the selling stockholder. Our net proceeds will be approximately $34,297,000 if the underwriters fully exercise their over-allotment option to purchase 421,125 shares of our common stock from us.

We expect to use the net proceeds of the offering for general corporate purposes, working capital, potential repayment of debt, of which approximately $3 million is currently outstanding, and capital expenditures, including expenditures for expansion of our production capabilities. A portion of the net proceeds of this offering may also be used to acquire or invest in complementary businesses or products or to obtain the right to use complementary technologies. Although we from time to time evaluate potential acquisitions of such businesses, products or technologies, and anticipate continuing to make these evaluations, we have no present understandings, commitments or agreements with respect to any acquisitions.

The amounts and timing of our actual expenditures will depend on numerous factors, including the status of our product development efforts, sales and marketing activities, technological advances, the amount of cash generated or used by our operations, and competition. We may find it necessary or advisable to use the net proceeds for other purposes, and we will have broad discretion in the application of the balance of the net proceeds. Pending the uses described above, we intend to invest the net proceeds in short-term, interest-bearing securities and debt instruments in compliance with our investment policy. We believe that our available cash, together with the net proceeds of this offering, will be sufficient to meet our capital requirements for at least the next twelve months.

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## PRICE RANGE OF COMMON STOCK

Our common stock is listed on the Nasdaq National Market under the symbol BLTI. The following table sets forth the high and low closing sale prices of our common stock as reported by the Nasdaq National Market for the periods indicated.

| | High | Low |
|---|---|---|
| Fiscal Year Ended December 31, 2001 | | |
| First Quarter | $ 3.03 | $ 1.53 |
| Second Quarter | 5.07 | 2.09 |
| Third Quarter | 6.59 | 3.47 |
| Fourth Quarter | 6.80 | 3.60 |
| Fiscal Year Ended December 31, 2002 | | |
| First Quarter | $ 6.58 | $ 5.11 |
| Second Quarter | 5.88 | 4.00 |
| Third Quarter | 5.14 | 3.80 |
| Fourth Quarter | 5.89 | 3.68 |
| Fiscal Year Ended December 31, 2003 | | |
| First Quarter | $ 8.29 | $ 5.30 |
| Second Quarter | 14.78 | 8.18 |
| Third Quarter (through September 19, 2003) | 14.93 | 10.50 |

On September 19, 2003, the last reported sale price of our common stock on the Nasdaq National Market was $12.85 per share. As of September 19, 2003, there were approximately 280 holders of record of our common stock. Based on information provided by our transfer agent and registrar, we believe that there are approximately 12,005 beneficial owners of our common stock.

## DIVIDEND POLICY

We have never declared or paid cash dividends on our common stock. We anticipate that we will retain earnings to support and to finance the growth and development of our business. As a result, we do not plan to pay any cash dividends in the near future. Our current policy is to retain all earnings to finance future growth. Any future determination relating to dividend policy will be made at the discretion of our Board of Directors and will depend on a number of factors, including our future earnings, capital requirements, financial condition, future prospects, and other factors as the Board of Directors may deem relevant.

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## CAPITALIZATION

The following table sets forth our capitalization as of June 30, 2003 on an:

- actual basis;
- as adjusted for the sale of 2,500,000 shares of our common stock offered by us under this prospectus at the public offering price of $12.85 per share, the last reported sales price of our common stock on the Nasdaq National Market on September 19, 2003, after deducting underwriting discounts and commissions and offering expenses payable by us.

This capitalization table should be read in conjunction with our consolidated financial statements and related notes beginning on page F-1.

| | June 30, 2003 | |
|---|---|---|
| | Actual | As Adjusted for Offering |
| | (in thousands) | |
| Cash and cash equivalents | $ 6,646 | $ 35,883 |
| Line of credit | 1,792 | 1,792 |
| Short-term debt | 1,332 | 1,332 |
| Total debt | 3,124 | 3,124 |
| Stockholders equity: | | |
| Preferred stock, par value $0.001; 1,000,000 shares authorized, no shares issued and outstanding | | |
| Common stock, $0.001 par value: 50,000,000 shares authorized actual and as adjusted; 21,519,000 shares issued and outstanding actual and 24,019,000 shares issued and outstanding as adjusted for offering(1) | 22 | 25 |
| Additional paid-in capital | 56,704 | 85,938 |
| Accumulated other comprehensive income | (134) | (134) |
| Accumulated deficit | (44,146) | (44,146) |
| Total stockholders equity | 12,446 | 41,683 |
| Total capitalization | $ 15,570 | $ 44,807 |

(1) The outstanding share information excludes outstanding options to purchase 2,786,948 shares of common stock exercisable at a weighted-average exercise price per share, as of June 30, 2003, of $3.84 and an additional 887,713 shares of common stock reserved for future grant or issuance under our equity incentive compensation plans.

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## SELECTED CONSOLIDATED FINANCIAL DATA

**(In thousands, except per share data)**

The following selected consolidated financial data should be read in conjunction with the Management s Discussion and Analysis of Financial Condition and Results of Operations and our consolidated financial statements and related notes included elsewhere in this prospectus. The consolidated selected financial data set forth below with respect to the consolidated statements of operations data for the years ended December 31, 2000, 2001 and 2002 and the consolidated balance sheet data at December 31, 2001 and 2002, were derived from the audited consolidated financial statements included elsewhere in this prospectus. We derived the consolidated statement of operations data for the years ended December 31, 1998 and 1999 and the consolidated balance sheet data as of December 31, 1998 and 1999 from our audited financial statements not included in this prospectus. We derived the selected financial data with respect to the consolidated statements of operations data for the six months ended June 30, 2002 and 2003, and with respect to the consolidated balance sheet data at June 30, 2003, from unaudited consolidated financial statements included elsewhere in this prospectus. The data set forth below as of December 31, 2001 and 2002 and for the three years then ended and as of June 30, 2002 and the six months then ended, reflects the recent restatement of our financial statements to account for a change in the timing of revenue recognition, as more fully explained in Management s Discussion and Analysis of Financial Condition and Results of Operation and Note 2 to the consolidated financial statements included elsewhere in this prospectus.

| | Fiscal Years Ended December 31, | | | | | Six Months Ended June 30, | |
|---|---|---|---|---|---|---|---|
| | 1998 | 1999 | 2000 | 2001 | 2002 | 2002 (Restated) | 2003[3] |
| | | | (Restated) | | | | |
| **Consolidated Statements of Operations Data:** | | | | | | | |
| Net sales | $ 1,465 | $ 7,004 | $ 9,495 | $ 16,546 | $ 27,257 | $ 12,275 | $ 19,557 |
| Cost of sales | 1,418 | 4,152 | 4,816 | 6,938 | 10,485 | 4,827 | 7,362 |
| Gross profit | 47 | 2,852 | 4,679 | 9,608 | 16,772 | 7,448 | 12,195 |
| Other income | | | | 79 | 63 | 32 | 32 |
| Operating expenses: | | | | | | | |
| Sales and marketing | 1,629 | 2,701 | 4,211 | 7,314 | 10,729 | 4,637 | 7,233 |
| General and administrative | 1,780 | 2,473 | 1,841 | 2,011 | 3,010 | 1,332 | 1,880 |
| Engineering and development[1] | 6,960 | 2,427 | 2,288 | 1,520 | 1,684 | 788 | 1,033 |
| Total operating expenses | 10,369 | 7,601 | 8,340 | 10,845 | 15,423 | 6,757 | 10,146 |
| Income (loss) from operations | (10,322) | (4,749) | (3,661) | (1,158) | 1,412 | 723 | 2,081 |
| Non-operating income (loss) | (24) | (49) | (94) | (123) | 86 | 61 | 112 |
| Income (loss) before cumulative effect of change in accounting principle | $ (10,346) | $ (4,798) | $ (3,755) | $ (1,281) | $ 1,498 | $ 784 | $ 2,193 |
| Cumulative effect of change in accounting principle | | | (34) | | | | |
| Net income (loss) | $ (10,346) | $ (4,798) | $ (3,789) | $ (1,281) | $ 1,498 | $ 784 | $ 2,193 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Income (loss) per share before cumulative effect of change in accounting principle: | | | | | | | |
| Basic | $ (0.69) | $ (0.28) | $ (0.20) | $ (0.07) | $ 0.08 | $ 0.04 | $ 0.11 |
| Diluted | $ (0.69) | $ (0.28) | $ (0.20) | $ (0.07) | $ 0.07 | $ 0.04 | $ 0.10 |
| Cumulative effect of change in accounting principle per share: | | | | | | | |
| Basic | $ | $ | $ 0.00 | $ | $ | $ | $ |
| Diluted | $ | $ | $ 0.00 | $ | $ | $ | $ |
| Net income (loss) per share: | | | | | | | |
| Basic | $ (0.69) | $ (0.28) | $ (0.20) | $ (0.07) | $ 0.08 | $ 0.04 | $ 0.11 |
| Diluted | $ (0.69) | $ (0.28) | $ (0.20) | $ (0.07) | $ 0.07 | $ 0.04 | $ 0.10 |
| Shares used in computing net income (loss) per share: | | | | | | | |
| Basic | 15,062 | 17,254 | 19,171 | 19,510 | 19,929 | 19,910 | 20,781 |
| Diluted | 15,062 | 17,254 | 19,171 | 19,510 | 21,303 | 21,454 | 22,691 |

| | December 31, | | | | | June 30, |
|---|---|---|---|---|---|---|
| | 1998 | 1999 | 2000(4) | 2001 | 2002 | 2003(3) |
| | | | (Restated) | | | |
| **Consolidated Balance Sheet Data:** | | | | | | |
| Cash and cash equivalents | $ 425 | $ 1,181 | $ 2,002 | $ 2,670 | $ 3,940 | $ 6,646 |
| Working capital (deficit) | 89 | (1,331) | (268) | 201 | 1,418 | 4,869 |
| Total assets | 3,911 | 2,672 | 6,822 | 8,253 | 16,003 | 25,605 |
| Total debt(2) | 1,705 | 1,342 | 2,967 | 1,792 | 3,012 | 3,124 |
| Stockholders equity (deficit) | 662 | (939) | 994 | 645 | 3,121 | 12,446 |

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(1) Includes charges in 1998 of $5.1 million related to a write-off of in-process research and development.
(2) Includes line of credit and short-term debt.
(3) On May 21, 2003 we acquired the American Dental Laser product line and related dental laser assets of American Medical Technologies, Inc. for approximately $5.8 million. Refer to Note 9 in the notes to the consolidated financial statements included elsewhere in this prospectus.
(4) The consolidated balance sheet data as of December 31, 2000 previously reported a working capital deficit of $206,000, total assets of $6.6 million and stockholders equity of $1.1 million.

The following table presents our consolidated balance sheet data as of June 30, 2003, which we derived from our unaudited financial statements included elsewhere in this prospectus. The as adjusted for the offering data gives effect to the sale of 2,500,000 shares of common stock by us in this offering at an assumed public offering price of $12.85 per share, which was the last reported sales price of our common stock on the Nasdaq National Market on September 19, 2003, and after deducting underwriting discounts and commissions and estimated offering expenses payable by us.

| | June 30, 2003 | |
|---|---|---|
| | **Actual** | **As Adjusted for Offering** |
| | (in thousands) | |
| **Consolidated Balance Sheet Data:** | | |
| Cash and cash equivalents | $ 6,646 | $ 35,883 |
| Working capital | 4,869 | 34,106 |
| Total assets | 25,605 | 54,842 |
| Total debt | 3,124 | 3,124 |
| Stockholders equity | 12,446 | 41,683 |

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**MANAGEMENT S DISCUSSION AND ANALYSIS OF**

**FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*The following discussion of our results of operations and financial condition should be read together with the consolidated financial statements and the notes to those statements included in this prospectus and other financial information incorporated by reference in this prospectus. This discussion may contain forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from the results anticipated in any forward-looking statements as a result of a variety of factors, including those discussed in Risk Factors and elsewhere in this prospectus.*

**Restatement of Financial Statements**

We recently restated our previously issued financial statements for each of the three years in the period ended December 31, 2002, the three months ended March 31, 2003, and interim periods ended in 2002 and 2001. The restated financial statements were included in an amendment to our Annual Report on Form 10-K/A for the year ended December 31, 2002, and amended quarterly reports on Form 10-Q/A for each of the quarterly periods ended in 2002 and the quarterly period ended March 31, 2003, which were filed with the Securities and Exchange Commission on September 17, 2003. On September 29, 2003, we also filed an amendment to our Current Report on Form 8-K originally filed on June 4, 2003, and amended on June 23, 2003 and August 1, 2003, to make corresponding changes to the pro forma financial statements that we filed in relation to our acquisition of the American Dental Laser product line and other dental laser assets of American Technologies, Inc. in May 2003. The restatement of our financial statements had no effect on the financial statements of the business we acquired from American Technologies, Inc., which are set forth in their entirety in the financial statements included elsewhere in this prospectus.

As reported in the above-referenced amended filings, the restatement related to a change in the timing of revenue recognition. Staff Accounting Bulletin No. 101 ( SAB 101 ), Revenue Recognition in Financial Statements, requires the transfer of title and the risks and rewards of ownership to the customer before the recognition of revenue. We originally prepared our financial statements on the basis that this transfer of title occurred upon shipment. After the issuance of our consolidated financial statements as of and for the year ended December 31, 2002, it was determined, with respect to sales to domestic customers, that title transferred upon receipt of full payment, due to a clause in our purchase orders. As a result, we restated our consolidated financial statements as of December 31, 2001 and December 31, 2002 and for each of the three years in the period ended December 31, 2002 to defer revenue upon shipment and to recognize it upon receipt of full payment for our domestic customers. We reflected the impact of this change, as measured at January 1, 2000, as the cumulative effect of a change in accounting principle for the adoption of SAB 101. The $34,000 cumulative effect of change in accounting principle was recognized as income during the year ended December 31, 2000, which included $168,000 of revenue. We also restated our consolidated financial statements for the six month period ended June 30, 2002 included elsewhere in this prospectus to defer revenue upon shipment and to recognize it upon receipt of full payment for our domestic customers. It was also determined that revenue recognition for products shipped directly to customers in Europe, which we commenced in 2002, is appropriate at the time of installation, which is when the customer is obligated to pay, and not at the time of shipment as recognized in the previously filed financial statements. In conjunction with these revisions, we have deferred the revenue, the related cost of inventory and related sales commissions associated with the sale of our products.

As a result of the restatement, our net revenue for 2002 decreased by $1,942,000, our gross profit decreased by $1,325,000 and our net income was reduced by $1,132,000, or $0.05 per fully diluted share. For 2001, our net revenue decreased by $1,341,000, our gross profit decreased by $980,000 and our net loss increased by $873,000, or $0.05 per fully diluted share. For 2000, our net revenue decreased by $162,000, our gross profit decreased by $149,000 and our net loss increased by $61,000, or $0.01 per fully diluted share. Also as a result of the restatement, our net revenue for the six months ended June 30, 2002 decreased by $115,000, our gross profit decreased by $15,000, and our net income decreased by $4,000, or $0.01 per fully diluted share.

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The statements of operations were restated as follows (in thousands, except per share data):

| Year Ended December 31, 2000 | As Reported | Restated |
|---|---|---|
| Net sales | $ 9,657 | $ 9,495 |
| Cost of sales | 4,829 | 4,816 |
| Operating expenses | 8,462 | 8,340 |
| Loss from operations | (3,634) | (3,661) |
| Loss before cumulative effect of change in accounting principle | (3,728) | (3,755) |
| Cumulative effect of change in accounting principle | | (34) |
| Net loss | $ (3,728) | $ (3,789) |
| Cumulative effect of change in accounting principle per share: | | |
| Basic | $ 0.00 | $ 0.00 |
| Diluted | $ 0.00 | $ 0.00 |
| Net loss per share: | | |
| Basic | $ (0.19) | $ (0.20) |
| Diluted | $ (0.19) | $ (0.20) |

| Year Ended December 31, 2001 | As Reported | Restated |
|---|---|---|
| Net sales | $ 17,887 | $ 16,546 |
| Cost of sales | 7,299 | 6,938 |
| Operating expenses | 10,952 | 10,845 |
| Loss from operations | (364) | (1,158) |
| Net loss | $ (408) | $ (1,281) |
| Net loss per share: | | |
| Basic | $ (0.02) | $ (0.07) |
| Diluted | $ (0.02) | $ (0.07) |

| Year Ended December 31, 2002 | As Reported | Restated |
|---|---|---|
| Net sales | $ 29,199 | $ 27,257 |
| Cost of sales | 11,102 | 10,485 |
| Operating expenses | 15,616 | 15,423 |
| Income from operations | 2,481 | 1,412 |
| Net income | $ 2,630 | $ 1,498 |
| Net income per share: | | |
| Basic | $ 0.13 | $ 0.08 |
| Diluted | $ 0.12 | $ 0.07 |

| Six Months ended June 30, 2002 | As Reported | Restated |
|---|---|---|
| Net sales | $ 12,390 | $ 12,275 |
| Cost of sales | 4,927 | 4,827 |
| Operating expenses | 6,768 | 6,757 |
| Income from operations | 695 | 723 |
| Net income | $ 788 | $ 784 |
| Net income per share: | | |
| Basic | $ 0.04 | $ 0.04 |
| Diluted | $ 0.04 | $ 0.04 |

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The balance sheets were restated as follows (in thousands, except per share data):

| December 31, 2002 | As Reported | Restated |
|---|---|---|
| Working capital | $ 3,484 | $ 1,481 |
| Total assets | 14,395 | 16,003 |
| Stockholders equity | 5,187 | 3,121 |

| December 31, 2001 | As Reported | Restated |
|---|---|---|
| Working capital | $ 1,135 | $ 201 |
| Total assets | 7,561 | 8,253 |
| Stockholders equity | 1,579 | 645 |

The following discussion and analysis should be read in conjunction with the financial statements and related notes included in the amended filings referenced above.

**Overview**

We are the world s leading dental laser company. We design, manufacture and market proprietary dental laser systems that allow dentists, oral surgeons and other specialists to perform a broad range of common dental procedures, including cosmetic applications. Our systems provide superior performance for many types of dental procedures, with less pain and faster recovery times than are generally achieved with drills and other dental instruments. We have clearance from the U. S. Food and Drug Administration to market our laser systems in the United States. We also have the approvals necessary to sell our laser systems in Canada, the European Union and other international markets. Since 1998, we have sold more than 2,000 laser systems in over 20 countries.

We have the following principal product lines: (i) Waterlase system; (ii) LaserSmile system; (iii) American Dental Laser products, including the Diolase and Pulsemaster systems; and (iv) related accessories and disposables for use with our laser systems. Our product, the Waterlase system, is used for hard and soft tissue dental procedures, and can be used to perform most procedures currently performed using dental drills, scalpels and other traditional dental instruments. The LaserSmile system is used for a range of soft tissue procedures and tooth whitening. Our newly acquired Diolase and Pulsemaster systems are primarily used for soft tissue procedures. We also manufacture and sell accessories and disposables, such as handpieces, laser tips and tooth whitening gel, for use with our dental laser systems.

***Company Background***

From inception in 1987 until 1998, we were engaged primarily in the research and development of the use of water and laser technology. The Company was originally formed as Societe Endo Technic, SA, or SET, in 1984 in Marseilles, France, to develop and market various endodontic and laser products developed by Dr. Guy Levy, then chairman of the Endodontics Department at the University of Marseilles. In 1987, SET was moved to the United States and was merged with a public holding company, Pamplona Capital Corp. In 1994, we changed our name to BioLase Technology, Inc. Through the end of fiscal 2000, we were financed by approximately $42 million in stockholder investments through a series of private placements of stock and the exercise of warrants and stock options.

Since 1998, our objective has been to become the leading designer, manufacturer and marketer of laser systems for the dental industry. We have focused our efforts on receiving governmental clearances with the U.S. Food and Drug Administration as well as furthering the commercial success and viability of our water and laser technology via our direct sales campaign initiatives, intellectual property advancements and strategic acquisitions. In 1998, we began the commercialization of our systems based on water and laser technology.

***Recent Acquisitions***

The selective pursuit of acquisitions represents an important component of our business strategy. We focus primarily on those candidates that will enable us to consolidate positions of leadership in our existing markets,

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further develop our portfolio of intellectual property, expand our strategic partnerships with leading companies and increase our capability and capacity to derive value for our customers and stockholders.

In December 2001, we formed BIOLASE Europe, GmbH, a wholly owned subsidiary based in Germany. In February 2002, BIOLASE Europe acquired a laser manufacturing facility in Germany and commenced manufacturing operations at that location. This acquisition has enabled us to initiate an expansion of our sales in Europe and neighboring regions. We purchased the facility for cash consideration of approximately Euros 1.2 million, which we agreed to pay in installments through 2003, subject to reduction if we were unable to conclude a patent license arrangement with the seller and another company. We did not conclude that arrangement and the consideration was reduced to Euros 989,000 per the agreement. The purchase agreement provides for a payment of Euros 582,000 by April 1, 2003, which was never paid due to subsequent discussions with the seller regarding a further reduction to the purchase price. The purchase agreement provides for the payment of Euros 175,000 and 232,000 on September 30 and December 1, 2003, respectively. Outstanding amounts under the purchase agreement bear interest at less than one percent per annum. Based on our further discussions with the seller, in September 2003, the maximum consideration was reduced to Euros 986,000, which we agreed to pay on October 10, 2003, as full and final payment to the seller under the purchase agreement.

On May 21, 2003, we acquired the American Dental Laser product line and other dental laser assets of American Medical Technologies, Inc., or AMT, for approximately $5.8 million, consisting of $1.8 million in cash, 307,500 shares of our common stock and $134,000 in costs directly attributable to the acquisition. As a part of the purchase transaction, we and AMT agreed to dismiss with prejudice the lawsuit we had filed in October 2002 against AMT which alleged infringement of certain of our patents. In the dismissal, AMT acknowledged that it had infringed our intellectual property rights as identified in our complaint and recognized that the patents we had asserted in the legal action are valid and enforceable. The acquired assets included dental laser patents, customer lists, brand names and other intellectual property as well as laser systems, including the Diolase and Pulsemaster systems. The purchase price will be allocated to the assets based on their fair value. We intend to sell the Diolase and Pulsemaster systems both domestically and internationally under the American Dental Laser brand name, commencing in the second half of 2003. We expect sales of the new systems to begin in the second half of 2003.

***Accounting Policies***

Our discussion and analysis of our financial condition and results of operations are based upon our 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 amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses for each period.

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The following represents a summary of our critical accounting policies, defined as those policies that we believe are: (i) the most important to the portrayal of our financial condition and results of operations, and (ii) that require our most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effects of matters that are inherently uncertain.

*Revenue Recognition.* We record sales in accordance with SEC Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements, or SAB 101, as amended by SAB 101A and 101B. SAB 101 requires that four basic criteria must be met before revenue can be recognized:

- persuasive evidence of an arrangement exists;
- delivery has occurred and title and the risks and rewards of ownership have been transferred to our customer or services have been rendered;
- the price is fixed and determinable; and
- collectibility is reasonably assured.

Assuming that all of the above criteria have been met, we record revenue for domestic sales when we receive payment in full, due to a clause in our purchase order that states title transfers upon payment in full; we record revenue for international direct sales when the product is installed, which is when the customer is obligated to pay, and we record revenue for sales to distributors upon delivery.

*Valuation of Accounts Receivable.* We maintain an allowance for uncollectible accounts receivable to estimate the risk of extending credit to customers. The allowance is estimated based on customer compliance with credit terms, the financial condition of the customer and collection history where applicable. Additional allowances could be required if the financial condition of our customers were to be impaired beyond our estimates.

*Valuation of Inventory.* Inventory is valued at the lower of cost (estimated using the first-in, first-out method) or market. We periodically evaluate the carrying value of inventories and maintain an allowance for obsolescence to adjust the carrying value as necessary to the lower of cost or market. The allowance is based on physical and technical functionality as well as other factors affecting the recoverability of the asset through future sales. Unfavorable changes in estimates of obsolete inventory would result in an increase in the allowance and a decrease in gross profit.

*Valuation of Long-Lived Assets.* Property, plant and equipment, intangible and certain other long-lived assets are amortized over their useful lives. Useful lives are based on our estimate of the period that the assets will generate revenue or otherwise productively support our business goals. Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable through future business operations. In our estimate, no provision for impairment is currently required on any of our long-lived assets.

*Warranty Cost.* Products sold directly to end-users are covered by a warranty against defects in material and workmanship for a period of one year. Products sold internationally to distributors are covered by a warranty on parts for up to fourteen months with additional coverage on certain components for up to two years. We accrue a warranty reserve to estimate the risk of incurring costs to provide warranty services. The accrual is based on our historical experience and our expectation of future conditions. An increase in warranty claims or in the costs associated with servicing those claims would result in an increase in the accrual and a decrease in gross profit.

*Litigation and Other Contingencies.* We regularly evaluate our exposure to threatened or pending litigation and other business contingencies. Because of the uncertainties related to the amount of loss from litigation and other business contingencies, the recording of losses relating to such exposures requires significant judgment about the potential range of outcomes. As additional information about current or future litigation or other contingencies becomes available, we will assess whether such information warrants the recording of additional expense relating to contingencies. To be recorded as expense, a loss contingency must be both probable and measurable. If a loss contingency is material but is not both probable and estimable, we will disclose it in notes to the financial statements.

**Results of Operations**

The following table sets forth certain data from our consolidated income statements for the years ended December 31, 2000, 2001 and 2002, and for the six months ended June 30, 2002 and 2003, expressed as a percentage of net sales:

| | Fiscal Years Ended December 31, (Restated) | | | Six Months Ended June 30, | |
|---|---|---|---|---|---|
| | 2000 | 2001 | 2002 | 2002 (Restated) | 2003 |
| **Consolidated Statements of Operations Data:** | | | | | |
| Net sales | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |
| Cost of sales | 50.7 | 41.9 | 38.5 | 39.3 | 37.6 |
| Gross profit | 49.3 | 58.1 | 61.5 | 60.7 | 62.4 |
| Other income | | 0.5 | 0.2 | 0.3 | 0.2 |
| Operating expenses: | | | | | |
| Sales and marketing | 44.4 | 44.2 | 39.4 | 37.8 | 37.0 |
| General and administrative | 19.4 | 12.2 | 11.0 | 10.9 | 9.6 |
| Engineering and development | 24.1 | 9.2 | 6.2 | 6.4 | 5.3 |
| Total operating expenses | 87.9 | 65.6 | 56.6 | 55.1 | 51.9 |
| Income (loss) from operations | (38.6) | (7.0) | 5.1 | 5.9 | 10.7 |
| Non-operating income (loss) | (1.0) | (0.7) | 0.4 | 0.5 | 0.6 |
| Income (loss) before cumulative effect of change in accounting principle | (39.6) | (7.7) | 5.5 | 6.4 | 11.3 |
| Cumulative effect of change in accounting principle | (0.4) | | | | |
| Net income (loss) | (40.0)% | (7.7)% | 5.5% | 6.4% | 11.3% |

*Net Sales.* Net sales consists of sales of our laser systems, related disposables and accessories and service revenue. We have at various times experienced fluctuations in sales due to seasonality. In our experience, sales in the first quarter typically are lower than average, and sales in the fourth quarter typically are stronger than average, due to the buying patterns of dental professionals. The fourth quarter of 2002 accounted for 30% of our net sales for the year, whereas the first quarter of 2002 accounted for 18% of net sales for the year. Sales in the third quarter tend to be even with and may sometimes be lower than sales in the second quarter due to vacation patterns. The third quarter accounted for 25% of our net sales in 2002, whereas the second quarter accounted for 27% of our net sales in 2002. Our historical seasonality pattern is a recurring trend that we expect to continue. Consequently we do not necessarily match the timing of our expenditures to the expected quarterly seasonality effects on revenue but rather anticipate the expected sales over the full year as a determinant of our spending levels. Since many of our costs are fixed in the short term, if we have a shortfall in sales resulting from a change in our historical seasonality pattern, or otherwise, we may be unable to reduce expenses quickly enough to avoid losses.

Many dentists finance their purchases through third party leasing companies or banks. In these transactions, we receive payment in full from the leasing company or bank, or from the dentist, who receives funds from the leasing company or bank. The dentist pays the leasing company or bank in installments and we do not bear the credit risk that the dentist might not make payments. The leasing companies and banks do not have recourse to us for a dentist s failure to make payments. Approximately 38% of our revenue in 2000, 43% of our revenue in 2001, 36% of our revenue in 2002 and 28% of our revenue for the first six months of 2003 were generated from

dentists who financed their purchase through National Technology Leasing Corporation, an equipment leasing broker.

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*Cost of Sales.* Cost of sales is comprised of all costs to manufacture our products, including materials, labor and related overhead costs such as depreciation, warranty and service costs.

*Sales and Marketing.* Sales and marketing expenses consist of salaries and benefits, commissions, and other costs related to our direct sales force, advertising costs and expenses related to trade shows and seminars.

*General and Administrative.* General and administrative expenses consist of salaries and benefits of administrative personnel as well as insurance, professional and regulatory fees and provisions for doubtful accounts.

*Engineering and Development.* Engineering and development expenses consist of engineering personnel salaries and benefits, prototype supplies, contract services and consulting fees related to product development.

*Non-Operating Income (Loss).* Non-operating income (loss) consists of interest income and expense, foreign currency gains and losses and similar items not directly related to our operations. Interest income relates to interest earned on our cash balances, and interest expense relates to interest costs on our line of credit. We generate a substantial portion of our revenue from the sale of products outside the United States. Sales to customers or distributors outside the United States accounted for approximately 23% of our revenue for the year ended December 31, 2002. Sales in Europe and Canada accounted for approximately 11% and 1% of our revenue for the year ended December 31, 2002, while sales in Asia and countries in the Pacific Rim accounted for approximately 12% of our revenue for 2002. Our sales in Europe are denominated principally in Euros, and our sales in other international markets are denominated in dollars. As we do not engage in hedging transactions to offset foreign currency fluctuations, we are at risk for changes in the value of the dollar relative to the value of the Euro. An increase in the relative value of the dollar would lead to less income from sales denominated in Euros unless we increase prices, which may not be possible due to competitive conditions in Europe. Conversely, a decrease in the relative value of the dollar would lead to more income from sales denominated in Euros. Additionally, we are obligated to repay the debt on our German facility in Euros. Thus, we are also at risk for changes in the value of the dollar relative to the Euro with respect to our obligation to repay the debt on our German facility. An increase in the value of the dollar relative to the Euro would reduce the cost associated with repayment of the debt on our German facility, whereas a decrease in the relative value of the dollar would increase the cost associated with repayment of the debt on our German facility.

*Income Taxes.* At this time, no provision for income tax is recognized due to the availability of net operating loss carry forwards. At such times as the recoverability of deferred tax assets, including the net operating loss carry forwards, becomes more likely realizable than not, we will reduce the valuation allowance against our deferred tax assets, record an income tax benefit and subsequently record a provision for income taxes for financial statement purposes based on the amount of taxable net income.

**Six Months Ended June 30, 2003 Compared With Six Months Ended June 30, 2002**

Comparing the results of operations between the six months ended June 30, 2003 and June 30, 2002, the most significant change affecting operating results is the increase in sales. Sales for the six months ended June 30, 2003 increased 59% over sales for the six months ended June 30, 2002.

*Net Sales*. Net sales for the six months ended June 30, 2003 were $19.6 million, an increase of $7.3 million, as compared with net sales of $12.3 million for the six months ended June 30, 2002. The increase in sales resulted from an increased number of units sold. The Waterlase and

LaserSmile systems accounted for 82% and 13% of our net sales for the six months ended June 30, 2003, respectively. We expect the Waterlase will continue to account for the majority of our sales. The recent decline in interest rates may have benefited purchasers of our products by reducing the interest expense to finance the purchase or lease of our products, although we do not believe it is possible to measure the effect of lower interest rates on our sales.

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International sales for the six months ended June 30, 2003 were $4.2 million, or 21% of total net sales, as compared with $2.0 million, or 17% of total net sales, for the six months ended June 30, 2002. The increase was in part related to the expansion of our manufacturing operations. Sales of products manufactured at our facility in Germany accounted for 17% of our revenue for the six months ended June 30, 2003, as compared with 4% of our revenue for the six months ended June 30, 2002. In February of 2003, we terminated our distributor in Germany primarily due to its failure to meet sales quotas under its distribution agreement with us. The agreement was originally signed in 2000 and renewed in 2002. The agreement required minimum sales of $10,000,000 over the two-year term following the renewal. The average quarterly sales generated by our distributor from the time of the renewal until we terminated the distributor were nearly 50% less than the quota provided under the distribution agreement. To replace the distributor, we entered into contracts with independent sales agents within Germany, which we believe provides a better sales channel in Germany. The termination of the distribution agreement did not adversely affect sales for the quarter. Sales by our distributor generated approximately $1.8 million of revenue for the year ended December 31, 2002. No sales were made by our distributor in 2003. Sales by our direct sales force accounted for approximately $1.6 million of revenue for the six months ended June 30, 2003. We intend to continue to sell through distributors in our other international markets and to increase and strengthen our international distribution network.

Our experience for the first six months of 2003 and 2002 is consistent with our experience with the seasonality of our business, with the first quarter being the weakest quarter and sales increasing in the second quarter. Our net sales for the first quarter of 2003 were $9.2 million, whereas our net sales for the second quarter of 2003 were $10.4 million. Our net sales for the first quarter of 2002 were $5.0 million, whereas our net sales for the second quarter of 2002 were $7.3 million.

*Gross Profit*. Gross profit for the six months ended June 30, 2003 was $12.2 million, or 62% of net sales, an increase of $4.8 million, as compared with gross profit of $7.4 million, or 61% of net sales for the six months ended June 30, 2002. The increase in gross profit is attributable to leveraging the increase in net sales against fixed and partially fixed manufacturing costs, reflecting better absorption of fixed manufacturing costs. These efficiencies and cost savings have been partially offset by $225,000 through the addition of production and field technician resources to support anticipated sales growth. Sales of the recently acquired Diolase and Pulsemaster systems are not anticipated to have a significant impact on gross margin.

*Other Income.* Other income consists of gain on sale of assets. The gain on sale of assets for the six months ended June 30, 2003 and June 30, 2002 of $32,000 and $32,000, respectively, consists of the amortization of the deferred gain relating to the sale and leaseback of our manufacturing facility in San Clemente, California in March 2001.

***Operating Expenses***

Operating expenses for the six months ended June 30, 2003 were $10.1 million, or 52% of net sales as compared with $6.8 million, or 55% of net sales for the six months ended June 30, 2002. Approximately 79% of the increase, or $2.6 million, are sales and marketing costs that were incurred to generate the increase in net sales.

*Sales and Marketing*. Sales and marketing expenses for the six months ended June 30, 2003 were $7.2 million, or 37% of net sales, as compared with $4.6 million, or 38% of net sales, for the six months ended June 30, 2002. The increase in absolute dollars was due to higher commission expense related to the increase in sales, as well as increases of $180,000 in costs related to our national seminar marketing program, an increase of approximately $450,000 in international sales and marketing and approximately $150,000 associated with an increase in the size and scope of the World Clinical Laser Institute symposium that we sponsored in January 2003. We anticipate incremental costs relating to the marketing and sale of the American Dental Laser products for the second half of 2003. These expenses should not be material relative to our total planned costs.

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*General and Administrative*. General and administrative expenses for the six months ended June 30, 2003 was $1.9 million, or 10% of net sales, as compared with $1.3 million, or 11% of net sales, for the six months ended June 30, 2002. The increase in absolute dollars was due to an increase of $175,000 in the provision for doubtful accounts, $125,000 in bank charges relating to credit card sales and an increase of $350,000 in employee group and corporate insurance costs. General and administrative costs also increased to support the growth of our company. No significant additional general and administrative costs have been incurred or are expected from the acquisition and production of the American Dental Laser products except for amortization expense related to certain intangible assets acquired.

*Engineering and Development*. Engineering and development expenses for the six months ended June 30, 2003 was $1.0 million, or 5% of net sales, as compared with $788,000, or 6% of net sales, for the six months ended June 30, 2002. The increase in absolute dollars is due to costs and consulting fees related to product development. The change in engineering and development expenses as a percent of net sales reflects the larger sales base and normal fluctuations in the scope of current research and development projects. The American Dental Laser products have become part of our ongoing development and design improvements.

***Non-Operating Income (Loss)***

*Gain on Foreign Currency Transactions*. We realized a $108,000 gain on foreign currency transactions for the six months ended June 30, 2003, compared to $19,000 for the six months ended June 30, 2002 due to the changes in exchange rates between the United States dollar and Euro.

*Gain on Forward Exchange Contracts*. In the six months ended June 30, 2003, we realized a gain of $22,000 due to the increase in the fair market value of our forward exchange contract, which we purchased in connection with the debt incurred to acquire our facility in Germany. On February 3, 2003, the contract expired and was not renewed.

*Interest Income*. Interest income relates to interest earned on our cash balances. Interest income for the six months ended June 30, 2003 was $13,000 as compared with $7,000 for the six months ended June 30, 2002, due to an increase in our cash balances over this period.

*Interest Expense*. Interest expense decreased $35,000, or 53%, to $31,000 for the six months ended June 30, 2003, as compared with June 30, 2002 due to a decrease in the effective interest rate on our credit facility. In May 2003, we entered into a $5.0 million credit facility with a bank to replace our existing line of credit. The new line of credit will bear interest at LIBOR plus 2.25% as compared with the previous line of LIBOR plus 0.5%. Although the nominal rate on the new facility is higher, the previous facility was burdened by the amortization of the cost of a third-party guaranty.

*Income Taxes*. No provision for income tax was recognized for the six months ended June 30, 2003 due to the availability of net operating loss carry forwards. No income tax benefit was recognized in the six months ended June 30, 2002, as there was no assurance that the benefit of the net operating loss carry forwards would be realized. If in our judgment the recoverability of deferred tax assets, including the net operating loss carry forward, becomes more likely realizable than not, we will reduce the valuation allowance against our deferred tax assets, record an income tax benefit and subsequently record a provision for income tax for financial statement purposes based on the amount of taxable net income.

**Year Ended December 31, 2002 Compared With Year Ended December 31, 2001**

Comparing the results of operations between the prior years, the most significant change affecting operating results is the increase in sales. Sales for the year ended December 31, 2002 increased 65% over sales for the year ended December 31, 2001.

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*Net Sales.* Net sales for the year ended December 31, 2002 were $27.3 million, an increase of $10.8 million, as compared with net sales of $16.5 million for the year ended December 31, 2001. The increase in sales in both 2002 and 2001 resulted from the increased number of units sold of our laser systems. Our Waterlase system accounted for 77% of net sales in 2002 and 82% of net sales in 2001. Our LaserSmile system was introduced in the third quarter of 2001 and accounted for 18% of net sales in 2002 as compared with 16% of net sales in 2001.

International sales for the year ended December 31, 2002 were $6.2 million, or 23% of total net sales, as compared with $3.3 million, or 20% of total net sales, for the year ended December 31, 2001. The increase in international sales in 2002 was the result of a renewed effort to strengthen our network of international distributors after concentrating our resources in 2001 in the domestic market. The formation of BIOLASE Europe in 2002 and the acquisition of a production and service facility in Germany was an important step to increase our visibility in Europe as well as to improve our ability to service European customers. Sales of products manufactured at our German facility accounted for 9% of our revenue in 2002. In comparison, all of our revenue in 2001 was generated from the sale of products manufactured in the United States. We plan to continue to add resources to our international sales program to take advantage of the large market potential and we expect that our international sales will continue to grow over time as a percentage of our total net sales. Although most of our international sales are made through independent distributors, we began making direct sales to dentists in Europe in 2002 with the support of our German distributor. Based on the overall increase and detailed review of sales, we increased our allowance on accounts receivable from $108,000 at December 31, 2001 to $202,000 at December 31, 2002.

*Gross Profit.* Gross profit for the years ended December 31, 2002 and 2001 was $16.8 million and $9.6 million, respectively. The gross margin on sales for those same periods was 62% and 58%, respectively. The increase in both gross profit and gross margin was attributable to leveraging the increase in our net sales against fixed and partially fixed manufacturing costs, reflecting better absorption of fixed manufacturing costs. The increase in gross profit is also due to increased manufacturing efficiencies and design changes through engineering and product development, which reduced the cost of materials by 10%. These efficiencies and cost savings were partially offset by the start-up costs for our German production and service facility of approximately $165,000 in 2002 and the addition of production resources of approximately $621,000 to support anticipated sales growth. While we believe there is additional leverage to be realized from future increases in sales, increases in fixed costs will also accompany growth and may constrain increases in gross margin. In addition, an increase in the mix of sales to international distributors will also tend to decrease gross profit since such sales are made at wholesale prices.

***Other Income***

Other income consists of gain on sale of assets. The gain on sale of assets for the year ended December 31, 2002 of $63,000 was related to the sale and leaseback of our manufacturing facility in San Clemente, California in March 2001. This sale resulted in a gain of $316,000, which is being recognized over the remaining term of the lease, which expires in 2006. Gain on sales of assets in 2001 included this amortization of deferred gain plus a gain on the sale of certain other assets.

***Operating Expenses***

Operating expenses for the year ended December 31, 2002 were $15.4 million, or 57% of net sales, as compared with $10.8 million, or 66% of net sales, for the year ended December 31, 2001. Most of the increases in operating expenses for each year were sales and marketing costs that were incurred to generate the increase in sales, including a growing sales force and related expenses.

*Sales and Marketing*. Sales and marketing expenses for the year ended December 31, 2002 was $10.8 million, or 39% of net sales, as compared with $7.3 million, or 44% of net sales, for the year ended December 31, 2001. The increase in absolute dollars from year to year was attributable to higher commission

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expense related to the increased sales and to the cost of additional sales personnel of approximately $600,000 in the United States. In addition during 2002, we expanded the scope of our nationwide seminar-marketing program and our sponsorship of education and training programs for existing and potential customers, as a result of which we incurred additional expenses of $871,000. Although growing 47% in 2002 in absolute dollars, sales and marketing expense as a percentage of net sales decreased from 44% in 2001 to 39% in 2002 due to the increase in sales generated by these efforts. In 2002, in addition to a number of local and regional symposiums, we sponsored two national and two international symposiums presented by the World Clinical Laser Institute, an organization that provides education and training in laser dentistry.

*General and Administrative*. General and administrative expenses for the year ended December 31, 2002 was $3.0 million, or 11% of net sales, as compared with $2.0 million, or 12% of net sales, for the year ended December 31, 2001. The increase in absolute dollars in 2002 was due to administrative costs associated with the operations of BIOLASE Europe of $140,000, increases in the costs of legal fees relating to regulatory compliance and various legal proceedings in the amount of $201,000, and increases in the infrastructure needed to support the growth of our sales. Insurance premiums increased in 2001 as a result of the increase in net sales and increased by $328,000 in 2002 both as a result of the increase in sales and as a result of general insurance market conditions. We expect additional increases in 2003 due to adverse markets for workers compensation, group health insurance and liability insurance.

*Engineering and Development*. Engineering and development expenses for the year ended December 31, 2002 was $1.7 million, or 6% of net sales, as compared with $1.5 million, or 9% of net sales, for the year ended December 31, 2001. The increase in absolute dollars in 2002 was related to new product development and enhancements. The decrease in research and development expenses as a percent of net sales reflects the larger sales base and fluctuations in the scope of current research and development projects.

***Non-Operating Income (Loss)***

*Unrealized Gain on Forward Exchange Contract.* In the year ended December 31, 2002, we recognized an unrealized gain on forward contracts of $152,000 due to the increase in the fair market value of our forward exchange contract.

*Interest Income.* Interest income for the year ended December 31, 2002 was $18,000 compared with $44,000 in 2001. Even though our cash balances have increased over this period, continuing reductions in interest rates have resulted in lower interest income.

*Interest Expense.* Interest expense was $135,000 for the year ended December 31, 2002 compared with $167,000 in 2001. Interest expense in 2002 included the amortization of the cost of issuing stock in connection with the extension of our line of credit in December 2001. Interest expense in 2001 included three months of interest on the note payable on our San Clemente manufacturing facility, which was sold and leased back in March 2001.

*Income Tax.* No provision for income tax was recognized for the year ended December 31, 2002 due to the availability of net operating loss carry forwards. No income tax benefit was recognized in the year ended December 31, 2002 as there was no assurance that the benefit of the net operating loss carry forwards would be realized. At such time as the recoverability of deferred tax assets, including the net operating loss carry forward, becomes more likely realizable than not, we will reduce the valuation allowance against our deferred tax assets, record an income tax benefit and subsequently record a provision for income tax for financial statement purposes based on the amount of taxable net income. As of December 31, 2002, we had net operating loss carry forwards for federal and state purposes of approximately $34.9 million and $7.5 million, respectively, which began expiring in 2001. As of December 31, 2002, we had research and development credit carryforwards for federal and state purposes of approximately $332,000 and $170,000, respectively. The utilization of net operating loss and credit carry forwards may be limited under the provisions of Internal Revenue Code Section 382 and similar state provisions.

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**Year Ended December 31, 2001 Compared With Year Ended December 31, 2000**

Comparing the results of operations between the prior years, the most significant change affecting operating results is the increase in sales. Sales for the year ended December 31, 2001 increased 74% over sales for the year ended December 31, 2000.

*Net Sales*. Net sales in 2001 were $16.5 million, an increase of $7.0 million, as compared with net sales of $9.5 million in 2000. This increase was due to a 176%, or $7.6 million growth in domestic sales of our Waterlase system. The Waterlase systems accounted for approximately 84% of net sales for the year ended December 31, 2001, as compared with 97% of net sales for the year ended December 31, 2000. Domestic sales also increased by $1.5 million in the third and fourth quarters of 2001 due to the introduction of our LaserSmile system. These increases were offset by a 28%, or $1.1 million decrease in international sales in 2001 as we concentrated our resources on growing sales in the domestic market.

*Gross Profit*. Gross profit increased 104% to $9.6 million in 2001 from $4.7 million in 2000. Gross margin increased from 49% of net sales in 2000 to 58% of net sales in 2001. This increase was the result of spreading the fixed costs of manufacturing over more units, an improvement in labor productivity, and engineering cost reductions, which collectively produced a 9% reduction in the material components of the products.

***Other Income***

Other income consists of gain on sale of assets. The gain on sale of assets of $79,000 in 2001 is related to two transactions. In 2000, we purchased our San Clemente manufacturing facility and offices in order to avoid moving our operations. In 2001, we sold the facility and leased it back for a five-year term with an additional five year option, resulting in a gain of $316,000. We are recognizing that gain for accounting purposes over the term of the lease. In 2001, we recognized $48,000 of this gain. We also sold inventory and assets relating to our inactive subsidiary, Societe Endo Technic, in 2001 for a gain of $31,000.

***Operating Expenses***

*Sales and Marketing*. Sales and marketing expenses for the year ended December 31, 2001 was $7.3 million, or 44% of net sales, as compared with $4.2 million, or 44% of net sales, for the year ended December 31, 2000. The increase in absolute dollars was due to the 85% increase in net sales in 2001 and included increased sales commissions and increased cost of $536,000 associated with an increase in the number of sales representatives. Marketing costs also increased by $945,000 as we increased the number of trade shows, seminars and symposiums that we attended and sponsored.

*General and Administrative*. General and administrative expenses for the year ended December 31, 2001 was $2.0 million, or 12% of net sales, as compared with $1.8 million, or 19% of net sales, for the year ended December 31, 2000. The increase in absolute dollars in 2001 related to the cost of infrastructure needed to support the growth of the business.

*Engineering and Development*. Engineering and development expenses for the year ended December 31, 2001 was $1.5 million, or 9% of net sales, as compared with $2.3 million, or 24% of net sales, for the year ended December 31, 2000. This decrease was related to the change in the development cycle for our products. Engineering costs also decreased by approximately $100,000 as a result of process improvements, which reduced the number of employees needed to sustain the activities of the function.

***Non-Operating Income (Loss)***

*Interest Income*. Interest income for the year ended December 31, 2001 was $44,000 compared with $69,000 for the period ended December 31, 2000. Even though our cash balances have increased over this period, continuing reductions in interest rates have resulted in lower interest income.

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*Interest Expense*. Although the variable interest rate on our line of credit decreased with other short-term interest rates in 2001, we incurred interest expense on the mortgage note payable that financed the purchase of our facility. The interest expense from the mortgage note for three months of 2001 offset the decrease in interest on our line of credit.

**Liquidity and Capital Resources**

At June 30, 2003, we had $4.9 million in net working capital as compared with $1.4 million at December 31, 2002, $201,000 at December 31, 2001 and a working capital deficit of $268,000 at December 31, 2000. Our principal source of liquidity at June 30, 2003 consisted of our cash balance of $6.6 million. For the six months ended June 30, 2003, our primary sources of cash were from operating activities of $1.3 million and the exercise of stock options and warrants of $3.4 million. These sources of cash were decreased by investments in property and equipment of $136,000 and our acquisition of the laser assets of American Medical Technologies of $1.8 million. The net effect on cash of operating, investing and financing transactions for the six months ended June 30, 2003 was an increase of $2.7 million.

For the year ended December 31, 2002, our sources of cash were from operating activities of $635,000 and the exercise of stock options and warrants of $1.0 million. These sources of cash were reduced by investments in property and equipment of $478,000. The net effect on cash of operating, investing and financing transactions for the year ended December 31, 2002 was an increase of $1.3 million.

In 2001, we incurred negative cash flow of $1.0 million from operating activities, substantially all resulting from the net increase in working capital. We financed our negative cash flow from operations through the exercise of warrants and stock options of $803,000 and from net cash received on the sale and leaseback of our San Clemente facility of $1.2 million.

Several key indicators of liquidity are summarized in the following table (in thousands, except ratio amounts):

| | Fiscal Years Ended December 31, | | | Six Months Ended June 30, |
|---|---|---|---|---|
| | **2000** | **2001** | **2002** | **2003** |
| Working capital (deficit) (restated) | $ (268) | $ 201 | $ 1,418 | $ 4,869 |
| Cash provided by (used in) operations | (3,778) | (1,037) | 635 | 1,321 |
| Proceeds from the exercise of stock options and warrants | 3,201 | 803 | 1,035 | 3,402 |
| Current ratio (restated) | 0.9 | 1.0 | 1.1 | 1.4 |
| Accounts receivable collection period (days) | 20.3 | 32.1 | 44.5 | 47.6 |
| Inventory turnover | 4.8 | 5.1 | 5.3 | 4.5 |

At June 30, 2003, we had $1.8 million outstanding under a $5.0 million revolving credit facility with Bank of the West. This same amount was outstanding at December 31, 2002 under a $1.8 million credit line with BSI AG. The facility with Bank of the West was entered into May 14, 2003 and is secured by all of our assets, is for a term of one year, bears interest at LIBOR plus 2.25%, and is payable on demand upon expiration of the stated term. Approximately $1.8 million was drawn immediately to pay off the bank line of credit with BSI AG. Under the terms of our credit line with Bank of the West, we are subject to certain covenants, which include, among other things, covenants to maintain a specified minimum tangible net worth and a specified ratio of current assets to current liabilities, and a covenant to maintain profitability. If we fail to satisfy these covenants and we fail to cure any breach of these covenants within a specified number of days after receipt of notice, Bank of the

West could accelerate the entire amount borrowed by us and cancel the line of credit. Our credit line has an outstanding balance of approximately $1.8 million as of September 19, 2003. As a result of the restatement of our financial statements for the years ended December 31, 2000, 2001 and 2002, as explained in Amendment No. 1 to our annual report on Form 10-K/A for the year ended December 31, 2002, our accumulated deficit and

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our net tangible equity have decreased. Consequently, we were not in compliance with the following three covenants as of June 30, 2003: timely reporting of our financial statements for the period ended June 30, 2003; minimum tangible net equity, which is $6,897,000 compared with a minimum required tangible net equity of $7,000,000; and the ratio of total liabilities to tangible net equity, which is 1.91 compared with a maximum allowed ratio of 1.75. We have obtained waivers from the bank for each item of non-compliance as of June 30, 2003. We anticipate that we will be in compliance with these covenants as of September 30, 2003, the next evaluation date for determining compliance with the covenants under the facility; although there is no assurance that we will be in compliance at that time. At June 30, 2003 we had $6.6 million in available cash. We believe any cancellation of our bank line would not have a material impact on our liquidity and that our cash from operations and the net proceeds of this offering will be sufficient to finance the cost of our operations.

We purchased our production facility in Germany in February 2002 for cash consideration of approximately Euros 1.2 million payable in installments through 2003, subject to reduction in certain circumstances. The maximum consideration was reduced to Euros 989,000 in accordance with the terms of the agreement with the seller. The purchase agreement provides for a payment of Euros 582,000 by April 1, 2003, which was never paid due to subsequent discussions with the seller regarding a further reduction to the purchase price. The purchase agreement provides for the payment of Euros 175,000 and 232,000 on September 30 and December 1, 2003 respectively. Outstanding amounts under the purchase agreement bear interest at less than one percent per annum. Based on our further discussions with the seller, in September 2003, the maximum consideration was reduced to Euros 986,000, which we agreed to pay on October 10, 2003, as full and final payment to the seller under the purchase agreement.

On May 21, 2003 we acquired the American Dental Laser product line from American Medical Technologies, Inc., or AMT, for approximately $5.8 million. The assets acquired included dental laser patents, customer lists, brand names and other intellectual property as well as laser products. No outstanding debt of AMT was assumed in the transaction. The consideration paid by us consisted of approximately $1.8 million cash, $134,000 in transaction costs directly attributable to the acquisition and 307,500 shares of common stock with a fair value of approximately $3.8 million. For purposes of computing the purchase price, the value of the common stock of $12.38 per share was determined by taking the average closing price of our common stock as quoted on the Nasdaq National Market between May 19, 2003 and May 23, 2003.

We had no material commitments for capital expenditures as of June 30, 2003 and have not entered into any material commitments after that date.

The following table presents our expected cash requirements for contractual obligations outstanding as of June 30, 2003, and for the periods ending on December 31 indicated below (in thousands):

| | June 30, 2003 | Six Months Ending December 31, 2003 | Years Ending December 31, 2004 | 2005 | 2006 |
|---|---|---|---|---|---|
| Line of credit | $ 1,792 | $ 1,792 | $ | $ | $ |
| Short-term debt | 1,332 | 1,332 | | | |
| Operating leases | 704 | 133 | 261 | 249 | 61 |
| Total | $ 3,828 | $ 3,257 | $ 261 | $ 249 | $ 61 |

We believe that our current cash balances, cash expected to be generated from our operations, together with additional cash expected to be received through the exercise of stock options will be adequate to meet our debt service requirements and sustain our operations for at least the next twelve months. Beyond the next twelve months, if we continue to grow our sales volume at approximately the rate it has grown over the past several years, the adequacy of our cash balances to meet operating and capital needs will depend on our ability to be able to continue to generate sufficient cash flow from operations and our ability to borrow to support the funds necessary to support that growth rate. We believe the net proceeds of this offering, together with our cash balances and funds available under our bank credit line, will be sufficient to finance the cost of this growth.

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**Recent Accounting Pronouncements**

In April 2002, the Financial Accounting Standards Board, or FASB, issued Statement of Financial Accounting Standards, or SFAS, No. 145, Rescission of SFAS Nos. 4, 44 and 64, Amendment of SFAS No. 13, and Technical Corrections. The significant items from SFAS 145 that are relevant to us are the provisions regarding extinguishment of debt and the accounting for sale-leaseback transactions. The provisions of this statement are applicable for financial statements issued on or subsequent to May 15, 2002. The adoption of this statement did not have an impact on our consolidated financial statements.

In July 2002, the FASB issued SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities. This statement addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force, or EITF, Issue No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring). The provisions of this statement are effective for exit or disposal activities initiated after December 31, 2002. The adoption of this statement did not have an impact on our consolidated financial statements.

In November 2002, the EITF reached a consensus on Issue No. 00-21. Accounting for Revenue Arrangements with Multiple Deliverables. This Issue provides guidance on when and how to separate elements of an arrangement that may involve the delivery or performance of multiple products, services and rights to use assets into separate units of accounting. The guidance in the consensus is effective for revenue arrangements entered into in fiscal periods, interim or annual, beginning after June 15, 2003. We will adopt Issue No. 00-21 in the quarter beginning July 1, 2003. We do not believe that the adoption of Issue No. 00-21 will have a material impact to our consolidated financial position, results of operations or cash flows.

In November 2002, the FASB issued Interpretation No. 45, Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, or FIN 45. FIN 45 elaborates on the existing disclosure requirements for most guarantees, including loan guarantees such as standby letters of credit. It also requires that at the time a company issues a guarantee, our company must recognize an initial liability for the fair market value of the obligations it assumes under that guarantee and must disclose that information in our interim and annual financial statements. The initial recognition and measurement provisions of FIN 45 apply on a prospective basis to guarantees issued or modified after December 31, 2002. The adoption of FIN 45 did not have an impact on our consolidated financial statements.

In December 2002, the FASB issued SFAS No. 148, Accounting for Stock-Based Compensation-Transition and Disclosure-an amendment of FASB Statement No. 123. This amendment provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, this statement amends the disclosure requirement of Statement 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. SFAS 148 is effective for fiscal years ending after December 15, 2002. Since we are continuing to account for stock-based compensation according to APB 25, our adoption of SFAS No. 148 requires us to provide prominent disclosures about the effects of FAS 123 on reported income and will require us to disclose these affects in the interim financial statements as well.

In May 2003, the FASB issued statement of Financial Accounting Standards No. 150, Accounting For Certain Financial Instruments with Characteristics of both Liabilities and Equity ( SFAS 150 ). SFAS 150 establishes standards for how an issuer classifies and measures in its statement of financial position certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances) because that financial instrument embodies an obligation of the issuer. SFAS 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. We do not believe that the adoption of SFAS 150 will have a material impact to our consolidated financial position, results of operations, or cash flows.

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**Quantitative and Qualitative Disclosures about Market Risk**

As discussed in Note 5 to the Consolidated Financial Statements, we acquired a production facility in Germany in February of 2002. The debt related to those assets is payable in Euros at the exchange rate in effect as of the date of acquisition. That exchange rate was 0.8591. In conjunction with portion of the debt due in 2003, we entered into a forward contract to purchase approximately $700,000 of Euros at an exchange rate of 0.8575. On February 3, 2003, the contracts expired and were not renewed, resulting in a cumulative realized gain on the contracts of $174,000.

Since February 3, 2003, we have not engaged in transactions to offset currency fluctuations, and we are at risk for changes in the value of the dollar relative to the Euro with respect to our obligation to repay the debt on our German facility. The value of the German facility itself as stated in dollars on our balance sheet will vary as the exchange rate of the dollar and the Euro varies.

Our sales in Europe are denominated principally in Euros, and our sales in other international markets are denominated in dollars. As a result, an increase in the relative value of the dollar to the Euro would lead to less income from sales denominated in Euros, unless we increase prices, which may not be possible due to competitive conditions in Europe. Additionally, since expenses relating to our manufacturing operations in Germany are paid in Euros, an increase in the value of the Euro relative to the dollar would increase the expenses associated with our German manufacturing operations and reduce our earnings.

Our bank line of credit bears interest at a variable rate tied to LIBOR plus 2.25%, which makes the current effective interest rate 3.4% at August 31, 2003. A 10% increase in LIBOR would increase the effective interest rate from 3.4% to 3.5%, which would not result in a material difference to our interest expense on our outstanding bank debt of $1.8 million.

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## BUSINESS

### Overview

We are the world s leading dental laser company. We design, manufacture and market proprietary dental laser systems that allow dentists, oral surgeons and other specialists to perform a broad range of common dental procedures, including cosmetic applications. Our systems provide clinically superior performance for many types of dental procedures, with less pain and faster recovery times than are generally achieved with drills and other dental instruments. We have clearance from the U. S. Food and Drug Administration to market our laser systems in the United States. We also have the approvals necessary to sell our laser systems in Canada, the European Union and other international markets. Since 1998, we have sold more than 2,000 laser systems in over 20 countries.

Our primary product, the Waterlase system, uses a patented combination of water and laser to perform most procedures currently performed using dental drills, scalpels and other traditional dental instruments. We refer to our patented interaction of water with laser as YSGG Laser Hydrokinetics. YSGG is a shortened abbreviation referring to the unique crystal (Er, Cr: YSGG) laser used in the Waterlase, which contains the elements erbium, chromium, yttrium, scandium, gallium and garnet. This unique crystal laser produces energy with specific absorption and tissue interaction characteristics optimized for dental applications. Hydrokinetics refers to the interaction of laser with water to produce energy to cut tissue. Through YSGG Laser Hydrokinetics, the Waterlase system can precisely cut hard tissue, such as bone and teeth, and soft tissue, such as gums, with minimal or no damage to surrounding tissue. The Waterlase is the best selling dental laser system and we estimate it currently accounts for a majority of all dental lasers sold worldwide.

We also offer the LaserSmile system, which uses a laser to perform soft tissue and cosmetic procedures, including tooth whitening. The LaserSmile serves the growing markets for cosmetic and hygiene procedures. In May 2003, we acquired the American Dental Laser product line, which includes the Diolase and Pulsemaster systems, that can be used for a variety of soft tissue applications. The Diolase and Pulsemaster, together with our Waterlase and LaserSmile systems, offer practitioners a broad product line with a range of features and price points. We also manufacture and sell accessories and disposables for our laser systems, such as handpieces, laser tips and tooth whitening gel.

We believe there is a large market for our products in the United States and abroad. According to the American Dental Association, there are over 160,000 practicing dentists in the United States. According to the World Federation of Dentistry, an international dental organization, there are at least 700,000 dentists worldwide, and we believe that a substantial percentage of them practice in major international markets outside the United States. The use of lasers in dentistry is growing. However, we believe only a small percentage of dentists currently use laser systems, and that there is a significant opportunity to increase sales of our products worldwide.

Our goal is to establish our laser systems as essential tools in dentistry and to continue our leading position in the dental laser market. Our sales and marketing efforts focus on educating dental professionals and patients on the benefits of our laser systems, particularly our Waterlase system. In 2002, we founded the World Clinical Laser Institute, an association that includes prominent dental industry leaders, to formalize our efforts to educate and train dentists and surgeons in laser dentistry. We participate in numerous other symposia and dental industry events to stimulate demand for our products. We have also developed numerous relationships with dental schools, research facilities and dental institutions, in the United States and abroad, which use our products for education and training. More than 20 institutions use our products, including St. Barnabas Hospital and the dental schools of Columbia University, Loma Linda University, Tufts University, University of Barcelona and University of Vienna. We believe this will expand awareness of our products among new generations of dental professionals.

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**Industry Background**

*General*

More than 200 million hard tissue procedures are performed annually in the United States, according to a 1999 survey by the American Dental Association. Hard tissue procedures include cavity preparation, inlays, crowns, root canals and other procedures involving bone or teeth. Based on this survey, more than 1.2 million soft tissue procedures are performed annually in the United States. Soft tissue procedures include gum line alteration, gum grafts and other procedures involving soft dental tissue. According to statistics compiled by the American Dental Association, over 90% of hard tissue procedures and 60% of soft tissue procedures in the United States are performed by general dentists, and the rest are performed by oral surgeons, periodontists and other specialists.

The American Dental Association estimates that the demand for dental services in the United States will continue to grow due to population growth and the increased awareness of the benefits associated with preventive dentistry in reducing the incidence of oral disease. According to the U.S. Center for Medicare and Medicaid Services, annual expenditures in the United States in 2000 for dental services were $60 billion, and are expected to increase to approximately $100 billion by 2010.

*Traditional Dental Instruments*

Dental procedures are performed on hard tissue, such as bone and teeth, and soft tissue, such as gum and other oral tissue. Dentists and other specialists choose from a variety of instruments depending on the tissue involved and the type of procedure. Most procedures require the use of multiple instruments to achieve the desired result.

*High Speed Drills*. Most dentists use high speed drills for hard tissue procedures, such as preparing cavities for filling and gaining access for performing root canals. Adverse effects associated with drills include heat production, vibration and noise. The cutting and grinding action of high speed drills can cause damage to the patient s dental structure, including microfractures in teeth. Microfractures can provide an entry point for bacteria, which can cause tooth decay and weaken the tooth s underlying structure, which can lead to fractures and broken cusps. Crowns and root canals may become necessary as a result of damage caused during previous dental procedures.

*Cutting Instruments*. Soft tissue procedures, such as reshaping gum lines and grafting on new gum tissue, are typically performed by oral surgeons or periodontists using scalpels, scissors and other cutting tools. Due to the pain and discomfort associated with procedures performed with these instruments, most soft tissue procedures require the use of anesthetics, which cause numbness and discomfort, and often require stitches. Use of scalpels, scissors and other cutting tools typically cause bleeding, post-operative swelling and discomfort. Bleeding reduces the practitioner s visibility and efficiency, and generally makes procedures more cumbersome. Bleeding is a particular problem for patients with immune deficiencies or blood disorders, and patients taking blood-thinning medications.

*Alternative Dental Instruments*

Alternative technologies have been developed over the years to address the problems associated with traditional methods used in dentistry. Most alternatives have addressed either hard or soft tissue applications. The predominant alternative technologies and their limitations are discussed below.

*Air Abrasion Systems*. Air abrasion systems were introduced as an alternative to the high speed drill for hard tissue procedures. Air abrasion systems blow a powerful air stream of aluminum oxide particles to erode hard tissue and remove the harder forms of decay. Air abrasion is most commonly used to repair cracks and discolorations, clean out pits and fissures, prepare cavities to be filled with composites and prepare tooth surfaces for bonding. However, air abrasion is not suitable for a variety of hard tissue procedures including bone, and cannot be used on, or very near to, soft tissue. In addition, the use of air abrasion is time consuming and scatters particles that can be inhaled by patients and staff, and that can damage equipment and instruments. Due to these limitations, we believe the popularity of these systems has declined over the last few years.

*Electrosurge Systems.* A commonly used technology, known as electrosurge, was developed to cut soft tissue. Electrosurge systems use an electrical spark that simultaneously cuts and cauterizes tissue, resulting in less bleeding than occurs with scalpels. Traditional electrosurge results in deep penetration, which can cause unwanted damage to surrounding tissue, and is generally less precise than lasers. Electrosurge is not suitable for hard tissue procedures and, due to the depth of penetration, generally requires use of anesthesia and involves a lengthy healing process. Use of most electrosurge units is restricted near metal fillings and dental implants. Additionally, electrosurge generally cannot be used with patients with implanted pacemakers and defibrillators.

*Traditional Laser Systems.* More recently, lasers have gained acceptance for use in general and cosmetic dentistry. Most lasers used in dentistry have been adapted from other medical applications, such as dermatology, and were not designed to perform a wide range of common dental procedures. Most dental lasers use thermal energy to cut tissue and are used primarily for soft tissue procedures.

Due to the limitations associated with traditional and alternative dental instruments, we believe there is a large market opportunity for dental laser systems that provide superior clinical results and help reduce the trauma, pain and discomfort associated with dental procedures. We also believe there is a significant opportunity among dental practitioners for new, more effective tools that increase patient satisfaction, improve outcomes and enhance practice profitability.

**The BioLase Solution**

We believe the superior performance and ease of use of our systems will position them as the instruments of choice among practitioners and patients for a broad range of common dental procedures. We have developed our laser systems and related products specifically for the dental market to more effectively perform a broad range of dental procedures. The skill level and dexterity necessary to operate our laser systems are similar to those necessary to operate conventional drills and other dental equipment. Our laser systems also have the advantage of being able to perform procedures in narrow spaces where access for conventional instruments often is limited. Our systems are intended to complement traditional tools, such as dental drills, which perform functions that our systems do not address, such as cutting metal fillings and certain polishing and grinding functions.

Our primary product, the Waterlase system, is the best selling dental laser system. The Waterlase precisely cuts hard tissue, such as bone and teeth, and soft tissue, such as gums, with minimal or no damage to surrounding tissue and dental structure. Our LaserSmile system is designed to complement the Waterlase, and is used in soft tissue procedures and tooth whitening. We recently acquired the American Dental Laser product line, which includes the Diolase and Pulsemaster systems, primarily for use in soft tissue procedures. The Diolase and Pulsemaster, together with our Waterlase and LaserSmile systems, will offer practitioners a broad product line with a range of features and price points.

A small percentage of dental professionals worldwide currently use lasers, and our systems are more expensive than traditional dental tools. However, we believe that the significant performance advantages of our systems, the potential return on investment that our systems offer practitioners and the options available to finance the purchase of our systems will enable us to continue to increase our sales and leading market position.

We believe the demand for our systems will continue to expand as we increase awareness of the benefits to patients and dental professionals.

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***Benefits to Dental Professionals***

*Additional procedures through increased efficiency*. Our systems often shorten and reduce the number of patient visits, providing dental professionals with the ability to service more patients. For hard tissue procedures, the Waterlase reduces the need for anesthesia and enables dental practitioners to perform multiple procedures in one visit. An advantage of the Waterlase is that it can be used to perform cavity preparations in multiple quadrants. In contrast, many dentists using high speed drills usually do not perform cavity preparations in more than one quadrant per visit because of concerns relating to use of anesthesia in multiple regions. For soft tissue procedures, the Waterlase and LaserSmile systems allow tissue to be cut more precisely and with minimal bleeding. The LaserSmile performs tooth whitening faster than competing non-laser systems due to its high power and the fast activation of our proprietary whitening gel.

*Expanded range of procedures and revenue opportunities.* Our laser systems often allow general dentists to perform surgical and cosmetic procedures that they are unable or unwilling to perform with conventional methods, and which would typically be referred to a specialist. These procedures include crown lengthening, frenectomy and biopsy. Our systems allow dentists to perform these procedures easily and efficiently, increasing their range of skills and professional satisfaction.

*Increased loyalty and expanded patient base.* We believe the improved patient comfort and convenience offered by our systems will improve patient retention, attract new patients and increase demand for elective procedures.

*Fewer post-op complications*. Our laser systems can reduce trauma, swelling and general discomfort, resulting in fewer post-operative complications that require follow up treatment. Practitioners can devote time to new cases, rather than treating complications from prior procedures.

***Benefits to Patients***

*Comfort*. With our Waterlase system, patients experience dramatically improved comfort during and after most procedures. In most cases, procedures can be performed without anesthesia, which eliminates the pain associated with injections and the feeling of numbness following the procedure.

*Convenience*. Dentists generally prefer to perform procedures that require anesthesia in no more than one or two quadrants of the mouth in a single visit because of concerns related to the use of anesthesia in multiple quadrants. Our systems do not require anesthesia in most cases, which allows procedures to be performed in multiple quadrants during a single office visit. This reduces the number of visits necessary to complete the patient s treatment plan.

*Reduced trauma*. Trauma to the dental structure can be reduced because the laser avoids the vibration and microfractures associated with the high speed dental drill. For soft tissue applications, our laser systems cut with less bleeding than typically achieved with conventional instruments.

*Broader range of available procedures*. Due to the improved comfort and convenience of our systems, we believe patients are more likely to consider cosmetic and other elective procedures that would generally be time consuming and uncomfortable.

**Business Strategy**

Our objectives are to increase our leadership position in the dental laser market and to establish our laser systems as essential tools in dentistry. Our business strategy consists of the following key elements:

*Increase awareness of our laser systems among dental practitioners and patients*. We intend to further penetrate the dental market by educating dental practitioners and patients about the clinical benefits of our laser systems, particularly the Waterlase system. We plan to increase adoption of our laser systems by practitioners through our continued participation in key industry trade shows, the World Clinical

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Laser Institute, dental schools and other educational forums. We also intend to market our systems to practitioners through our direct sales force and advertising. We have recently begun and plan to continue marketing efforts aimed directly at patients.

*Expand sales and distribution capabilities*. In the United States, we intend to continue to build a direct sales force and marketing team. Internationally, we intend to use established dental and medical device distributors and to use a direct sales force in select countries. We are developing an infrastructure to support growth in sales and marketing. This infrastructure includes information technology systems and personnel to manage our sales force, compile sales and marketing data, and better serve our customers and distributors.

*Expand product platform and applications*. We plan to expand our product line and product applications by developing product enhancements and new laser technologies. Additionally, we may strategically acquire complementary products and technologies. We recently acquired the American Dental Laser product line, including the Diolase and Pulsemaster systems, which we believe will enable us to increase market penetration by offering a broad line of laser systems with a range of features and price points.

*Continue high quality manufacturing and customer service.* Our manufacturing operations in California and Germany are focused on producing high quality dental laser systems. We intend to continually develop and refine our manufacturing processes to increase production efficiencies and product quality. We provide high quality maintenance and support services through our support hotline and dedicated staff of in-house and field service personnel. Additionally, we plan to maintain and expand our network of factory-trained service technicians to provide maintenance and support services to customers in Europe and other markets outside the United States.

*Strengthen and defend technology leadership*. We believe our proprietary Waterlase system and YSGG Laser Hydrokinetic technology represents significant advancements in dentistry. We will pursue the protection of our intellectual property rights by expanding our existing patent portfolio in the United States and abroad. We intend to strategically enforce our intellectual property rights worldwide.

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**Products**

We have two principal product lines. Our BioLase product line includes the Waterlase and LaserSmile systems, which we developed through our own research and development. We recently acquired the American Dental Laser product line, which includes the Diolase and Pulsemaster systems.

We currently sell our products in over 20 countries. All of our laser systems have been cleared by the U.S. Food and Drug Administration for the applications listed below, which enables us to market the systems in the United States. Our systems have the CE Mark and may be sold in the European Union. Additionally, we have approval to sell our Waterlase system in Canada, Australia, New Zealand and other Pacific Rim countries.

| PRODUCT | SELECTED APPLICATIONS | TECHNOLOGY |
|---|---|---|
| ***BioLase Product Line*** | | |
| Waterlase System | *Hard Tissue*: Cavity preparation, caries removal, roughening or etching, root canal and other hard tissue surgical applications. | Solid State Crystal, Erbium, Chromium: Yttrium, Scandium, Gallium, Garnet (Er, Cr: YSGG), Laser with Air-Water Spray |
| | *Bone*: Cutting, shaping, contouring, resection, crown lengthening (restorative), apicoectomy or amputation of root end, and other oral osseous or bone procedures. | |
| | *Soft Tissue*: Incision, excision and biopsy of soft tissue, frenectomy, troughing, fibroma removal, hemostasis, aphthous oral ulcers, operculectomy and other soft tissue surgical applications. | |
| | *Cosmetic*: Gingivectomy, gingivoplasty and crown lengthening. | |
| LaserSmile System | *Soft Tissue*: Incision, excision and biopsy of soft tissue, frenectomy, troughing, gingivoplasty and other soft tissue surgical applications. | Semiconductor Diode Laser |
| | *Cosmetic*: Gingivectomy, gingivoplasty and tooth whitening. | |
| ***American Dental Laser Product Line*** | | |

| | | |
|---|---|---|
| Diolase System | *Soft Tissue*: Incision, excision and biopsy of soft tissue, frenectomy, troughing and other soft tissue surgical applications.<br><br>*Cosmetic*: Gingivectomy and gingivoplasty. | Semiconductor Diode Laser |
| Pulsemaster System | *Soft Tissue*: Incision, excision and biopsy of soft tissue, frenectomy, troughing, gingivectomy, gingivoplasty and other soft tissue surgical applications.<br><br>*Cosmetic*: Gingivectomy and gingivoplasty. | Neodymium: Yttrium, Aluminum, Garnet (Nd:YAG), Crystal Laser |

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***BioLase Product Line***

The following are the two laser systems developed by our in-house team of engineers.

*Waterlase System.* The Waterlase laser uses an Er, Cr: YSGG crystal, which produces a unique wavelength optimized for dental applications. Using YSGG Laser Hydrokinetics, the Waterlase enables highly controlled cutting of bone and tooth with minimal to no damage to surrounding tissue, resulting in less trauma and pain than is achieved with dental drills or other dental instruments. The Waterlase can cut teeth or bone in narrow spaces with limited access for conventional instruments. By reducing or eliminating the water spray level, the Waterlase can also be used to perform a number of soft tissue procedures. Our Waterlase cuts soft tissue efficiently and provides effective coagulation in many types of soft tissue procedures. The approximate list price of the Waterlase system is $50,000.

*LaserSmile System.* The LaserSmile system uses a semiconductor diode laser primarily for use in soft tissue and cosmetic procedures, particularly tooth whitening. For tooth whitening, the LaserSmile is used with our proprietary gel to whiten teeth faster than competitive non-laser whitening systems. In addition, the high power of the LaserSmile makes it particularly effective in soft tissue procedures where deeper penetration and faster coagulation is desired. The approximate list price of the LaserSmile system is $23,000.

***American Dental Laser Product Line***

We recently acquired the American Dental Laser product line, including the Diolase and Pulsemaster systems. We believe that the Diolase system complements our Waterlase and LaserSmile systems and will enable us to increase market penetration by offering a broad line of laser systems with a range of features and price points.

*Diolase System.* Our recently acquired Diolase system uses a semiconductor diode laser for a range of dental soft tissue, cosmetic and hygiene procedures. The Diolase has simpler features than our other systems, and is positioned as an entry level laser system. The approximate list price of the Diolase system is $14,000.

*Pulsemaster System.* Our recently acquired Pulsemaster system uses the popular Nd:YAG crystal that is broadly accepted for a variety of soft tissue procedures. The Pulsemaster system is well established and has been adopted by many dental practitioners, especially for periodontal procedures. The Pulsemaster system performs many of the same functions as our existing LaserSmile system. As a result, we plan to make the Pulsemaster available only in limited quantities, on a made-to-order basis, to dental practitioners who express a strong preference for that system. The approximate list price of the Pulsemaster system is $27,500.

***Related Accessories and Disposable Products***

We also manufacture and sell disposable products and accessories for our laser systems. Our Waterlase system uses disposable laser tips of differing sizes and shapes depending on the procedures being performed. We also market flexible fibers, handpieces, tooth whitening gel and aftercare products for our LaserSmile system. In connection with our acquisition of the American Dental Laser product line, we acquired a complete line of accessories for the Diolase and Pulsemaster systems, as well as other accessories marketed under the American Dental Laser brand name.

***Warranties and Insurance***

Our laser systems sold to end-users and distributors are covered by a one year and fourteen-month warranty, respectively, against defects in material and workmanship. Our warranty covers parts and service for direct sales and parts only for distributor sales with additional coverage on certain components for up to two years. We sell service contracts that cover the period after the expiration of our standard warranty coverage for our laser systems. Extended warranty coverage provided under our service contracts varies by the type of system and the level of service desired by the customer. In addition, we maintain product liability insurance with respect to our products with a general coverage limit of $12 million in the aggregate. Since commencing the sale of our systems, no product liability claims have been initiated against us.

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**Manufacturing**

We manufacture, assemble and test our products at manufacturing facilities located in San Clemente, California, and Floss, Germany. We acquired our German manufacturing facility in 2002. We manufacture and install our systems and provide maintenance services for products sold in Europe and other international markets through our German operations. Sales of products manufactured at our German facility accounted for 9% of our revenue in 2002 and 17% of our revenue for the six months ended June 30, 2003.

We use an integrated approach to manufacturing, including the assembly of laser heads, electronics and cabinetry, which allows us to maintain high quality and control cost. We obtain components and subassemblies for our products from third party suppliers, most of which are located in the United States. We generally purchase components and subassemblies from a limited group of suppliers through purchase orders. We have no written supply contracts with our key suppliers. Three key components used in our Waterlase system, which accounted for approximately 77% of our revenue in 2002 and approximately 82% of our revenue for the six months ended June 30, 2003, are each supplied by a separate single-source supplier. The Waterlase hand pieces are made by a leading European supplier of precision hand tools, and the laser crystal and fiber components are each made by a separate supplier. We have not experienced material delays from the suppliers of these three key components, and we have identified and tested alternative suppliers for each of these components. However, an unexpected interruption in a single source supplier could create manufacturing delays, and disrupt sales as we sought to replace the supplier, which we estimate could take up to three months.

Our manufacturing facilities are ISO 9001 certified. ISO 9001 certification provides guidelines for quality of company systems associated with the design, manufacturing, installation and servicing of company products. In addition, both the U.S. and German facilities are registered with the U.S. Food and Drug Administration and are compliant with the FDA s Good Manufacturing Practice guidelines.

**Marketing and Sales**

***Marketing***

We currently market our laser systems in the United States, Canada, Australia and various countries throughout Europe and the Pacific Rim. Our marketing efforts are focused on increasing brand and specific product awareness among dental practitioners. We recently began efforts to increase awareness of the benefits of our products by marketing directly to patients.

*Dental Practitioners.* We currently market our laser systems directly to dental practitioners through regional, national and international trade shows and seminars. We also use brochures, direct mailers, press releases, posters and other promotional materials, as well as print and electronic media news coverage. In 2002, we founded the World Clinical Laser Institute to formalize our efforts to educate and train dental practitioners in laser dentistry. The Institute conducts and sponsors educational programs domestically and internationally for dental practitioners, researchers and academicians, including two or three day seminars and training sessions involving in-depth discussions on the use of lasers in dentistry. In addition, we have developed relationships with research institutions, dental schools and clinical laboratories, which use our products in training and demonstrations. We believe these relationships will increase awareness of our products.

*Patients.* We recently began to market the benefits of our laser systems directly to patients through marketing and advertising programs, including print media and radio spots, sponsored jointly by dental practitioners and us in selected markets that we feel have strong growth potential. We believe that making patients aware of our laser systems and their benefits will increase demand for our products.

***Sales***

We currently sell our products primarily to dentists in general practice. The majority of the dentists in the United States, as well as the majority of our customers, are sole practitioners. As awareness of our laser systems

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increases, we expect an increase in demand for our products among group practices. We also expect our laser systems to gain acceptance among oral surgeons and other dental specialists, as they become better aware of the clinical benefits and new treatment options available through use of our laser systems.

International sales account for a significant portion of our revenue. International sales accounted for approximately 23% or our revenue in 2002, 20% of our revenue in 2001 and 41% or our revenue in 2000. Sales in Asia, Pacific Rim countries and Australia accounted for approximately 12% of our revenue in 2002, while sales in Europe and Canada accounted for 11% and 1% of our 2002 revenue, respectively. In 2001, sales in Europe accounted for approximately 9% of revenue for the year, whereas sales in Asia and Pacific Rim countries accounted for approximately 8% of the revenue. In 2000, sales in Europe accounted for approximately 24% of our revenue for the year, and sales in Asia and Pacific Rim countries accounted for approximately 11% of the revenue for the year.

*Direct Sales.* We sell products in the United States and Canada through our direct sales force, which is organized by region and consists of two regional managers and approximately 25 sales representatives. Each of our direct sales employees receives a base salary and commissions on sales. We plan to expand our direct sales force in territories that represent growing markets. We sell products in Germany through independent sales representatives who receive commissions on sales.

*Distributors.* Except for sales in Canada and Germany, we sell products outside the United States primarily through a network of independent distributors located in Europe, Asia and Australia. Generally, our distributors enter into exclusive agreements in which they purchase systems and disposables from us at a wholesale dealer price and resell them to dentists in their sales territories. All sales to distributors are final and we can terminate our arrangements with dealers and distributors for cause or non-performance. We have exclusive arrangements with certain distributors for select territories, under which distributors are generally required to satisfy certain minimum purchase requirements to maintain exclusivity. Sales to distributors are generally paid in advance or secured with a letter of credit.

*Seasonality.* We have experienced a distinct seasonal pattern over the past several years. The fourth quarter, ending December 31, has generally been the strongest quarter, and in 2002 accounted for approximately 30% of our 2002 revenue. By contrast, the first quarter is generally the slowest sales quarter and in 2002 accounted for only 18% of 2002 revenue. The second quarter is generally stronger than the first quarter and in 2002 accounted for approximately 27% of our 2002 revenue. The third quarter has generally been flat compared to the second quarter and accounted for approximately 25% of our revenue in 2002. We believe the seasonality demonstrated in the fourth and first quarters is due to the buying patterns of many dentists, including the response to certain tax advantages offered in the United States for capital equipment purchases. We also believe the lack of growth in the third quarter compared to the second quarter is due to general practice patterns in which vacations occur in the third quarter of the year. As a result of this seasonality, our growth metrics compare growth in a quarter to the same quarter in the prior year and is not focused on growth in consecutive quarters which has been and we expect will continue to be skewed by this seasonality effect.

*Customer Service.* We provide maintenance and support services through our support hotline, service personnel and network of factory-trained service technicians. We provide maintenance and support services in the United States and Germany through our employee service technicians. We train and maintain a network of service technicians trained at our factory locations, who provide maintenance and support services in all other countries where we do business. Our distributors are responsible for providing maintenance and support services for products sold by them. We provide parts to distributors at no additional charge for products covered under warranty.

*Financing Options.* Many dentists finance their purchases through third party leasing companies or banks. In these transactions, we receive payment in full from the leasing company or bank, or from the dentist, who receives funds from the leasing company or bank. The dentist pays the leasing company or bank in installments and we do not bear the credit risk that the dentist might not make payments. The leasing companies and banks

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do not have recourse to us for a dentist s failure to make payments. Approximately 36% of our revenue in 2002 was generated from sales to dentists who financed their purchase through National Technology Leasing Corporation, an equipment leasing broker. National Technology Leasing arranges financing through banks. We have an agreement with National Technology Leasing which requires us to refer to National Technology Leasing customers who request a referral to a leasing company. In exchange, National Technology Leasing agreed to be available at our trade shows, seminars, symposiums and other sales events, participate in product promotions and otherwise be available to our customers. Our agreement with National Technology Leasing also provides that National Technology Leasing will from time to time sponsor marketing programs for our products. Our customers are under no obligation to finance the purchase or lease of any equipment through National Technology Leasing and we refer only those customers that request a referral from us. If leasing arrangements were no longer available through National Technology Leasing or the banks with which it deals, we believe our customers would be able to obtain financing through a variety of other leasing companies or banks that frequently approach us to provide financing for our products.

**Research and Product Development**

Research and development activities are essential to maintaining and enhancing our business. We believe our research and development team has demonstrated its ability to develop innovative products that meet evolving market needs. Our research and development group consists of 12 individuals with medical device and laser development experience and other relevant backgrounds, the majority of whom have degrees in physics or engineering, including three Ph.D.s. During the years ended December 31, 2000, 2001 and 2002, our research and development expenses were approximately $2.3 million, $1.5 million and $1.7 million, respectively. We intend to focus our research and development activities on improving our existing products and extending our product range in order to provide dental practitioners and patients with less painful and clinically superior laser systems.

**Intellectual Property and Proprietary Rights**

We rely, in part, on a combination of patents, trademarks, trade secrets, copyright and other intellectual property rights to protect our technology. We have over 60 issued patents and numerous pending patents. More than half of our existing patents were issued in the United States, and the rest were issued in Europe and in other countries. Our patents are directed to the use of laser and water in dentistry, laser energy exciting water, laser characteristics, fluid conditioning, laser accessories, laser technology development and other technologies for dental and medical applications. We have patent applications pending and plan to apply for other patents in the future as we develop new technologies. While we hold a variety of patents covering a broad range of technologies incorporated in our products, we rely on approximately one half of our patents in particular to protect the core technology incorporated in our systems, including our Waterlase system, which accounted for approximately 77% of our revenue in 2002 and approximately 82% of our revenue for the six months ended June 30, 2003. Four of these patents expire in 2009, and the balance have expiration dates ranging from 2010 to 2015.

We are currently involved in two patent lawsuits related to our Waterlase system with Diodem, LLC, a privately-held California limited liability company. In May 2003, we initiated a lawsuit against Diodem, in which we are seeking a judicial declaration that technology in our Waterlase does not infringe four patents owned by Diodem. Diodem was founded by the former chief executive officer of Premier Laser Systems, Inc., a medical laser company which filed for bankruptcy protection in March 2000. Diodem claims to have acquired the four patents at issue in the case from Premier Laser. Also, in May 2003, Diodem added us as a party to a patent infringement lawsuit it had previously filed. Diodem alleges that the technology in our Waterlase system infringes the four patents it acquired from Premier Laser. Diodem s suit seeks monetary damages, an injunction and other relief. Both of these lawsuits are in their preliminary stages, and may proceed for an extended period of time. Although the outcome of these actions cannot be determined with certainty, we believe our technology and products do not infringe any valid patent rights owned by Diodem, and we intend to continue to vigorously defend against Diodem s infringement action and pursue our declaratory relief action against Diodem.

**Competition**

We compete with a number of companies that market traditional dental products, such as dental drills, as well as other companies that market laser technologies in dental and other medical markets. In the domestic hard tissue dental market, we believe our Waterlase product primarily competes with laser systems manufactured by Hoya ConBio, a subsidiary of Hoya Photonics, a large Japanese manufacturer primarily of optics and crystals, and OpusDent Ltd., a subsidiary of Lumenis, an Israeli company. In the international market, our Waterlase system competes primarily with products manufactured by several other companies, including KaVo, Deka Dental Corporation and Fotona d.d.

The Waterlase system also competes with non-laser based systems, including traditional high and low-speed dental drills and air abrasion systems that are used for dental procedures. Our LaserSmile system and our newly acquired Diolase and Pulsemaster systems compete with other laser systems, as well as with scalpels, scissors and a variety of other cutting tools that have been traditionally used to perform soft tissue procedures. The LaserSmile also competes directly with a number of laser systems manufactured by a variety of companies, including the companies named above. In the market for tooth whitening, the LaserSmile competes with other products and instruments used by dentists, as well as tooth whitening strips and other over the counter products.

Traditional and commonly used cutting tools are less expensive for performing dental procedures. For example, a high speed drill or an electrosurge device can be purchased for less than $1,000 each. However, we believe our systems offer substantial benefits that outweigh cost concerns. In addition, our systems are not designed to perform certain functions that high speed drills can perform, such as cutting metal fillings and certain polishing and grinding functions. High speed drills will still be needed for these functions, and our systems are not intended to replace all applications of the high speed drill.

We also compete on the basis of proprietary technology, product features, performance, service and reputation. Some of the manufacturers that develop competing laser systems have greater financial, marketing and technical resources than we do. In addition, some competitors have developed, and others may attempt to develop, products with applications similar to the those performed by our laser systems.

**Government Regulation**

Our products are regulated as medical devices. Accordingly, our product development, testing, labeling, manufacturing, processes and promotional activities are regulated extensively by government agencies in the United States and other countries in which we market and sell our products. We have clearance from the U.S. Food and Drug Administration, or FDA, to market our laser systems in the United States. We also have the approvals necessary to sell our laser systems in Canada, the European Union and other international markets. We are currently pursuing regulatory approval to market and sell our products in Japan.

***United States***

In the United States, the FDA regulates the design, manufacture, distribution, quality standards and marketing of medical devices. We have clearance from the FDA to market our Waterlase and LaserSmile systems in the United States for dental procedures on both adult and pediatric patients. In 1998, we received FDA clearance to market the Millennium, the earlier generation of our current Waterlase system, for certain dental hard tissue applications. This clearance allowed us to commence domestic sales and marketing of our technology for hard and soft tissue applications. During 1999 and 2000, to meet the demand for soft-tissue and cosmetic dentistry applications, we designed a semiconductor diode laser system, which is now marketed as our LaserSmile system. We received FDA clearance to market the system for a variety of soft-tissue medical

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applications in September 1999. In 2001, we received FDA clearance to market the LaserSmile system for cosmetic tooth whitening.

In 2002 and 2003, our Waterlase system became the first laser system to receive FDA clearance for three new types of procedures. In 2002, we received clearance to market the Waterlase system for root canal, encompassing all four of the fundamental steps of the procedure. We also received clearance in 2002 to market this system for cutting, shaving, contouring and resection of oral osseous tissues, or bone. In January 2003, we received FDA clearance to market the Waterlase for use in apicoectomy surgery, a procedure for root canal infections and complications that includes cutting gum, bone (to access the infected area) and the apex of the tooth to access the infected area. The clearance also relates to flap surgical procedures. Flaps are frequently performed in conjunction with many procedures, including periodontal, implant placement and recovery, extraction of wisdom teeth, exposure of impacted teeth for orthodontics as well as additional procedures.

Our newly acquired Diolase system received FDA clearances in 1997 to be marketed for a variety of soft tissue dental applications. FDA clearances were issued in 1994 to market the Pulsemaster system for a number of soft tissue procedures. We are in the process of transferring those clearances to our company.

As we develop new products and applications or make any significant modifications to our existing products, we will need to obtain the regulatory approvals necessary to market such products for dental, cosmetic and other medical procedures in our target markets. There are two principal methods by which FDA regulated devices may be marketed in the United States: pre-market approval, or PMA, and 510(k) clearance. A PMA application is required for a device that does not qualify for consideration for 510(k) clearance. The review period for a PMA application is fixed at 180 days, but the FDA typically takes much longer to complete the review. As part of the approval of a PMA application, the FDA typically requires human clinical testing to determine safety and efficacy of the device. To conduct human clinical testing, typically the FDA must approve an Investigational Device Exemption, or an IDE. To date, none of our products have required a PMA application.

To obtain 510(k) clearance, we must demonstrate that our device for which clearance is sought is substantially equivalent to a previously cleared 510(k) device or other appropriate predicate device. The FDA s stated intention is to review 510(k) notifications as quickly as possible, generally within 90 days. However, the complexity of a submission or a requirement for additional information will typically extend the review period beyond 90 days. Domestic marketing of the product must be deferred until clearance is received from the FDA. In some instances, an IDE is required for clinical trials for a 510(k) clearance. If a request for 510(k) clearance is turned down by the FDA, then a PMA may be required. We intend to utilize the 510(k) notification procedure whenever possible. To date, all of our products that have been subject to regulation by the FDA have qualified for 510(k) clearance.

After a device receives 510(k) clearance, any modification that could significantly affect its safety or effectiveness, or that would constitute a major change in its intended use, will require a new 510(k) clearance, or could even require a PMA application. The FDA requires each manufacturer to make this determination initially, but the FDA can review any such decision and can disagree with a manufacturer s determination. If the FDA disagrees with a manufacturer s determination, the FDA can require the manufacturer to cease marketing and/or recall the modified device until 510(k) clearance or a PMA is obtained.

The FDA also imposes various requirements on manufacturers and sellers of products it regulates under its jurisdiction, such as labeling, manufacturing practices, record keeping and reporting. The FDA also may require post-marketing practices, record keeping and reporting requirements.

We also are subject to unannounced inspections by the FDA for both the U.S. and BIOLASE Europe offices, and the Food and Drug Branch of the California Department of Health Services, and these inspections may include the manufacturing facilities of our subcontractors.

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We are also subject to regulation under the Radiation Control for Safety and Health Act of 1968, or the Safety Act, administered by the Center for Devices and Radiological Health, or CDRH, of the FDA. The CDRH controls energy emissions of light and sound and electronic waves from electronic products. These regulations require a laser manufacturer to file new product and annual reports, to maintain quality control, product testing and sales records, to distribute appropriate operation manuals, to incorporate certain design and operating features in lasers sold to end-users and to certify and label each laser sold to end-users as one of four classes of lasers based on the level of radiation from the laser. In addition, various warning labels must be affixed to the product and certain protective devices must be installed, depending upon the class of product. Under the Safety Act, we are also required to register with the FDA as a medical device manufacturer and are subject to inspection on a routine basis by the FDA for compliance with Good Manufacturing Practice, or GMP, regulations. The GMP regulations impose certain procedural and documentation requirements upon us relevant to our manufacturing, testing and quality control activities. We believe both of our facilities comply with the GMP guidelines. The CDRH is empowered to seek remedies for violations of these regulatory requirements under the Federal Food, Drug and Cosmetic Act. We believe that we are currently in substantial compliance with these regulations.

Various state dental boards are considering the adoption of restrictions on the use of lasers by dental hygienists. Approximately 30 states currently allow dental hygienists to use lasers to perform certain dental procedures. In addition, dental boards in a number of states are considering educational requirements regarding the use of dental lasers. The scope of these restrictions and educational requirements is not now known, and they could have an adverse effect on sales of our laser-based products.

Failure to comply with applicable regulatory requirements can result in an enforcement action by the FDA, which may include any of the following sanctions:

- fines, injunctions and civil penalties;
- recall or seizure of our products;
- operating restrictions, partial suspension or total shutdown of production;
- refusing our request for 510(k) clearance or PMA approval of new products;
- withdrawing 510(k) clearance or PMA approvals that are already granted; and
- criminal prosecution.

***International***

Foreign sales of our laser-based products are subject to the regulatory requirements of the foreign country or, if applicable, the harmonized standards of the European Union. These regulatory requirements vary widely among the countries and may include technical approvals, such as electrical safety, as well as demonstration of clinical efficacy. We have a CE Mark for our Waterlase and LaserSmile systems, which permits us to commercially distribute these systems throughout the European Union. We rely on export certifications from the FDA to comply with certain regulatory requirements in several foreign jurisdictions, such as New Zealand, Canada and countries in Western Europe. We also received clearance to market our Waterlase and LaserSmile systems in Canada and Australia for a variety of applications. We are currently working to meet certain foreign country regulatory requirements for certain of our products, including Japan. There can be no assurance that additional approvals in Japan or elsewhere will be obtained.

***Other Regulatory Requirements***

In addition to the regulatory framework for product clearances and approvals, we are subject to extensive and frequently changing regulations under many other laws administered by U.S. and foreign governmental agencies on the national, state and local levels, including requirements regarding occupational health and safety and the use, handling and disposing of toxic or hazardous substances.

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**Third Party Reimbursement**

Many procedures performed with our laser systems are covered by insurance to the same extent as they would be if performed using traditional dental instruments. Most therapeutic procedures performed with our laser systems are reimbursable to a certain extent under dental insurance plans, whereas cosmetic procedures are not. International market acceptance for our products may depend, in part, on the availability of reimbursement within prevailing health care payment systems. Reimbursement and health care payment systems in international markets vary significantly by country, and include both government-sponsored health care and private insurance.

**Employees**

At September 19, 2003, we employed approximately 139 people, of which there are approximately 50 in manufacturing and quality and control, 12 in research and development, approximately 50 in sales and sales support, 15 in customer technical support and 12 in administration. Our employees are not represented by any collective bargaining agreement and we believe our employee relations are good.

**Facilities**

Our corporate headquarters are located at 981 Calle Amanecer, San Clemente, California, where we lease 23,000 square feet of space for manufacturing and administrative functions. The lease on this facility expires on March 31, 2006. Our wholly-owned subsidiary, BIOLASE Europe, owns a manufacturing facility totaling approximately 20,000 square feet of space in Floss, Germany. Our subsidiary currently leases half of the facility to an unrelated party and uses the remaining portion of the facility for its manufacturing operations. We believe that our facilities are sufficient for our current needs.

**Legal Proceedings**

We are currently involved in two related patent lawsuits with Diodem, LLC, a California limited liability company. On May 2, 2003, we initiated a civil action in the U.S. District Court for the Central District of California against Diodem. In this lawsuit we are seeking a judicial declaration against Diodem that technology we use in our laser systems does not infringe four patents owned by Diodem. Diodem was founded by Collete Cozean, the former chief executive officer of Premier Laser Systems, Inc., a medical laser company which filed for bankruptcy protection in March 2000. Diodem claims to have acquired the four patents at issue in the case from Premier Laser. In 2000 we initiated a patent infringement lawsuit against Premier Laser seeking damages and to prevent Premier from selling competing dental lasers on the grounds that they infringed on certain of our patents. The lawsuit was stayed by the bankruptcy court after Premier filed for bankruptcy.

In response to our lawsuit against Diodem, on May 5, 2003, Diodem added us as a party to an infringement lawsuit it had previously filed in the U.S. District Court for the Central District of California. The other parties to this lawsuit are American Medical Technologies, Inc., Lumenis and its subsidiary OpusDent, Ltd., and Hoya Photonics and its subsidiary Hoya ConBio. OpusDent and Hoya ConBio manufacture and sell dental lasers pursuant to patents originally licensed to them by American Medical Technologies. We acquired the licensed patents and related license agreements in our acquisition of the American Dental Laser product line from American Medical Technologies. In July 2003, American Medical Technologies was dismissed from the lawsuit without prejudice, however, we and the other defendants remain in the suit.

Diodem s lawsuit relates both to our Waterlase and to the patents and licenses we acquired from American Medical Technologies. Diodem alleges that technology used in our Waterlase infringes the four patents it acquired from Premier Laser. Diodem also alleges that the products sold by OpusDent and Hoya ConBio pursuant to the licenses we acquired from American Medical Technologies infringe on the patents Diodem acquired from Premier Laser. Diodem s infringement suit seeks treble damages, a preliminary and permanent injunction from further alleged infringement, attorneys fees and other unspecified damages. Both of these lawsuits are in their preliminary stages, and may proceed for an extended period of time. Although the outcome

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of these actions cannot be determined with certainty, we believe our technology and products do not infringe any valid patent rights owned by Diodem, and we intend to continue to vigorously defend against Diodem s infringement action and pursue our declaratory relief action against Diodem.

These lawsuits could result in significant expenses and diversion of management s time and other resources. If Diodem successfully asserts an infringement claim against us in its infringement lawsuit, our operations may be significantly impacted, especially to the extent that it affects our right to use the technology incorporated in our Waterlase system, which accounted for approximately 77% of our revenue in 2002 and approximately 82% of our revenue for the six months ended June 30, 2003. Diodem s claims related to the licenses to Hoya ConBio and OpusDent, which we acquired from American Medical Technologies, could reduce or eliminate royalties we might receive under those licenses, which for American Medical Technologies were approximately $127,000 in 2002 or approximately 2.9% of its total revenue for that year. Diodem s infringement proceeding could also result in significant limitations on our ability to manufacture, market and sell our products, including our Waterlase system, as well as delays and costs associated with redesigning our products and payments of license fees, monetary damages and other payments. Additionally, we may be enjoined from incorporating certain technology into our products, all of which could significantly impede our operations, increase operating expenses, reduce our revenue and cause us to incur losses.

From time to time, we may become involved in various legal proceeding relating to our business. We are currently a party to at least three other legal proceedings involving claims for damages. We do not believe any of these other legal proceedings will have a material adverse effect on our financial condition, results of operations or cash flows.

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## MANAGEMENT

### Executive Officers and Directors

The following table sets forth information concerning our executive officers and directors, including their ages as of September 19, 2003:

| Name | Age | Position |
|---|---|---|
| Federico Pignatelli(1)(2) | 50 | Chairman of the Board |
| Jeffrey W. Jones | 45 | President, Chief Executive Officer and Director |
| William A. Owens(1) | 62 | Director |
| George V. d Arbeloff(1)(2) | 58 | Director |
| Keith G. Bateman | 50 | Executive Vice President |
| Edson J. Rood | 60 | Vice President, Chief Financial Officer and Secretary |
| Ioana Rizoiu | 39 | Vice President, Research and Development |

(1) Member of Audit Committee
(2) Member of Compensation Committee

*Federico Pignatelli* has served as the Chairman of our Board since 1994 and as our director since 1991. He is the Founder and President of Art & Fashion Group since 1992. Art & Fashion Group is a holding company of an array of businesses providing services to the advertising industry, including the world s largest complex of digital and film still photography studios for production and post-production. Previously, Mr. Pignatelli was a Managing Director at Gruntal & Company, an investment banking and brokerage firm and was a Managing Director of Ladenburg, Thalmann & Co., another investment banking and brokerage firm.

*Jeffrey W. Jones* has served as our President, Chief Executive Officer and as a director since 1998 and as Managing Director of BIOLASE Europe GmbH, our wholly-owned subsidiary, since 2001. From 1986 to 1998, Mr. Jones served in various executive capacities for a group of privately-held companies, including the McMahan Enterprise Group and HGM Medical Laser Systems, a manufacturer of medical lasers used in ophthalmologic, dental and anesthetic applications. At various times during the above mentioned period, he served as President and Chief Executive Officer of these companies.

*William A. Owens* joined our Board in 1998. Admiral Owens is currently Chief Executive Officer and Chairman of Teledesic LLC, a developer of satellite communications networks. He joined Teledesic in 1998. From 1996 to 1998, Admiral Owens was President, Chief Operating Officer and Vice Chairman of Science Applications International Corporation, a Fortune 500 research and engineering company. Admiral Owens retired from the United States Navy in 1996 after 34 years of service. During his naval career, his positions included Vice Chairman of the Joint Chiefs of Staff, the nation s second-highest ranking military officer, from 1993 to 1996; Deputy Chief of Naval Operations for Resources, Warfare Requirements and Assessments from 1991 to 1993; Commander of the United States Sixth Fleet from 1990 to 1991; and senior military assistant to the Office of the Secretary of Defense from 1988 to 1991. Admiral Owens also serves as a director of British American Tobacco Holding Ltd., Symantec Corporation, Microvision, Inc., WFI Networks, Inc., IDT Inc., Telstra LLC, Nortel Inc., Cray Inc., Polycom Inc., ViaSat Inc., and TIBCO Software Inc.

*George V. d Arbeloff* joined our Board in 1996. Since 2000, Mr. d Arbeloff has served as the Chairman of Big Idea Group, Inc., a company that links inventors with other companies buying innovation. From 1996 to 2000, Mr. d Arbeloff served as Chief Executive Officer of Retail Solutions, Inc., a small early-stage private company which sought bankruptcy protection in June 2000. From 1967 to 1996, he served in various executive

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capacities at Teradyne, Inc., a manufacturer of testing equipment for the semiconductor and electronics industries, including Vice President of Investor Relations from 1995 to 1996, Vice President and General Manager of the Semiconductor Test Group from 1992 to 1995 and Vice President and General Manager of the Industrial/Consumer Division of the Semiconductor Test Group from 1982 to 1992.

*Keith G. Bateman* has served as our Executive Vice President since 2002 and Vice President of Global Sales from 1999 to 2001. From 1994 to 1998, Mr. Bateman held executive positions with the international and domestic divisions of HGM Medical Laser Systems, Inc., a manufacturer of medical lasers used in ophthalmologic, dental and anesthetic applications. Prior to that, he held several positions in sales, marketing and management at various companies in the computer industry.

*Edson J. Rood* joined us in July 2001 as our Vice President, Chief Financial Officer and Secretary. From 1990 to 2001, Mr. Rood served as Chief Financial Officer for Scripps Health. Prior to 1990, Mr. Rood served as Vice President of Finance for Scripps Hospitals, and he served with the accounting firm of Arthur Young & Company.

*Ioana Rizoiu* has served as our Vice President of Research and Development since 1997. From 1995 to 1997, Ms. Rizoiu served as Director of Research and Development, and from 1992 to 1995, she was a physicist with BioLase.

**Board of Directors and Committees of the Board**

Our Board currently consists of four members. Each Board member is elected at the annual meeting of stockholders and holds office until the next annual meeting and until his successor is elected and qualified. Our Board and executive management team have discussed increasing the size of our Board to five members. Our Board is currently in the process of seeking to identify a qualified individual who would be willing to serve as an additional independent director.

The Audit Committee currently consists of three directors, Federico Pignatelli, William A. Owens and George V. d Arbeloff. The Committee is a standing committee of, and operates under a written charter adopted by, our Board. The Audit Committee reviews and monitors our financial statements and accounting practices, appoints, determines funding for, and oversees our independent auditors, reviews the results and scope of the audit and other services provided by our independent auditors, and reviews and evaluates our audit and control functions.

The Compensation Committee currently consists of two directors, Federico Pignatelli and George V. d Arbeloff. The Committee is primarily responsible for reviewing and developing our general compensation policies and making recommendations to the Board of Directors on compensation levels for our executive officers. The Compensation Committee also reviews and makes recommendations to the Board of Directors on matters relating to employee compensation and benefit plans.

**Compensation Committee Interlocks and Insider Participation**

None of our executive officers serves as a member of the Board of Directors or the Compensation Committee of any other company that has one or more executive officers serving as a member of our Board of Directors or Compensation Committee. None of our employees or current or former officers are members of our Compensation Committee.

**Compensation of Directors**

Directors who are not employees of us do not currently receive any cash compensation for their service as members of the Board of Directors or any Board committee. However, directors are reimbursed for all reasonable travel and lodging expenses incurred by them in attending Board and committee meetings.

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Under the automatic option grant program in effect under the 2002 Stock Incentive Plan, each individual who is elected to the Board as a non-employee director, at an annual meeting of stockholders or at a special meeting at which directors are elected, automatically is granted, on the date of such election, an option to purchase 30,000 shares of our common stock. The grant is made upon the director s initial election and each time he or she is reelected at the next annual meeting of our stockholders. Each option vests at a rate of 7,500 shares per quarter, commencing three months after the date of grant. If a non-employee director becomes a director for the first time on a date other than the date of a meeting at which all directors are elected, he or she automatically is granted an option to purchase the number of shares equal to (a) 2,500 multiplied by (b) the difference between 12 and the number of months since the last meeting at which directors were elected, vesting at a rate of 2,500 shares per month.

Each automatic grant under the 2002 Stock Incentive Plan has an exercise price per share equal to the fair market value per share of common stock on the grant date and has a maximum term of ten years, subject to earlier termination twelve months after the date of the optionee s cessation of Board service for any reason. Each automatic option is immediately exercisable for all of the option shares. However, any shares purchased under the option are subject to repurchase by us, at the lower of the exercise price paid per share or the fair market value per share (determined at the time of repurchase), should the optionee cease Board service prior to vesting in those shares. The shares subject to each initial option grant and each annual option grant will immediately vest in full if certain changes in control or ownership occur or if the optionee dies or becomes disabled while serving as a director.

Under this automatic option grant program, Messrs. Pignatelli, Owens and d Arbeloff each received an automatic option grant on May 23, 2002, to purchase 30,000 shares of our common stock at an exercise price of $5.31 per share. On April 29, 2003 they each received an automatic option grant under this program to purchase 30,000 additional shares of our common stock at an exercise price of $11.07 per share.

**Executive Compensation**

The following table contains summary information concerning the annual compensation for the years ended December 31, 2000, 2001 and 2002 for our President and Chief Executive Officer, and our other executive officers who earned over $100,000 for the year ended December 31, 2002.

| | | **Annual Compensation** | | | **Long-Term Compensation Awards** |
|---|---|---|---|---|---|
| **Name and Principal Position** | **Year** | **Salary ($)** | **Bonus ($)** | **Other Annual Compensation ($)** | **Securities Underlying Options (#)** |
| Jeffrey W. Jones<br>President and Chief Executive Officer | 2002 | $ 240,000 | $ 96,000[1] | $ 20,540[2] | |
| | 2001 | 240,000 | | 54,634[3] | 300,000 |
| | 2000 | 240,000 | | 4,500[4] | 100,000 |
| Keith G. Bateman<br>Executive Vice President | 2002 | 110,000 | | | |
| | 2001 | 110,000 | | | |
| | 2000 | | 8,797 | 7,665 | |

| | | | | |
|---|---|---|---|---|
| Total share-based compensation expense | $ 5,915 | $ 5,311 | $ 11,703 | $ 10,215 |

Beginning in 2008, we changed the method by which we provide share-based compensation to our employees by granting RSUs as a form of share-based compensation. Prior to 2008, we issued stock options as share-based compensation to our employees. Beginning in 2015, we granted PSUs to two of our executives. An RSU is the conditional right to receive one share of common stock upon satisfaction of the vesting requirement. A PSU is the conditional right to receive one share of common stock upon meeting a performance obligation along with the satisfaction of the vesting requirement. Share-based compensation activity by type of grant as of June 28, 2016 and changes during the 26 weeks then ended are presented below.

Summary Details for RSUs

| | Shares | Weighted-Average Grant Date Fair Value | Weighted-Average Remaining Contractual Term (years) | Aggregate Intrinsic Value |
|---|---|---|---|---|
| Outstanding at December 29, 2015 | 984,586 | $ 32.86 | | |
| Granted | 271,824 | 41.61 | | |
| Forfeited | (15,445) | 31.63 | | |
| Vested | (324,945) | 33.17 | | |
| Outstanding at June 28, 2016 | 916,020 | $ 35.36 | 1.3 | $ 41,060 |

As of June 28, 2016, with respect to unvested RSUs, there was $19.4 million of unrecognized compensation cost that is expected to be recognized over a weighted-average period of 1.3 years. The vesting terms of the RSUs range from approximately 1.0 to 5.0 years. The total intrinsic value of RSUs vested during the 26 weeks ended June 28, 2016 and June 30, 2015 was $13.0 million and $17.4 million, respectively. The excess tax benefit realized from tax deductions associated with vested restricted stock units for the 26 weeks ended June 28, 2016 and June 30, 2015 was $0.9 million and $2.0 million, respectively.

Summary Details for PSUs

In 2015, we granted PSUs to two of our executives subject to a one-year vesting and the achievement of certain earnings targets, which determine the number of units to vest at the end of the vesting period. Share-based compensation is recognized for the number of units expected to vest at the end of the period and is expensed beginning on the grant date and through the performance period. For each grant, PSUs vest after meeting the performance and service conditions.

On January 8, 2015, we granted PSUs with a grant date fair value of approximately $4.0 million based on the grant date price per share of $34.77. On January 8, 2016, 144,000 shares vested related to this PSU grant and were distributed during the 13 weeks ended March 29, 2016. On November 19, 2015, we granted PSUs with a grant date fair value of approximately $3.9 million based on the grant date price per share of $34.11. As of June 28, 2016, with respect to unvested PSUs, there was $2.1 million of unrecognized compensation cost that is expected to be recognized over a weighted-average period of 0.5 years. The distribution of vested performance stock units as common stock related to the November 19, 2015 grants will occur in the first quarter of 2017.

Summary Details for Stock Options

| | Shares | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term (years) | Aggregate Intrinsic Value |
|---|---|---|---|---|
| Outstanding at December 29, 2015 | 328,498 | $ 13.10 | | |
| Granted | — | — | | |
| Cancelled/Expired | (1,622) | 14.80 | | |
| Exercised | (152,577) | 12.23 | | |
| Outstanding at June 28, 2016 | 174,299 | $ 13.85 | 0.9 | $ 5,398 |
| Exercisable at June 28, 2016 | 174,299 | $ 13.85 | 0.9 | $ 5,398 |

No stock options vested during 26 weeks ended June 28, 2016 or June 30, 2015. For the 26 weeks ended June 28, 2016 and June 30, 2015, the total intrinsic value of options exercised was $4.6 million and $3.6 million, respectively.

For the 26 weeks ended June 28, 2016 and June 30, 2015, cash received before tax withholdings from options exercised was $1.9 million and $2.7 million, respectively. The excess tax benefit realized from deductions associated with options exercised for the 26 weeks ended June 28, 2016 and June 30, 2015 was $1.3 million and $1.0 million, respectively.

(3) Long-term Debt

Long-term debt consisted of the following:

| | June 28, 2016 | December 29, 2015 |
|---|---|---|
| Installment loan, due 2020 | $ 623 | $ 694 |
| Revolver | 50,000 | 25,000 |
| | 50,623 | 25,694 |
| Less current maturities | 151 | 144 |
| | $ 50,472 | $ 25,550 |

The interest rate for our installment loan outstanding at both June 28, 2016 and December 29, 2015 was 10.46%.  The debt is secured by certain land and building assets and is subject to certain prepayment penalties.

On November 1, 2013, we entered into Omnibus Amendment No. 1 and Consent to Credit Agreement and Guaranty with respect to our revolving credit facility dated as of August 12, 2011 with a syndicate of commercial lenders led by JPMorgan Chase Bank, N.A., PNC Bank, N.A., and Wells Fargo, N.A. The amended revolving credit facility, which has a maturity date of November 1, 2018, remains an unsecured, revolving credit agreement under which we may borrow up to $200.0 million. The amendment provides us with the option to increase the revolving credit facility by $200.0 million, up to $400.0 million, subject to certain limitations.

The terms of the amended revolving credit facility require us to pay interest on outstanding borrowings at the London Interbank Offered Rate ("LIBOR") plus a margin of 0.875% to 1.875%, depending on our leverage ratio, or the Alternate Base Rate, which is the higher of the issuing bank's prime lending rate, the Federal Funds rate plus 0.50% or the Adjusted Eurodollar Rate for a one month interest period on such day plus 1.0%. We are also required to pay a commitment fee of 0.125% to 0.30% per year on any unused portion of the amended revolving credit facility, depending on our leverage ratio. The weighted-average interest rate for the amended revolving credit facility at June 28, 2016 and December 29, 2015 was 1.32% and 3.22%, respectively, including the impact of an interest rate swap which expired on January 7, 2016. At June 28, 2016, we had $50.0 million outstanding under the revolving credit facility and $143.4 million of availability, net of $6.6 million of outstanding letters of credit.

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The lenders' obligation to extend credit under the amended revolving credit facility depends on us maintaining certain financial covenants, including a minimum consolidated fixed charge coverage ratio of 2.00 to 1.00 and a maximum consolidated leverage ratio of 3.00 to 1.00. The amended revolving credit facility permits us to incur additional secured or unsecured indebtedness outside the facility, except for the incurrence of secured indebtedness that in the aggregate exceeds 15% of our consolidated tangible net worth or circumstances where the incurrence of secured or unsecured indebtedness would prevent us from complying with our financial covenants. We were in compliance with all financial covenants as of June 28, 2016.

(4) Income Taxes

A reconciliation of the statutory federal income tax rate to our effective tax rate for the 13 and 26 weeks ended June 28, 2016 and June 30, 2015 is as follows:

| | 13 Weeks Ended | | | | 26 Weeks Ended | | | |
|---|---|---|---|---|---|---|---|---|
| | June 28, 2016 | | June 30, 2015 | | June 28, 2016 | | June 30, 2015 | |
| Tax at statutory federal rate | 35.0 | % | 35.0 | % | 35.0 | % | 35.0 | % |
| State and local tax, net of federal benefit | 3.5 | | 3.5 | | 3.5 | | 3.5 | |
| FICA tip tax credit | (6.5) | | (7.3) | | (6.8) | | (7.1) | |
| Work opportunity tax credit | (0.9) | | (0.7) | | (0.8) | | (0.7) | |
| Net income attributable to noncontrolling interests | (0.9) | | (1.2) | | (0.9) | | (1.0) | |
| Other | 0.0 | | 0.4 | | 0.1 | | 0.6 | |
| Total | 30.2 | % | 29.7 | % | 30.1 | % | 30.3 | % |

(5)Derivative and Hedging Activities

We enter into derivative instruments for risk management purposes only, including derivatives designated as hedging instruments under Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 815, Derivatives and Hedging ("ASC 815"). We use interest rate-related derivative instruments to manage our exposure to fluctuations of interest rates. By using these instruments, we expose ourselves, from time to time, to credit risk and market risk. Credit risk is the failure of the counterparty to perform under the terms of the derivative contract. When the fair value of a derivative contract is positive, the counterparty owes us, which creates credit risk for us. We attempt to minimize the credit risk by entering into transactions with high-quality counterparties whose credit rating is evaluated on a quarterly basis. Market risk is the adverse effect on the value of a financial instrument that results from a change in interest rates. We attempt to minimize market risk by establishing and monitoring parameters that limit the types and degree of market risk that may be taken.

Interest Rate Swaps

On January 7, 2009, we entered into an interest rate swap, starting on February 7, 2009, with a notional amount of $25.0 million to hedge a portion of the cash flows of our variable rate borrowings. We designated the interest rate swap as a cash flow hedge of our exposure to variability in future cash flows attributable to interest payments on a $25.0 million tranche of floating rate debt borrowed under our amended revolving credit facility. Under the terms of the swap, we paid a fixed rate of 2.34% on the $25.0 million notional amount and received payments from the counterparty based on the one month LIBOR for a term that ended on January 7, 2016, effectively resulting in a fixed rate on the LIBOR component of the $25.0 million notional amount.

We entered into the above interest rate swap with the objective of eliminating the variability of our interest cost that arises because of changes in the variable interest rate for the designated interest payments. Changes in the fair value of the interest rate swap were reported as a component of accumulated other comprehensive income or loss ("AOCI"). Additionally, amounts related to the yield adjustment of the hedged interest payments were subsequently reclassified into interest expense in the same period during which the related interest affected earnings. We reclassified a loss from AOCI, net of tax, in our unaudited condensed consolidated balance sheet to interest expense in our unaudited condensed consolidated statement of income and comprehensive income when the interest rate swap expired on January 7, 2016. See note 10 for fair value discussion of this interest rate swap.

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As of December 29, 2015, we had an interest rate swap designated as a hedging instrument under ASC 815 which was recorded as a derivative liability of $45,000 in other accrued liabilities on the unaudited condensed consolidated balance sheet.

The following table summarizes the effect of our interest rate swaps in the unaudited condensed consolidated statements of income and comprehensive income for the 13 and 26 weeks ended June 28, 2016 and June 30, 2015:

| | 13 Weeks Ended | | 26 Weeks Ended | |
|---|---|---|---|---|
| | June 28, 2016 | June 30, 2015 | June 28, 2016 | June 30, 2015 |
| Gain recognized in AOCI, net of tax (effective portion) (1) | $ — | $ 215 | $ 27 | $ 416 |
| Loss reclassified from AOCI to income (effective portion) (1) | $ — | $ 367 | $ 45 | $ 736 |

(1) The 26 weeks ended June 28, 2016 included the effect of one interest rate swap which expired on January 7, 2016, while the 13 and 26 weeks ended June 30, 2015 included the effect of two interest rate swaps, one of which expired on November 7, 2015.

The loss reclassified from AOCI to income was recognized in interest expense on our unaudited condensed consolidated statements of income and comprehensive income. For each of the 13 and 26 weeks ended June 28, 2016 and June 30, 2015, we did not recognize any gain or loss due to hedge ineffectiveness related to the derivative instruments in the unaudited condensed consolidated statements of income and comprehensive income.

(6)Recent Accounting Pronouncements

Revenue Recognition

(Accounting Standards Update 2014-09, "ASU 2014-09")

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers, which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The ASU will replace most existing revenue recognition guidance in GAAP when it becomes effective.   In July 2015, the FASB approved a one-year deferral of the effective date of the new revenue standard.  ASU 2014-09 is now effective for fiscal years beginning on or after December 15, 2017 (our 2018 fiscal year) with early adoption permitted in the first quarter of 2017. The standard permits the use of either the retrospective or cumulative effect transition method. In March and April 2016, the FASB issued the following amendments to clarify the implementation guidance: ASU No. 2016-08, Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net) and ASU No. 2016-10, Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing. The standard will not impact our recognition of revenue from company-owned restaurants or our recognition of continuing fees from franchisees, which are based on a percentage of franchise sales. We are continuing to evaluate the impact the adoption of this standard will have on the recognition of other less significant revenue transactions such as initial fees from franchisees as well as the method of adoption.

Inventory

(Accounting Standards Update 2015-11, "ASU 2015-11")

In July 2015, the FASB issued ASU 2015-11, Inventory, which simplifies the measurement principle of inventories valued under the First-In, First-Out ("FIFO") or weighted average methods from the lower of cost or market to the lower of cost and net realizable value. ASU 2015-11 is effective for reporting periods beginning after December 15, 2016 (our 2017 fiscal year). We do not expect the standard to have a material impact on our consolidated financial position, results of operations or cash flows upon adoption.

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Deferred Taxes

(Accounting Standards Update 2015-17, "ASU 2015-17")

In November 2015, the FASB issued ASU 2015-17, Balance Sheet Classification of Deferred Taxes, which requires that deferred tax assets and liabilities be classified as noncurrent on the consolidated balance sheet. ASU 2015-17 is effective for annual periods beginning after December 15, 2016 (our 2017 fiscal year), including interim periods within those annual periods. Early adoption is permitted as of the beginning of an interim or annual reporting period. Upon adoption, ASU 2015-17 may be applied either prospectively or retrospectively. We do not expect the adoption of this guidance to have a material impact on our consolidated financial position, results of operations or cash flows.

Leases

(Accounting Standards Update 2016-02, "ASU 2016-02")

In February 2016, the FASB issued ASU 2016-02, Leases, which requires an entity to recognize a right-of-use asset and a lease liability for virtually all leases. This update also requires additional disclosures about the amount, timing, and uncertainty of cash flows arising from leases. ASU 2016-02 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018 (our 2019 fiscal year). Early adoption is permitted. A modified retrospective approach is required for all leases existing or entered into after the beginning of the earliest comparative period in the consolidated financial statements. We are currently assessing the impact of this new standard on our consolidated financial position, results of operations and cash flows and we have not determined the effect of the amended guidance on our ongoing financial reporting.

Share-Based Compensation

(Accounting Standards Update 2016-09, "ASU 2016-09")

In March 2016, the FASB issued ASU 2016-09, Compensation – Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting, which is intended to simplify several aspects of the accounting for share-based payment transactions. The amendments in this update cover such areas as the recognition of excess tax benefits and deficiencies, the classification of those excess tax benefits on the statement of cash flows, an accounting policy election for forfeitures, the amount an employer can withhold to cover income taxes and still qualify for equity classification and the classification of those taxes paid on the statement of cash flows. ASU 2016-09 is effective for annual periods beginning after December 15, 2016 (our 2017 fiscal year) and interim periods within those annual periods. Early adoption is permitted. We are currently assessing the impact of this new standard on our consolidated financial position, results of operations and cash flows as well as the method of adoption.

Financial Instruments

(Accounting Standards Update 2016-13, "ASU 2016-13")

In June 2016, the FASB issued ASU 2016-13, Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments, which requires measurement and recognition of expected versus incurred losses for financial assets held. ASU 2016-13 is effective for annual periods beginning after December 15, 2019 (our 2020 fiscal year), with early adoption permitted for annual periods beginning after December 15, 2018. We are currently assessing the impact of this new standard on our consolidated financial position, results of operations and cash flows.

(7)Commitments and Contingencies

The estimated cost of completing capital project commitments at June 28, 2016 and December 29, 2015 was approximately $171.8 million and $129.4 million, respectively.

Effective December 31, 2013, we sold two restaurants, which operated under the name Aspen Creek, located in Irving, Texas and Louisville, Kentucky. We assigned the leases associated with these restaurants to the acquirer, but remain contingently liable under the terms of the leases if the acquirer defaults. We are contingently liable for the initial terms of the leases and any optional renewal periods. The Irving lease has an initial term that expires December 2019, along with three five-year renewals. The Louisville lease has an initial term that expires November 2023, along with

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three five-year renewals. The assignment of the Louisville lease releases us from liability after the initial lease term expiration contingent upon certain conditions being met by the acquirer.

We entered into real estate lease agreements for five restaurant locations, listed in the table below, before granting franchise rights for those restaurants. We have subsequently assigned the leases to the franchisees, but remain contingently liable if a franchisee defaults, under the terms of the lease.

| | Lease Assignment Date | Current Lease Term Expiration |
|---|---|---|
| Everett, Massachusetts(1) | September 2002 | February 2018 |
| Longmont, Colorado | October 2003 | May 2019 |
| Montgomeryville, Pennsylvania | October 2004 | June 2021 |
| Fargo, North Dakota(1) | February 2006 | July 2021 |
| Logan, Utah | January 2009 | August 2019 |

(1) As discussed in note 8, these restaurants are owned, in whole or part, by certain officers, directors and 5% shareholders of the Company.

We are contingently liable for the initial terms of the leases and any optional renewal periods. All of the leases have three optional five-year renewals.

As of June 28, 2016 and December 29, 2015, we are contingently liable for $16.8 million and $17.2 million, respectively, for the seven leases discussed above. These amounts represent the maximum potential liability of future payments under the guarantees. In the event of default, the indemnity and default clauses in our assignment agreements govern our ability to pursue and recover damages incurred. No material liabilities have been recorded as of June 28, 2016 and December 29, 2015 as the likelihood of default was deemed to be less than probable and the fair value of the guarantees is not considered significant.

During the 13 and 26 weeks ended June 28, 2016, we bought most of our beef from three suppliers. Although there are a limited number of beef suppliers, we believe that other suppliers could provide a similar product on comparable terms. A change in suppliers, however, could cause supply shortages, higher costs to secure adequate supplies and a possible loss of sales, which would affect operating results adversely. We have no material minimum purchase commitments with our vendors that extend beyond a year.

On September 30, 2011, the U.S. Equal Employment Opportunity Commission ("EEOC") filed a lawsuit styled Equal Employment Opportunity Commission v. Texas Roadhouse, Inc., Texas Roadhouse Holdings LLC and Texas

Roadhouse Management Corp. in the United States District Court, District of Massachusetts, Civil Action Number 1:11-cv-11732. The complaint alleges that applicants over the age of 40 were denied employment in our restaurants in bartender, host, server and server assistant positions due to their age. The EEOC is seeking injunctive relief, remedial actions, payment of damages to the applicants, and costs. We have filed an answer to the complaint and trial is scheduled for January 2017. We deny liability and are vigorously defending this case; however, in view of the inherent uncertainties of litigation, the outcome of this case cannot be predicted at this time. We cannot estimate the amount or range of loss, if any, associated with this matter.

On July 15, 2016, the Florida Circuit Court in Palm Beach County approved a settlement agreement styled Andrew Lovett and Semaj Miller, individually and on behalf of others, v. Texas Roadhouse Management Corp. (Case no. 50-2016-CA-007714-MB-AO) resolving alleged violations of the federal Fair Labor Standards Act asserted on behalf of a purported nationwide class of current and former employees in exchange for a settlement payment not to exceed $9.5 million. To cover the estimated costs of the settlement, including estimated payments to any opt-in members and class attorneys, as well as related settlement administration costs, we recorded a charge of $5.5 million ($3.4 million after-tax) in the first quarter of 2016. The pre-tax charge was recorded in general and administrative expenses in our unaudited condensed consolidated statements of income and comprehensive income and in other accrued liabilities in our unaudited condensed consolidated balance sheets. Because the settlement is structured on an opt-in basis, the actual amount of the total settlement payment could vary from our estimate.

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Occasionally, we are a defendant in litigation arising in the ordinary course of our business, including "slip and fall" accidents, employment related claims and claims from guests or employees alleging illness, injury or food quality, health or operational concerns. In the opinion of management, the ultimate disposition of these matters, most of which are covered by insurance, will not have a material adverse effect on our consolidated financial position, results of operations or cash flows.

(8) Related Party Transactions

As of June 28, 2016 and June 30, 2015, we had 10 franchise restaurants owned in whole or part, by certain of our officers, directors and 5% stockholders of the company. For both of the 13 week periods ended June 28, 2016 and June 30, 2015, these entities paid us fees of approximately $0.5 million. For the 26 week periods ended June 28, 2016 and June 30, 2015, these entities paid us fees of approximately $1.0 million and $0.9 million, respectively. As disclosed in note 7, we are contingently liable on leases which are related to two of these restaurants.

(9) Earnings Per Share

The share and net income per share data for all periods presented are based on the historical weighted-average shares outstanding. The diluted earnings per share calculations show the effect of the weighted-average stock options and RSUs outstanding from our equity incentive plans as discussed in note 2.

The following table summarizes the nonvested stock and options that were outstanding but not included in the computation of diluted earnings per share because their inclusion would have had an anti-dilutive effect:

| | 13 Weeks Ended | | 26 Weeks Ended | |
|---|---|---|---|---|
| | June 28, 2016 | June 30, 2015 | June 28, 2016 | June 30, 2015 |
| Nonvested stock | — | 42 | 8,749 | 802 |
| Options | — | — | — | — |
| Total | — | 42 | 8,749 | 802 |

PSUs are not included in the diluted earnings per share calculation until the performance-based criteria have been met. See note 2 for further discussion of PSUs.

The following table sets forth the calculation of earnings per share and weighted-average shares outstanding (in thousands) as presented in the accompanying unaudited condensed consolidated statements of income and comprehensive income:

| | 13 Weeks Ended | | 26 Weeks Ended | |
|---|---|---|---|---|
| | June 28, 2016 | June 30, 2015 | June 28, 2016 | June 30, 2015 |
| Net income attributable to Texas Roadhouse, Inc. and subsidiaries | $ 33,605 | $ 21,138 | $ 69,198 | $ 53,430 |
| Basic EPS: | | | | |
| Weighted-average common shares outstanding | 70,368 | 70,026 | 70,269 | 69,933 |
| Basic EPS | $ 0.48 | $ 0.30 | $ 0.98 | $ 0.76 |
| Diluted EPS: | | | | |
| Weighted-average common shares outstanding | 70,368 | 70,026 | 70,269 | 69,933 |
| Dilutive effect of stock options and nonvested stock | 508 | 622 | 571 | 655 |
| Shares-diluted | 70,876 | 70,648 | 70,840 | 70,588 |
| Diluted EPS | $ 0.47 | $ 0.30 | $ 0.98 | $ 0.76 |

(10) Fair Value Measurements

ASC 820, Fair Value Measurements and Disclosures ("ASC 820"), establishes a framework for measuring fair value and expands disclosures about fair value measurements. ASC 820 establishes a three-level hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs in measuring fair value. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability on the measurement date.

Level 1Inputs based on quoted prices in active markets for identical assets.

Level 2Inputs other than quoted prices included within Level 1 that are observable for the assets, either directly or indirectly.

Level 3Inputs that are unobservable for the asset.

There were no transfers among levels within the fair value hierarchy during the 13 and 26 weeks ended June 28, 2016.

The following table presents the fair values for our financial assets and liabilities measured on a recurring basis:

| | Fair Value Measurements | | |
|---|---|---|---|
| | Level | June 28, 2016 | December 29, 2015 |
| Interest rate swap | 2 | $ — | $ (45) |
| Deferred compensation plan—assets | 1 | 19,921 | 17,401 |
| Deferred compensation plan—liabilities | 1 | (19,925) | (17,416) |

As of December 29, 2015, the fair value of our interest rate swap was determined based on industry-standard valuation models. Such models project future cash flows and discount the future amounts to present value using market-based observable inputs, including interest rate curves. See note 5 for discussion of our interest rate swap, which expired on January 7, 2016.

The Second Amended and Restated Deferred Compensation Plan of Texas Roadhouse Management Corp., as amended, (the "Deferred Compensation Plan") is a nonqualified deferred compensation plan which allows highly compensated employees to defer receipt of a portion of their compensation and contribute such amounts to one or more investment funds held in a rabbi trust. We report the accounts of the rabbi trust in other assets and the corresponding liability in other liabilities in our unaudited condensed consolidated financial statements. These investments are considered trading securities and are reported at fair value based on quoted market prices. The realized and unrealized holding gains and losses related to these investments, as well as the offsetting compensation expense, are recorded in general and administrative expense in the unaudited condensed consolidated statements of income and comprehensive income.

At June 28, 2016 and December 29, 2015, the fair values of cash and cash equivalents, accounts receivable and accounts payable approximated their carrying values based on the short-term nature of these instruments. The fair value of our amended revolving credit facility at June 28, 2016 and December 29, 2015 approximated its carrying value since it is a variable rate credit facility (Level 2). The fair value of our installment loan is estimated based on the current rates offered to us for instruments of similar terms and maturities. The carrying amounts and related estimated fair values for our installment loan are as follows:

| | June 28, 2016 | | December 29, 2015 | |
|---|---|---|---|---|
| | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| Installment loan—Level 2 | $ 623 | $ 736 | $ 694 | $ 779 |

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(11) Accumulated Other Comprehensive Loss

The components of the changes in accumulated other comprehensive loss for the 26 weeks ended June 28, 2016 were as follows:

| | Cash Flow Hedges | Foreign Currency Translation | Accumulated Other Comprehensive Loss |
|---|---|---|---|
| Balance as of December 29, 2015 | $ (27) | $ (82) | $ (109) |
| Other comprehensive loss before reclassifications | — | (66) | (66) |
| Reclassification adjustments to income (1) | 45 | — | 45 |
| Income taxes | (18) | 26 | 8 |
| Balance as of June 28, 2016 | $ — | $ (122) | $ (122) |

(1) For further discussion of amounts reclassified to income, see note 5.

(12) Stock Repurchase Program

On May 22, 2014, our Board of Directors approved a stock repurchase program under which we may repurchase up to $100.0 million of our common stock. This stock repurchase program has no expiration date and replaced a previous stock repurchase program which was approved on February 16, 2012. All repurchases to date under our stock repurchase program have been made through open market transactions. The timing and the amount of any repurchases will be determined by management under parameters established by our Board of Directors, based on an evaluation of our stock price, market conditions and other corporate considerations.

We did not repurchase any shares of common stock during the 13 week period ended June 28, 2016. For the 26 week period ended June 28, 2016, we paid approximately $4.1 million to repurchase 114,700 shares of our common stock. As of June 28, 2016, we had approximately $69.9 million remaining under our authorized stock repurchase program. For the 13 and 26 week periods ended June 30, 2015, we paid approximately $3.1 million to repurchase 88,089 shares of our common stock.

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

CAUTIONARY STATEMENT

This report contains forward-looking statements based on our current expectations, estimates and projections about our industry and certain assumptions made by us. Words such as "anticipates," "expects," "intends," "plans," "believes," "seek "estimates," "may," "will" and variations of these words or similar expressions are intended to identify forward-looking statements. In addition, any statements that refer to expectations, projections or other characterizations of future events or circumstances, including any underlying assumptions, are forward-looking statements. Such statements are not guarantees of future performance and are subject to certain risks, uncertainties and assumptions that are difficult to predict. Therefore, our actual results could differ materially and adversely from those expressed in any forward-looking statements as a result of various factors. The section entitled "Risk Factors" in our Annual Report on Form 10-K for the year ended December 29, 2015, in Part II, Item 1A in this Form 10-Q and disclosures in our other Securities and Exchange Commission ("SEC") filings discuss some of the important risk factors that may affect our business, results of operations, or financial condition. You should carefully consider those risks, in addition to the other information in this report, and in our other filings with the SEC, before deciding to invest in our Company or to maintain or increase your investment. We undertake no obligation to revise or update publicly any forward-looking statements for any reason. The information contained in this Form 10-Q is not a complete description of our business or the risks associated with an investment in our common stock. We urge you to carefully review and consider the various disclosures made by us in this report and in our other reports filed with the SEC that discuss our business in greater detail and advise interested parties of certain risks, uncertainties and other factors that may affect our business, results of operations or financial condition.

OVERVIEW

Texas Roadhouse, Inc. is a growing restaurant company operating predominately in the casual dining segment. Our founder, chairman and chief executive officer ("CEO"), W. Kent Taylor, started the business in 1993 with the opening of the first Texas Roadhouse restaurant in Clarksville, Indiana. Since then, we have grown to 499 restaurants in 49 states and five foreign countries. Our mission statement is "Legendary Food, Legendary Service®." Our operating strategy is designed to position each of our restaurants as the local hometown favorite for a broad segment of consumers seeking high quality, affordable meals served with friendly, attentive service. As of June 28, 2016, our 499 restaurants included:

- 415 "company restaurants," of which 399 were wholly-owned and 16 were majority-owned. The results of operations of company restaurants are included in our unaudited condensed consolidated statements of income and comprehensive income. The portion of income attributable to minority interests in company restaurants that are not wholly-owned is reflected in the line item entitled "Net income attributable to noncontrolling interests" in our unaudited condensed consolidated statements of income and comprehensive income. Of the 415 restaurants we owned and operated as of June 28, 2016, we operated 403 as Texas Roadhouse restaurants and operated 10 as Bubba’s 33 restaurants. In addition, we operated two restaurants outside of the casual dining segment.

· 84 "franchise restaurants," 24 of which we have a 5.0% to 10.0% ownership interest. The income derived from our minority interests in these franchise restaurants is reported in the line item entitled "Equity income from investments in unconsolidated affiliates" in our unaudited condensed consolidated statements of income and comprehensive income. Additionally, we provide various management services to these franchise restaurants, as well as six additional franchise restaurants in which we have no ownership interest. All of the franchise restaurants operated as Texas Roadhouse restaurants.

We have contractual arrangements which grant us the right to acquire at pre-determined formulas the remaining equity interests in 14 of the 16 majority-owned company restaurants and 68 of the franchise restaurants.

Throughout this report, we use the term "restaurants" to include Texas Roadhouse and Bubba’s 33, unless otherwise noted.

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Presentation of Financial and Operating Data

Throughout this report, the 13 weeks ended June 28, 2016 and June 30, 2015 are referred to as Q2 2016 and Q2 2015, respectively. The 26 weeks ended June 28, 2016 and June 30, 2015 are referred to as 2016 YTD and 2015 YTD, respectively.

Long-term Strategies to Grow Earnings Per Share and Create Shareholder Value

Our long-term strategies with respect to increasing net income and earnings per share, along with creating shareholder value, include the following:

Expanding Our Restaurant Base. We will continue to evaluate opportunities to develop Texas Roadhouse and Bubba's 33 restaurants in existing markets and in new domestic and international markets. Domestically, we will remain focused primarily on markets where we believe a significant demand for our restaurants exists because of population size, income levels and the presence of shopping and entertainment centers and a significant employment base. Our ability to expand our restaurant base is influenced by many factors beyond our control and, therefore, we may not be able to achieve our anticipated growth.

We currently plan to open approximately 30 company-owned restaurants in 2016 including approximately seven Bubba's 33 restaurants. In addition, we anticipate that our existing franchise partners will open approximately four, primarily international, Texas Roadhouse restaurants during 2016. In 2016 YTD, we opened 14 company-owned restaurants, including three Bubba's 33 restaurants. Additionally, in 2016 YTD, our franchise partners opened two international franchise restaurants.

Our average capital investment for Texas Roadhouse restaurants opened during 2015, including pre opening expenses and a capitalized rent factor, was $4.7 million, while the average capital investment, including pre-opening costs, for the four Bubba's 33 restaurants opened during the year was $6.0 million. We expect our average capital investment for Texas Roadhouse and Bubba's 33 restaurants opening in 2016 to be approximately $5.0 million and $6.4 million, respectively. The expected increases in our average capital investment for Texas Roadhouse and Bubba's 33 restaurants are primarily due to increases in building costs and pre-opening expenses. We continue to focus on driving sales and managing restaurant development costs in order to further increase our restaurant development in the future. Our capital investment (including cash and non cash costs) for new restaurants varies significantly depending on a number of factors including, but not limited to: the square footage, layout, scope of any required site work, type of construction labor, local permitting requirements, our ability to negotiate with landlords, cost of liquor and other licenses and hook up fees and geographical location.

We may, at our discretion, add franchise restaurants, domestically and/or internationally, primarily with franchisees who have demonstrated prior success with Texas Roadhouse or other restaurant concepts and in markets in which the franchisee demonstrates superior knowledge of the demographics and restaurant operating conditions. In conjunction with this strategy, we signed our first international franchise development agreement in 2010 for the development of Texas Roadhouse restaurants in eight countries in the Middle East. In addition to the Middle East, we currently have signed franchise development agreements for the development of Texas Roadhouse restaurants in Taiwan, the Philippines and Mexico. We currently have nine restaurants open in three countries in the Middle East, two restaurants open in Taiwan and one in the Philippines for a total of 12 restaurants in five foreign countries. Additionally, in 2010, we entered into a joint venture agreement with a casual dining restaurant operator in China for a minority ownership in four non Texas Roadhouse restaurants, all of which are currently open. We continue to explore opportunities in other countries for international expansion. We may also look to acquire domestic franchise restaurants under terms favorable to the Company and our stockholders. Additionally, from time to time, we will evaluate potential mergers, acquisitions, joint ventures or other strategic initiatives to acquire or develop additional concepts either domestically and/or internationally.

Maintaining and/or Improving Restaurant Level Profitability. We plan to maintain, or possibly increase, restaurant-level profitability (restaurant margin) through a combination of increased comparable restaurant sales and

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operating cost management. In general, we continue to balance the impacts of inflationary pressures with our value positioning as we remain focused on our long-term success. This may create a challenge in terms of maintaining and/or increasing restaurant margin, as a percentage of restaurant sales, in any given year, depending on the level of inflation we experience. In addition to restaurant margin, as a percentage of restaurant sales, we also focus on the growth of restaurant margin dollars per store week as a measure of restaurant-level profitability. In terms of driving higher guest traffic counts, we remain focused on encouraging repeat visits by our guests and attracting new guests through our continued commitment to operational standards relating to food and service quality. In order to attract new guests and increase the frequency of visits of our existing guests, we also continue to drive various localized marketing programs, to focus on speed of service and to increase throughput by adding seats in certain restaurants.

Leveraging Our Scalable Infrastructure. To support our growth, we continue to make investments in our infrastructure. Over the past several years, we have made significant investments in our infrastructure, including information systems, real estate, human resources, legal, marketing, international and restaurant operations, including the development of new concepts. Our goal is for general and administrative costs to increase at a slower growth rate than our revenue. Whether we are able to leverage our infrastructure in future years will depend, in part, on our new restaurant openings, our comparable restaurant sales growth rate going forward and the level of investment we continue to make in our infrastructure.

Returning Capital to Shareholders. We continue to pay dividends and evaluate opportunities to return capital to our shareholders through repurchases of common stock. In 2011, our Board of Directors declared our first quarterly dividend of $0.08 per share of common stock. We have consistently grown our per share dividend each year since that time and our long-term strategy includes increasing our regular quarterly dividend amount over time. On May 19, 2016, our Board of Directors declared a quarterly dividend of $0.19 per share of common stock. The declaration and payment of cash dividends on our common stock is at the discretion of our Board of Directors, and any decision to declare a dividend will be based on a number of factors, including, but not limited to, earnings, financial condition, applicable covenants under our amended revolving credit facility, other contractual restrictions and other factors deemed relevant.

In 2008, our Board of Directors approved our first stock repurchase program. From inception through June 28, 2016, we have paid $216.6 million through our authorized stock repurchase programs to repurchase 14,844,851 shares of our common stock at an average price per share of $14.59. On May 22, 2014, our Board of Directors approved a stock repurchase program under which we may repurchase up to $100.0 million of our common stock. This stock repurchase program has no expiration date and replaced a previous stock repurchase program which was approved on February 16, 2012. All repurchases to date have been made through open market transactions. As of June 28, 2016, $69.9 million remains authorized for stock repurchases.

Key Measures We Use to Evaluate Our Company

Key measures we use to evaluate and assess our business include the following:

Number of Restaurant Openings. Number of restaurant openings reflects the number of restaurants opened during a particular fiscal period. For company restaurant openings, we incur pre opening costs, which are defined below, before the restaurant opens. Typically, new Texas Roadhouse restaurants open with an initial start up period of higher than normalized sales volumes, which decrease to a steady level approximately three to six months after opening. However, although sales volumes are generally higher, so are initial costs, resulting in restaurant operating margins that are generally lower during the start up period of operation and increase to a steady level approximately three to six months after opening.

Comparable Restaurant Sales Growth. Comparable restaurant sales growth reflects the change in sales for company-owned restaurants over the same period in prior years for the comparable restaurant base. We define the comparable restaurant base to include those restaurants open for a full 18 months before the beginning of the current interim period excluding sales from restaurants closed during the period. Comparable restaurant sales growth can be impacted by changes in guest traffic counts or by changes in the per person average check amount. Menu price changes and the mix of menu items sold can affect the per person average check amount.

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Average Unit Volume. Average unit volume represents the average quarterly or annual restaurant sales for company-owned restaurants open for a full six months before the beginning of the period measured excluding sales from restaurants closed during the period. Growth in average unit volume in excess of comparable restaurant sales growth is generally an indication that newer restaurants are operating with sales levels in excess of the company average. Conversely, growth in average unit volume less than comparable restaurant sales growth is generally an indication that newer restaurants are operating with sales levels lower than the company average.

Store Weeks. Store weeks represent the number of weeks that our company restaurants were open during the reporting period.

Restaurant Margin. Restaurant margin represents restaurant sales less operating costs, including cost of sales, labor, rent and other operating costs. Depreciation and amortization expense, substantially all of which relates to restaurant-level assets, is excluded from restaurant operating costs and is shown separately as it represents a non-cash charge for the investment in our restaurants. Restaurant margin is widely regarded as a useful metric by which to evaluate restaurant-level operating efficiency and performance. Restaurant margin is not a measurement determined in accordance with generally accepted accounting principles ("GAAP") and should not be considered in isolation, or as an alternative, to income from operations or other similarly titled measures of other companies. Restaurant margin, as a percentage of restaurant sales, may fluctuate based on inflationary pressures, commodity costs and wage rates. As such, we also focus on the growth of restaurant margin dollars per store week as a measure of restaurant-level profitability as it provides additional insight on operating performance.

Other Key Definitions

Restaurant Sales. Restaurant sales include gross food and beverage sales, net of promotions and discounts, for all company-owned restaurants. Sales taxes collected from customers and remitted to governmental authorities are accounted for on a net basis and therefore are excluded from restaurant sales in the unaudited condensed consolidated statements of income and other comprehensive income.

Franchise Royalties and Fees. Domestic franchisees typically pay a $40,000 initial franchise fee for each new restaurant. In addition, at each renewal period, we receive a fee equal to the greater of 30% of the then-current initial franchise fee or $10,000 to $15,000. Franchise royalties consist of royalties in an amount up to 4.0% of gross sales, as defined in our franchise agreement, paid to us by our domestic franchisees. In addition, fees paid to us by our international franchisees are included in franchise royalties and fees. The terms of the international agreements may vary significantly from our domestic agreements.

Restaurant Cost of Sales. Restaurant cost of sales consists of food and beverage costs.

Restaurant Labor Expenses. Restaurant labor expenses include all direct and indirect labor costs incurred in operations except for profit sharing incentive compensation expenses earned by our restaurant managing partners and market partners. These profit sharing expenses are reflected in restaurant other operating expenses. Restaurant labor expenses also include share-based compensation expense related to restaurant-level employees.

Restaurant Rent Expense. Restaurant rent expense includes all rent, except pre-opening rent, associated with the leasing of real estate and includes base, percentage and straight-line rent expense.

Restaurant Other Operating Expenses. Restaurant other operating expenses consist of all other restaurant-level operating costs, the major components of which are utilities, supplies, local store advertising, repairs and maintenance, equipment rent, property taxes, credit card and gift card fees and general liability insurance offset by gift card breakage income. Profit sharing incentive compensation expenses earned by our restaurant managing partners and market partners are also included in restaurant other operating expenses.

Pre-opening Expenses. Pre-opening expenses, which are charged to operations as incurred, consist of expenses incurred before the opening of a new restaurant and are comprised principally of opening team and training compensation and benefits, travel expenses, rent, food, beverage and other initial supplies and expenses. On average, over 70% of total pre-opening costs incurred per restaurant opening relate to the hiring and training of employees. Pre-opening costs vary by location depending on a number of factors, including the size and physical layout of each location; the number of management and hourly employees required to operate each restaurant; the availability of qualified restaurant staff members; the cost of travel and lodging for different geographic areas; the timing of the restaurant opening; and the extent of unexpected delays, if any, in obtaining final licenses and permits to open the restaurants.

Depreciation and Amortization Expenses. Depreciation and amortization expenses ("D&A") include the depreciation of fixed assets and amortization of intangibles with definite lives, substantially all of which relates to restaurant-level assets.

Impairment and Closure Costs. Impairment and closure costs include any impairment of long-lived assets, including goodwill, where the carrying amount of the asset is not recoverable and exceeds the fair value of the asset and expenses associated with the closure of a restaurant. Closure costs also include any gains or losses associated with a relocated restaurant or the sale of a closed restaurant and/or assets held for sale as well as lease costs associated with closed or relocated restaurants.

General and Administrative Expenses. General and administrative expenses ("G&A") are comprised of expenses associated with corporate and administrative functions that support development and restaurant operations and provide an infrastructure to support future growth including the net amount of advertising costs incurred less amounts remitted by franchise restaurants. Supervision and accounting fees received from certain franchise restaurants are offset against G&A. G&A also includes share-based compensation expense related to executive officers, support center employees and area managers, including market partners. The realized and unrealized holding gains and losses related to the investments in our deferred compensation plan, as well as offsetting compensation expense, are also recorded in G&A.

Interest Expense, Net. Interest expense includes the cost of our debt or financing obligations including the amortization of loan fees, reduced by interest income and capitalized interest. Interest income includes earnings on cash and cash equivalents.

Equity Income from Unconsolidated Affiliates. As of June 28, 2016 and June 30, 2015, we owned a 5.0% to 10.0% equity interest in 24 franchise restaurants. Additionally, as of June 28, 2016 and June 30, 2015, we owned a 40% equity interest in four non-Texas Roadhouse restaurants as part of a joint venture agreement with a casual dining restaurant operator in China. Equity income from unconsolidated affiliates represents our percentage share of net income earned by these unconsolidated affiliates.

Net Income Attributable to Noncontrolling Interests. Net income attributable to noncontrolling interests represents the portion of income attributable to the other owners of the majority-owned restaurants. Our consolidated subsidiaries at June 28, 2016 and June 30, 2015 included 16 majority-owned restaurants, all of which were open.

Q2 2016 Financial Highlights

Total revenue increased $54.1 million, or 11.9%, to $508.8 million in Q2 2016 compared to $454.7 million in Q2 2015 primarily due to the opening of new restaurants combined with an increase in average unit volume driven by comparable restaurant sales growth. Comparable restaurant sales increased 4.5% at company restaurants in Q2 2016.

Restaurant margin, as percentage of restaurant sales, increased 302 basis points to 19.2% in Q2 2016 compared to 16.2% in Q2 2015 primarily due to commodity deflation of approximately 6.8% driven by lower food costs, primarily beef. The benefit of commodity deflation was partially offset by higher labor costs due to higher average wage rates. See page 20 for the definition of restaurant margin.

Net income increased $12.5 million, or 59.0%, to $33.6 million in Q2 2016 compared to $21.1 million in Q2 2015 primarily due to the increase in restaurant margin partially offset by higher general and administrative and depreciation costs as well as higher income tax expense.

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Results of Operations

| | 13 Weeks Ended | | | | 26 Weeks Ended | | | |
|---|---|---|---|---|---|---|---|---|
| | June 28, 2016 | | June 30, 2015 | | June 28, 2016 | | June 30, 2015 | |
| | $ | % | $ | % | $ | % | $ | % |
| | (In thousands) | | | | (In thousands) | | | |
| Consolidated Statements of Income: | | | | | | | | |
| Revenue: | | | | | | | | |
| Restaurant sales | 504,630 | 99.2 | 450,692 | 99.1 | 1,015,914 | 99.2 | 906,985 | 99.1 |
| Franchise royalties and fees | 4,178 | 0.8 | 4,006 | 0.9 | 8,453 | 0.8 | 7,943 | 0.9 |
| Total revenue | 508,808 | 100.0 | 454,698 | 100.0 | 1,024,367 | 100.0 | 914,928 | 100.0 |
| Costs and expenses: | | | | | | | | |
| (As a percentage of restaurant sales) | | | | | | | | |
| Restaurant operating costs (excluding depreciation and amortization shown separately below): | | | | | | | | |
| Cost of sales | 171,551 | 34.0 | 168,077 | 37.3 | 344,679 | 33.9 | 328,057 | 36.2 |
| Labor | 150,014 | 29.7 | 132,084 | 29.3 | 297,560 | 29.3 | 263,488 | 29.1 |
| Rent | 10,184 | 2.0 | 9,138 | 2.0 | 20,211 | 2.0 | 18,117 | 2.0 |
| Other operating | 75,887 | 15.0 | 68,358 | 15.2 | 153,499 | 15.1 | 137,675 | 15.2 |
| (As a percentage of total revenue) | | | | | | | | |
| Pre-opening | 4,411 | 0.9 | 4,909 | 1.1 | 9,236 | 0.9 | 8,727 | 1.0 |
| Depreciation and amortization | 20,238 | 4.0 | 16,816 | 3.7 | 39,777 | 3.9 | 33,151 | 3.6 |
| Impairment and closure | 30 | NM | — | NM | 41 | NM | — | NM |
| General and administrative | 26,711 | 5.2 | 23,620 | 5.2 | 56,771 | 5.5 | 45,417 | 5.0 |
| Total costs and expenses | 459,026 | 90.2 | 423,002 | 93.0 | 921,774 | 90.0 | 834,632 | 91.2 |
| Income from operations | 49,782 | 9.8 | 31,696 | 7.0 | 102,593 | 10.0 | 80,296 | 8.8 |
| Interest expense, net | 309 | 0.1 | 495 | 0.1 | 614 | 0.1 | 1,010 | 0.1 |
| Equity income from investments in unconsolidated affiliates | (475) | (0.1) | (467) | (0.1) | (827) | (0.1) | (839) | (0.1) |
| Income before taxes | 49,948 | 9.8 | 31,668 | 7.0 | 102,806 | 10.0 | 80,125 | 8.8 |
| Provision for income taxes | 15,087 | 3.0 | 9,402 | 2.1 | 30,944 | 3.0 | 24,278 | 2.7 |
| Net income including noncontrolling interests | 34,861 | 6.9 | 22,266 | 4.9 | 71,862 | 7.0 | 55,847 | 6.1 |
| Net income attributable to noncontrolling interests | 1,256 | 0.2 | 1,128 | 0.2 | 2,664 | 0.3 | 2,417 | 0.3 |
| Net income attributable to Texas Roadhouse, Inc. and subsidiaries | 33,605 | 6.6 | 21,138 | 4.6 | 69,198 | 6.8 | 53,430 | 5.8 |

| 13 Weeks Ended | | 26 Weeks Ended | |
|---|---|---|---|
| June 28, 2016 | June 30, 2015 | June 28, 2016 | June 30, 2015 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | $ | % | $ | % | $ | % | $ | % |
| Restaurant margin ($ in thousands) | 96,994 | 19.2 | 73,035 | 16.2 | 199,965 | 19.7 | 159,648 | 17.6 |
| Restaurant margin $/store week | 18,130 | | 14,804 | | 18,843 | | 16,307 | |

See page 20 for the definition of restaurant margin.

NM — Not meaningful

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Restaurant Unit Activity

| | Total | Texas Roadhouse | Bubba's 33 | Jaggers |
|---|---|---|---|---|
| Balance at December 29, 2015 | 483 | 474 | 7 | 2 |
| Company openings | 14 | 11 | 3 | — |
| Franchise openings | 2 | 2 | — | — |
| Balance at June 28, 2016 | 499 | 487 | 10 | 2 |

Q2 2016 (13 weeks) Compared to Q2 2015 (13 weeks) and 2016 YTD (26 weeks) compared to 2015 YTD (26 weeks)

Restaurant Sales. Restaurant sales increased by 12.0% in both Q2 2016 as compared to Q2 2015 and in 2016 YTD compared to 2015 YTD. The following table summarizes certain key drivers and/or attributes of restaurant sales at company restaurants for the periods presented. Company restaurant count activity is shown in the restaurant unit activity table above.

| | Q2 2016 | Q2 2015 | 2016 YTD | 2015 YTD |
|---|---|---|---|---|
| Company Restaurants: | | | | |
| Increase in store weeks | 8.4 % | 7.4 % | 8.4 % | 7.4 % |
| Increase in average unit volume | 3.7 % | 8.2 % | 4.0 % | 8.6 % |
| Other(1) | (0.1) % | (0.6) % | (0.4) % | (0.6) % |
| Total increase in restaurant sales | 12.0 % | 15.0 % | 12.0 % | 15.4 % |
| | | | | |
| Store weeks | 5,350 | 4,934 | 10,612 | 9,790 |
| Comparable restaurant sales growth | 4.5 % | 8.2 % | 4.5 % | 8.5 % |
| | | | | |
| Texas Roadhouse restaurants only: | | | | |
| Comparable restaurant sales growth | 4.5 % | 8.2 % | 4.5 % | 8.5 % |
| Average unit volume (in thousands) | $ 1,232 | $ 1,188 | $ 2,505 | $ 2,409 |
| | | | | |
| Weekly sales by group: | | | | |
| Comparable restaurants (361 and 334 units, respectively) | $ 95,434 | $ 91,346 | | |
| Average unit volume restaurants (24 and 27 units, respectively)(2) | $ 84,272 | $ 91,468 | | |
| Restaurants less than six months old (18 and 15 units, respectively) | $ 98,319 | $ 95,979 | | |

(1) Includes the impact of the year-over-year change in sales volume of all non-Texas Roadhouse restaurants, along with Texas Roadhouse restaurants open less than six months before the beginning of the period measured and, if applicable, the impact of restaurants closed or acquired during the period.

(2) Average unit volume restaurants include restaurants open a full six to 18 months before the beginning of the period measured.

The increases in restaurant sales for all periods presented were primarily attributable to the opening of new restaurants combined with an increase in average unit volume driven by comparable restaurant sales growth. Comparable restaurant sales growth for all periods presented was due to an increase in our guest traffic counts and an increase in our per person average check as shown in the table below.

| | Q2 2016 | | Q2 2015 | | 2016 YTD | | 2015 YTD | |
|---|---|---|---|---|---|---|---|---|
| Guest traffic counts | 2.9 | % | 6.5 | % | 3.0 | % | 6.6 | % |
| Per person average check | 1.6 | % | 1.7 | % | 1.5 | % | 1.8 | % |
| Comparable restaurant sales growth | 4.5 | % | 8.2 | % | 4.5 | % | 8.4 | % |

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Year-over-year sales for newer restaurants included in our average unit volume, but excluded from our comparable restaurant sales, partially offset the impact of positive comparable restaurant sales growth in Q2 2016 and 2016 YTD.

The increase in our per person average check for the periods presented was primarily driven by menu price increases taken in 2015 and 2014. In 2015 and 2014, we increased menu prices in the fourth quarter by approximately 2.0% and approximately 1.8%, respectively. These menu price increases were taken as a result of inflationary pressures, primarily commodities. In Q2 2016 and 2016 YTD, average guest check did not increase in line with the menu price increase implemented as some guests are purchasing fewer alcoholic and non-alcoholic beverages and/or shifting to lower menu price items.

In 2016, we plan to open approximately 30 company restaurants including approximately seven Bubba's 33 restaurants. We opened 14 company restaurants in 2016 YTD including 11 Texas Roadhouse restaurants and three Bubba's 33 restaurants. We have either begun construction or have sites under contract for purchase or lease for all of our expected 2016 openings.

Franchise Royalties and Fees. Franchise royalties and fees increased by $0.2 million, or by 4.3%, in Q2 2016 from Q2 2015 and increased by $0.5 million, or by 6.4% in 2016 YTD from 2015 YTD. In Q2 2016, the increase was primarily attributable to the opening of new franchise restaurants. In 2016 YTD, the increase was primarily attributable to the opening of new franchise restaurants and an increase in average unit volume. Franchise comparable restaurant sales increased 2.6% and 2.8% in Q2 2016 and 2016 YTD. Franchise restaurant count activity is shown in the restaurant unit activity table above. In 2016, we anticipate our franchise partners will open approximately four Texas Roadhouse restaurants, primarily international, two of which opened in 2016 YTD.

Restaurant Cost of Sales. Restaurant cost of sales, as a percentage of restaurant sales, decreased to 34.0% in Q2 2016 from 37.3% in Q2 2015 and decreased to 33.9% in 2016 YTD from 36.2% in 2015 YTD. These decreases were primarily attributable to commodity deflation and menu pricing actions, along with the benefit of operating efficiencies associated with process improvements at the restaurant level. Commodity deflation of approximately 6.8% in Q2 2016 and 4.0% in 2016 YTD was driven by lower food costs, primarily beef. Recent menu pricing actions are summarized in our discussion of restaurant sales above.

For 2016, we have fixed price contracts for approximately 70% of our overall food costs with the remainder subject to fluctuating market prices. We expect 2.5% to 3.0% food cost deflation in 2016.

Restaurant Labor Expenses. Restaurant labor expenses, as a percentage of restaurant sales, increased to 29.7% in Q2 2016 compared to 29.3% in Q2 2015 and increased to 29.3% in 2016 YTD compared to 29.1% in 2015 YTD. These increases were primarily attributable to higher average wage rates partially offset by the benefit from the increase in average unit volume along with lower payroll tax expense.

In 2016, we anticipate our labor costs will continue to be pressured by inflation due to increases in minimum and tip wage rates as well as regulatory changes. These increases in costs may or may not be offset by additional menu price adjustments and/or guest traffic growth.

Restaurant Rent Expense.  Restaurant rent expense, as a percentage of restaurant sales, remained unchanged at 2.0% in Q2 2016 and Q2 2015 as well as 2016 YTD and 2015 YTD.  The benefit from an increase in average unit volume was offset by an increase in rent expense, as a percentage of restaurant sales, related to newer restaurants.

Restaurant Other Operating Expenses.    Restaurant other operating expenses, as a percentage of restaurant sales, decreased to 15.0% in Q2 2016 from 15.2% in Q2 2015 and decreased to 15.1% in 2016 YTD from 15.2% in 2015 YTD.  The decrease in Q2 2016 was primarily attributable to an increase in average unit volume, lower costs associated with utilities and lower general liability self-insurance and was partially offset by higher third party gift card fees and higher bonus expense.  The decrease in 2016 YTD was primarily attributable to an increase in average unit volume and lower costs associated with utilities, partially offset by higher third party gift card fees and higher bonus expense.

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In Q2 2016, lower general liability self-insurance was due to changes in our claims development history included in our quarterly actuarial reserve estimate.  For all periods presented, utility costs were lower primarily due to lower electricity and natural gas rates while higher third party gift card fees were primarily due to the continued expansion of our third-party gift card program.  In addition, improved restaurant margins led to higher bonus expense.

Restaurant Pre-opening Expenses.  Pre-opening expenses decreased to $4.4 million in Q2 2016 from $4.9 million in Q2 2015 and increased to $9.2 million in 2016 YTD compared to $8.7 million in 2015 YTD.  The decrease in Q2 2016 and the increase in 2016 YTD were both primarily due to the number of restaurants opened during each period compared to the prior year period.  In Q2 2016, we opened seven restaurants compared to nine restaurants in Q2 2015, while we opened 14 restaurants in 2016 YTD compared to 12 restaurants in 2015 YTD.

Overall, we plan to open approximately 30 company-owned restaurants in 2016 compared to 29 company-owned restaurants in 2015.  Pre-opening costs will fluctuate from quarter to quarter based on the specific pre-opening costs incurred for each restaurant, the number and timing of restaurant openings and the number and timing of restaurant managers hired.

Depreciation and Amortization Expense.  D&A, as a percentage of total revenue, increased to 4.0% in Q2 2016 compared to 3.7% in Q2 2015 and increased to 3.9% in 2016 YTD compared to 3.6% in 2015 YTD.  This increase was primarily due to increased investment in short-lived assets, such as equipment, and higher depreciation, as a percentage of revenue, at new restaurants, partially offset by an increase in average unit volume.

In 2016, we expect D&A, as a percentage of revenue, to be higher than the prior year due to an increase in our capitalized costs related to restaurants opened in 2015 and 2016, along with an increase in the level of reinvestment in our existing restaurants.

General and Administrative Expenses.  G&A, as a percentage of total revenue, remained unchanged at 5.2% in Q2 2016 compared Q2 2015 and increased to 5.5% in 2016 YTD compared to 5.0% in 2015 YTD.  In Q2 2016, the increase in average unit volume offset higher costs associated with our managing partner conference and higher bonus expense.  The increase in 2016 YTD was primarily due to a pre-tax charge of $5.5 million ($3.4 million after-tax) related to the settlement of a legal matter, along with higher costs associated with our managing partner conference and higher bonus expense partially offset by an increase in average unit volume.  The $5.5 million charge had a $0.05 impact on diluted earnings per share in 2016 YTD.  See note 7 for further discussion of this charge.

Interest Expense, Net.  Interest expense decreased to $0.3 million in Q2 2016 compared to $0.5 million in Q2 2015 and decreased to $0.6 million in 2016 YTD compared to $1.0 million in 2015 YTD.  These decreases were primarily due to the expiration of our interest rate swaps.

Income Tax Expense. Our effective tax rate increased to 30.2% in Q2 2016 compared to 29.7% in Q2 2015 and decreased to 30.1% in 2016 YTD compared to 30.3% in 2015 YTD. We expect the tax rate to be approximately 30.0% for fiscal 2016.

Liquidity and Capital Resources

The following table presents a summary of our net cash provided by (used in) operating, investing and financing activities (in thousands):

| | 26 Weeks Ended | |
|---|---|---|
| | June 28, 2016 | June 30, 2015 |
| Net cash provided by operating activities | $ 114,068 | $ 94,823 |
| Net cash used in investing activities | (69,159) | (70,924) |
| Net cash used in financing activities | (8,938) | (39,056) |
| Net increase (decrease) in cash and cash equivalents | $ 35,971 | $ (15,157) |

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Net cash provided by operating activities was $114.1 million in 2016 YTD compared to $94.8 million in 2015 YTD. This increase was primarily due to an increase in net income and non-cash items such as depreciation and amortization expense partially offset by a decrease in working capital. The decrease in working capital was primarily due to a decrease in cash flows related to a change in the payment timing of accrued wages and deferred revenue related to gift cards partially offset by an increase in cash flows related to accounts receivable. The increase in cash flow from operations was primarily driven by an increase in comparable restaurant sales at existing restaurants, the continued opening of new restaurants and lower commodity inflation, primarily beef.

Our operations have not required significant working capital and, like many restaurant companies, we have been able to operate with negative working capital. Sales are primarily for cash, and restaurant operations do not require significant inventories or receivables. In addition, we receive trade credit for the purchase of food, beverages and supplies, thereby reducing the need for incremental working capital to support growth.

Net cash used in investing activities was $69.2 million in 2016 YTD compared to $70.9 million in 2015 YTD. The decrease was primarily due to decreased spending related to new restaurant openings partially offset by increased spending on capital expenditures related to the refurbishment of existing restaurants such as remodeling, room additions, parking expansions, and other general maintenance. Decreased spending related to restaurant openings in future years more than offset the increase in capital spending as a result of opening 14 restaurants in 2016 YTD compared to 12 restaurants in 2015 YTD.

We require capital principally for the development of new company restaurants and the refurbishment of existing restaurants. We either lease our restaurant site locations under operating leases for periods of five to 30 years (including renewal periods) or purchase the land where it is cost effective. As of June 28, 2016, we had developed 133 of the 415 company restaurants on land which we own.

The following table presents a summary of capital expenditures related to the development of new restaurants and the refurbishment of existing restaurants:

| | 2016 YTD | 2015 YTD |
|---|---|---|
| New company restaurants | $ 45,137 | $ 49,228 |
| Refurbishment of existing restaurants(1) | 24,022 | 21,705 |
| Total capital expenditures | $ 69,159 | $ 70,933 |
| | | |
| Restaurant-related repairs and maintenance expense(2) | $ 10,590 | $ 9,990 |

(1) Includes minimal capital expenditures related to the support center office.
(2) These amounts were recorded as an expense as incurred.

Our future capital requirements will primarily depend on the number of new restaurants we open, the timing of those openings and the restaurant prototype developed in a given fiscal year. These requirements will include costs directly related to opening new restaurants and may also include costs necessary to ensure that our infrastructure is able to support a larger restaurant base. In fiscal 2016, we expect our capital expenditures to be approximately $165.0 to $175.0 million, the majority of which will relate to planned restaurant openings, including approximately 30 restaurant openings in 2016. These amounts exclude any cash used for franchise acquisitions. We intend to satisfy our capital requirements over the next 12 months with cash on hand, net cash provided by operating activities and, if needed, funds available under our amended revolving credit facility. For 2016, we anticipate net cash provided by operating activities will exceed capital expenditures. We currently anticipate this excess will be used to pay dividends, as approved by our Board of Directors, repurchase common stock, and/or repay borrowings under our amended revolving credit facility.

Net cash used in financing activities was $8.9 million in 2016 YTD compared to $39.1 million in 2015 YTD. This decrease was primarily due to an increase in borrowings on our amended revolving credit facility and lower dividend payments in 2016 YTD. Dividend payments were higher in 2015 YTD due to the timing of a dividend payment.

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On May 22, 2014, our Board of Directors approved a stock repurchase program under which we may repurchase up to $100.0 million of our common stock. This stock repurchase program has no expiration date and replaced a previous stock repurchase program which was approved on February 16, 2012. All repurchases to date under our stock repurchase program have been made through open market transactions. The timing and the amount of any repurchases will be determined by management under parameters established by the Board of Directors, based on an evaluation of our stock price, market conditions and other corporate considerations. During 2016 YTD, we paid $4.1 million to repurchase 114,700 shares of our common stock, and we had approximately $69.9 million remaining under our authorized stock repurchase program as of June 28, 2016.

On May 19, 2016, our Board of Directors authorized the payment of a cash dividend of $0.19 per share of common stock. The payment of this dividend totaling $13.4 million was distributed on July 1, 2016 to shareholders of record at the close of business on June 15, 2016. The declared dividends are included as a liability in our unaudited condensed consolidated balance sheet as of June 28, 2016.

We paid distributions of $2.5 million and $2.3 million to equity holders of 16 of our majority-owned company restaurants in 2016 YTD and 2015 YTD, respectively.

On November 1, 2013, we entered into Omnibus Amendment No. 1 and Consent to Credit Agreement and Guaranty with respect to our revolving credit facility dated as of August 12, 2011 with a syndicate of commercial lenders led by JP Morgan Chase Bank, N.A., PNC Bank, N.A., and Wells Fargo, N.A. The amended revolving credit facility, which has a maturity date of November 1, 2018, remains an unsecured, revolving credit agreement under which we may borrow up to $200.0 million. The amendment provides us with the option to increase the revolving credit facility by $200.0 million, up to $400.0 million, subject to certain limitations.

The terms of the amended revolving credit facility require us to pay interest on outstanding borrowings at the London Interbank Offered Rate ("LIBOR") plus a margin of 0.875% to 1.875%, depending on our leverage ratio, or the Alternate Base Rate, which is the higher of the issuing bank’s prime lending rate, the Federal Funds rate plus 0.50% or the Adjusted Eurodollar Rate for a one month interest period on such day plus 1.0%. We are also required to pay a commitment fee of 0.125% to 0.30% per year on any unused portion of the amended revolving credit facility, depending on our leverage ratio. The weighted average interest rate for the amended revolving credit facility at June 28, 2016 was 1.32%. The weighted-average interest rate for the amended revolving credit facility at December 29, 2015 was 3.22%, including the impact of the interest rate swap. At June 28, 2016, we had $50.0 million outstanding under the revolving credit facility and $143.4 million of availability, net of $6.6 million of outstanding letters of credit.

The lenders’ obligation to extend credit under the amended revolving credit facility depends on us maintaining certain financial covenants, including a minimum consolidated fixed charge coverage ratio of 2.00 to 1.00 and a maximum consolidated leverage ratio of 3.00 to 1.00. The amended revolving credit facility permits us to incur additional secured or unsecured indebtedness outside the facility, except for the incurrence of secured indebtedness that in the aggregate exceeds 15% of our consolidated tangible net worth or circumstances where the incurrence of secured or unsecured indebtedness would prevent us from complying with our financial covenants. We were in compliance with all financial covenants as of June 28, 2016.

At June 28, 2016, in addition to the amounts outstanding on our amended revolving credit facility, we had one other note payable totaling $0.6 million with a fixed interest rate of 10.46%, which relates to the financing of a specific restaurant and is subject to certain prepayment penalties. Our total weighted-average effective interest rate at June 28, 2016 was 1.43%.

On January 7, 2009, we entered into an interest rate swap, starting on February 7, 2009, with a notional amount of $25.0 million to hedge a portion of the cash flows of our variable rate borrowings. We designated the interest rate swap as a cash flow hedge of our exposure to variability in future cash flows attributable to interest payments on a $25.0 million tranche of floating rate debt borrowed under our amended revolving credit facility. Under the terms of the swap, we paid a fixed rate of 2.34% on the $25.0 million notional amount and received payments from the counterparty based on the one month LIBOR for a term that ended on January 7, 2016, effectively resulting in a fixed rate on the LIBOR component of the $25.0 million notional amount.

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Contractual Obligations

The following table summarizes the amount of payments due under specified contractual obligations as of June 28, 2016 (in thousands):

| | Payments Due by Period | | | | |
|---|---|---|---|---|---|
| | Total | Less than 1 year | 1 - 3 Years | 3 - 5 Years | More than 5 years |
| Long-term debt obligations | $ 50,623 | $ 151 | 50,354 | 118 | $ — |
| Interest(1) | 1,667 | 718 | 945 | 4 | — |
| Operating lease obligations | 741,602 | 39,514 | 80,253 | 78,805 | 543,030 |
| Capital obligations | 171,835 | 171,835 | — | — | — |
| Total contractual obligations(2) | $ 965,727 | $ 212,218 | $ 131,552 | $ 78,927 | $ 543,030 |

(1) Uses interest rates as of June 28, 2016 for our variable rate debt. We assumed $50.0 million remains outstanding on the amended revolving credit facility until the expiration date. We calculated interest rate payments using the weighted average interest rate of 1.32%, which was the interest rate associated with our amended revolving credit facility at June 28, 2016. We assumed a constant rate until maturity for our fixed rate debt.

(2) Unrecognized tax benefits under Accounting Standards Codification 740 are immaterial and, therefore, are excluded from this amount.

We have no material minimum purchase commitments with our vendors that extend beyond a year. See note 7 to the unaudited condensed consolidated financial statements for a discussion of contractual obligations.

Off-Balance Sheet Arrangements

Except for operating leases (primarily restaurant leases), we do not have any material off-balance sheet arrangements.

Guarantees

Effective December 31, 2013, we sold two restaurants, which operated under the name Aspen Creek, located in Irving, Texas and Louisville, Kentucky. We assigned the leases associated with these restaurants to the acquirer, but remain contingently liable under the terms of the lease if the acquirer defaults. We are contingently liable for the initial term of the lease and any optional renewal periods. The Irving lease has an initial term that expires December 2019, along with three five year renewals. The Louisville lease has an initial term that expires November 2023, along with three five year renewals. The assignment of the Louisville lease releases us from liability after the initial lease term expiration contingent upon certain conditions being met by the acquirer.

We entered into real estate lease agreements for five restaurant locations, listed in the table below, before granting franchise rights for those restaurants. We have subsequently assigned the leases to the franchisees, but remain contingently liable if a franchisee defaults, under the terms of the lease.

| | Lease Assignment Date | Current Lease Term Expiration |
|---|---|---|
| Everett, Massachusetts(1) | September 2002 | February 2018 |
| Longmont, Colorado | October 2003 | May 2019 |
| Montgomeryville, Pennsylvania | October 2004 | June 2021 |
| Fargo, North Dakota(1) | February 2006 | July 2021 |
| Logan, Utah | January 2009 | August 2019 |

(1) As discussed in note 8, these restaurants are owned, in whole or part, by certain officers, directors and 5% shareholders of the Company.

We are contingently liable for the initial term of the lease and any optional renewal periods. All of the leases have three optional five-year renewals.

As of June 28, 2016 and December 29, 2015, we are contingently liable for $16.8 million and $17.2 million, respectively, for the seven leases discussed above. These amounts represent the maximum potential liability of future payments under the guarantees. In the event of default, the indemnity and default clauses in our assignment agreements govern our ability to pursue and recover damages incurred. No material liabilities have been recorded as of June 28, 2016 and December 29, 2015 as the likelihood of default was deemed to be less than probable and the fair value of the guarantees is not considered significant.

Recently Issued Accounting Standards

Revenue Recognition

(Accounting Standards Update 2014-09, "ASU 2014-09")

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers, which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The ASU will replace most existing revenue recognition guidance in GAAP when it becomes effective. In July 2015, the FASB approved a one-year deferral of the effective date of the new revenue standard. ASU 2014-09 is now effective for fiscal years beginning on or after December 15, 2017 (our 2018 fiscal year) with early adoption permitted in the first quarter of 2017. The standard permits the use of either the retrospective or cumulative effect transition method. In March and April 2016, the FASB issued the following amendments to clarify the implementation guidance: ASU No. 2016-08, Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net) and ASU No. 2016-10, Revenue from Contracts with Customers (Topic 606:) Identifying Performance Obligations and Licensing. The standard will not impact our recognition of revenue from company-owned restaurants or our recognition of continuing fees from franchisees, which are based on a percentage of franchise sales. We are continuing to evaluate the impact the adoption of this standard will have on the recognition of other less significant revenue transactions such as initial fees from franchisees as well as the method of adoption.

Inventory

(Accounting Standards Update 2015-11, "ASU 2015-11")

In July 2015, the FASB issued ASU 2015-11, Inventory, which simplifies the measurement principle of inventories valued under the First-In, First-Out ("FIFO") or weighted average methods from the lower of cost or market to the lower of cost and net realizable value. ASU 2015-11 is effective for reporting periods beginning after December 15, 2016 (our 2017 fiscal year). We do not expect the standard to have a material impact on our consolidated financial position, results of operations or cash flows upon adoption.

Deferred Taxes

(Accounting Standards Update 2015-17, "ASU 2015-17")

In November 2015, the FASB issued ASU 2015-17, Balance Sheet Classification of Deferred Taxes, which requires that deferred tax assets and liabilities be classified as noncurrent on the consolidated balance sheet. ASU 2015-17 is effective for annual periods beginning after December 15, 2016 (our 2017 fiscal year), including interim periods within those annual periods. Early adoption is permitted as of the beginning of an interim or annual reporting period. Upon adoption, ASU 2015-17 may be applied either prospectively or retrospectively. We do not expect the adoption of this guidance to have a material impact on our consolidated financial position, results of operations or cash flows.

Leases

(Accounting Standards Update 2016-02, "ASU 2016-02")

In February 2016, the FASB issued ASU 2016-02, Leases, which requires an entity to recognize a right-of-use asset and a lease liability for virtually all leases. This update also requires additional disclosures about the amount, timing, and uncertainty of cash flows arising from leases. ASU 2016-02 is effective for fiscal years, and interim periods within

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those fiscal years, beginning after December 15, 2018 (our 2019 fiscal year). Early adoption is permitted. A modified retrospective approach is required for all leases existing or entered into after the beginning of the earliest comparative period in the consolidated financial statements. We are currently assessing the impact of this new standard on our consolidated financial position, results of operations and cash flows and we have not determined the effect of the amended guidance on our ongoing financial reporting.

Share-Based Compensation

(Accounting Standards Update 2016-09, "ASU 2016-09")

In March 2016, the FASB issued ASU 2016-09, Compensation – Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting, which is intended to simplify several aspects of the accounting for share-based payment transactions. The amendments in this update cover such areas as the recognition of excess tax benefits and deficiencies, the classification of those excess tax benefits on the statement of cash flows, an accounting policy election for forfeitures, the amount an employer can withhold to cover income taxes and still qualify for equity classification and the classification of those taxes paid on the statement of cash flows. ASU 2016-09 is effective for annual periods beginning after December 15, 2016 (our 2017 fiscal year) and interim periods within those annual periods. Early adoption is permitted. We are currently assessing the impact of this new standard on our consolidated financial position, results of operations and cash flows as well as the method of adoption.

Financial Instruments

(Accounting Standards Update 2016-13, "ASU 2016-13")

In June 2016, the FASB issued ASU 2016-13, Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments, which requires measurement and recognition of expected versus incurred losses for financial assets held. ASU 2016-13 is effective for annual periods beginning after December 15, 2019 (our 2020 fiscal year), with early adoption permitted for annual periods beginning after December 15, 2018. We are currently assessing the impact of this new standard on our consolidated financial position, results of operations and cash flows.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to market risk from changes in interest rates on variable rate debt and changes in commodity prices. Our exposure to interest rate fluctuations is limited to our outstanding bank debt. The terms of the amended revolving credit facility require us to pay interest on outstanding borrowings at London Interbank Offering Rate ("LIBOR") plus a margin of 0.875% to 1.875%, depending on our leverage ratio, or the Alternate Base Rate, which is the higher of the issuing bank's prime lending rate, the Federal Funds rate plus 0.50% or the Adjusted Eurodollar Rate for a one month interest period on such day plus 1.0%. At June 28, 2016, we had $50.0 million outstanding under the amended revolving credit facility, which bears interest at approximately 87.5 to 187.5 basis points (depending on our leverage ratios) over LIBOR. The interest rate on our amended revolving credit facility at June 28, 2016 was 1.32%. We had one other note payable totaling $0.6 million with a fixed interest rate of 10.46%. Should interest rates based on this variable rate borrowing increase by one percentage point, our estimated annual interest expense would increase by $0.5 million.

In an effort to secure high quality, low cost ingredients used in the products sold in our restaurants, we employ various purchasing and pricing contract techniques. When purchasing certain types of commodities, we may be subject to prevailing market conditions resulting in unpredictable price volatility. For certain commodities, we may also enter into contracts for terms of one year or less that are either fixed price agreements or fixed volume agreements where the price is negotiated with reference to fluctuating market prices. We currently do not use financial instruments to hedge commodity prices, but we will continue to evaluate their effectiveness. Extreme and/or long term increases in commodity prices could adversely affect our future results, especially if we are unable, primarily due to competitive reasons, to increase menu prices. Additionally, if there is a time lag between the increasing commodity prices and our ability to increase menu prices or if we believe the commodity price increase to be short in duration and we choose not to pass on the cost increases, our short term financial results could be negatively affected.

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We are subject to business risk as our beef supply is highly dependent upon three vendors. If these vendors were unable to fulfill their obligations under their contracts, we may encounter supply shortages, higher costs to secure adequate supplies and a possible loss of sales, any of which would harm our business.

## ITEM 4. CONTROLS AND PROCEDURES

### Evaluation of disclosure controls and procedures

We have evaluated the effectiveness of the design and operation of our disclosure controls and procedures pursuant to, and as defined in, Rules 13a 15(e) and 15d 15(e) under the Securities Exchange Act of 1934, as amended, as of the end of the period covered by this report. Based on the evaluation, performed under the supervision and with the participation of our management, including the Chief Executive Officer (the "CEO") and the Chief Financial Officer (the "CFO"), our management, including the CEO and CFO, concluded that our disclosure controls and procedures were effective as of June 28, 2016.

### Changes in internal control

During the period covered by this report, there were no changes with respect to our internal control over financial reporting that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II — OTHER INFORMATION

ITEM 1.  LEGAL PROCEEDINGS

On September 30, 2011, the U.S. Equal Employment Opportunity Commission ("EEOC") filed a lawsuit styled Equal Employment Opportunity Commission v. Texas Roadhouse, Inc., Texas Roadhouse Holdings LLC and Texas Roadhouse Management Corp. in the United States District Court, District of Massachusetts, Civil Action Number 1:11-cv-11732. The complaint alleges that applicants over the age of 40 were denied employment in our restaurants in bartender, host, server and server assistant positions due to their age.  The EEOC is seeking injunctive relief, remedial actions, payment of damages to the applicants, and costs.  We have filed an answer to the complaint and trial is scheduled for January 2017.  We deny liability and are vigorously defending this case; however, in view of the inherent uncertainties of litigation, the outcome of this case cannot be predicted at this time.  We cannot estimate the amount or range of loss, if any, associated with this matter.

Occasionally, we are a defendant in litigation arising in the ordinary course of our business, including "slip and fall" accidents, employment related claims and claims from guests or employees alleging illness, injury or food quality, health or operational concerns. None of these types of litigation, most of which are covered by insurance, has had a material effect on us and, as of the date of this report, we are not party to any litigation that we believe could have a material adverse effect on our business.

ITEM 1A.  RISK FACTORS

Information regarding risk factors appears in our Annual Report on Form 10-K for the year ended December 29, 2015, under the heading "Special Note Regarding Forward-looking Statements" and in the Form 10-K Part I, Item 1A, Risk Factors.  There have been no material changes from the risk factors previously disclosed in our Form 10-K for the year ended December 29, 2015.

ITEM 2.  UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

On May 22, 2014, our Board of Directors approved a stock repurchase program which authorized us to repurchase up to $100.0 million of our common stock of which $69.9 million remained outstanding at June 28, 2016. This stock repurchase program has no expiration date and replaced a previous stock repurchase program which was approved on February 16, 2012.  All repurchases to date under our stock repurchase program have been made through open market transactions. The timing and the amount of any repurchases through this program will be determined by management under parameters established by our Board of Directors, based on an evaluation of our stock price, market conditions and other corporate considerations.

The following table includes information regarding purchases of our common stock made by us during the 13 weeks ended June 28, 2016 in connection with the repurchase program described above:

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs |
|---|---|---|---|---|
| March 30 to April 26 | — | $ — | — | $ 69,916,147 |
| April 27 to May 24 | — | $ — | — | $ 69,916,147 |
| May 25 to June 28 | — | $ — | — | $ 69,916,147 |
| Total | — | | — | |

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## ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

## ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

## ITEM 5. OTHER INFORMATION

None.

## ITEM 6. EXHIBITS

| Exhibit No. | Description |
|---|---|
| 3.1 | Amended and Restated Certificate of Incorporation, as amended, of Registrant |
| 31.1 | Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2 | Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 101.INS | XBRL Instance Document |
| 101.SCH | XBRL Schema Document |
| 101.CAL | XBRL Calculation Linkbase Document |
| 101.DEF | XBRL Definition Linkbase Document |
| 101.LAB | XBRL Label Linkbase Document |
| 101.PRE | XBRL Presentation Linkbase Document |

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SIGNATURES

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

| | | |
|---|---|---|
| | | TEXAS ROADHOUSE, INC. |
| Date: August 5, 2016 | By: | /s/ W. KENT TAYLOR<br>W. Kent Taylor<br>Chief Executive Officer (principal executive officer) |
| Date: August 5, 2016 | By: | /s/ SCOTT M. COLOSI<br>Scott M. Colosi<br>President, Chief Financial Officer<br>(principal financial officer)<br>(chief accounting officer) |

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