NUVASIVE INC
Form 10-Q
October 25, 2012
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# UNITED STATES SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# FORM 10-Q

**(Mark One)**

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

**For the quarterly period ended September 30, 2012**

**OR**

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

**For the transition period from to**

**Commission file number 000-50744**

# NUVASIVE, INC.

**(Exact name of registrant as specified in its charter)**

| | |
|---|---|
| **Delaware** | **33-0768598** |
| **(State or other jurisdiction of incorporation or organization)** | **(I.R.S. Employer Identification No.)** |

**7475 Lusk Boulevard**

**San Diego, CA 92121**

**(Address of principal executive offices, including zip code)**

**(858) 909-1800**

**(Registrant s telephone number, including area code)**

**(Former name, former address and former fiscal year, if changed since last report)**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes þ No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes þ No ¨

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

| | | | |
|---|---|---|---|
| Large accelerated filer þ | Accelerated filer ¨ | Non-accelerated filer ¨<br>(Do not check if a smaller reporting company) | Smaller reporting company ¨ |

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

As of October 19, 2012, there were 43,527,640 shares of the registrant s common stock outstanding.

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**NUVASIVE, INC.**

**QUARTERLY REPORT ON FORM 10-Q**

**September 30, 2012**

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**PART I. FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**NUVASIVE, INC.**

**CONDENSED CONSOLIDATED BALANCE SHEETS**

***(in thousands, except par value)***

| | September 30, 2012 (Unaudited) | December 31, 2011 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 107,731 | $ 163,492 |
| Short-term marketable securities | 134,899 | 146,228 |
| Accounts receivable, net | 78,140 | 87,736 |
| Inventory | 132,958 | 119,313 |
| Deferred tax assets, current | 54,550 | 54,550 |
| Prepaid expenses and other current assets | 7,264 | 20,518 |
| Total current assets | 515,542 | 591,837 |
| Property and equipment, net | 131,158 | 124,754 |
| Long-term marketable securities | 42,416 | 32,503 |
| Intangible assets, net | 105,086 | 108,140 |
| Goodwill | 162,333 | 159,349 |
| Deferred tax assets | 19,857 | 19,857 |
| Restricted cash and investments | 182,067 | 68,600 |
| Other assets | 26,169 | 18,522 |
| Total assets | $ 1,184,628 | $ 1,123,562 |
| **LIABILITIES AND STOCKHOLDERS EQUITY** | | |
| Current liabilities: | | |
| Accounts payable and accrued liabilities | $ 63,498 | $ 51,744 |
| Accrued payroll and related expenses | 22,527 | 22,215 |
| Litigation liability | | 101,200 |
| Acquisition-related liabilities | 32,389 | 32,221 |
| Senior Convertible Notes, current | 74,311 | |
| Total current liabilities | 192,725 | 207,380 |
| Senior Convertible Notes | 329,143 | 394,019 |
| Deferred tax liabilities | 4,180 | 3,952 |
| Litigation liability | 101,200 | |
| Other long-term liabilities | 15,581 | 13,461 |
| Commitments and contingencies | | |
| Noncontrolling interests | 10,033 | 10,705 |
| Stockholders equity: | | |
| Preferred stock, $0.001 par value; 5,000 shares authorized, none outstanding | | |
| Common stock, $0.001 par value; 120,000 shares authorized, 43,505 and 42,455 issued and outstanding at September 30, 2012 and December 31, 2011, respectively | 44 | 42 |
| Additional paid-in capital | 705,931 | 674,790 |
| Accumulated other comprehensive income | 1,166 | 477 |

| | | |
|---|---|---|
| Accumulated deficit | (175,375) | (181,264) |
| Total stockholders equity | 531,766 | 494,045 |
| Total liabilities and stockholders equity | $ 1,184,628 | $ 1,123,562 |

See accompanying notes to unaudited condensed consolidated financial statements.

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**NUVASIVE, INC.**

**UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

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

| | Three Months Ended September 30, 2012 | Three Months Ended September 30, 2011 | Nine Months Ended September 30, 2012 | Nine Months Ended September 30, 2011 |
|---|---|---|---|---|
| Revenue | $ 148,391 | $ 132,880 | $ 454,501 | $ 390,312 |
| Cost of goods sold (excluding amortization of purchased technology) | 37,746 | 26,015 | 111,213 | 75,049 |
| Gross profit | 110,645 | 106,865 | 343,288 | 315,263 |
| Operating expenses: | | | | |
| Sales, marketing and administrative | 87,052 | 85,482 | 273,669 | 254,025 |
| Research and development | 7,933 | 10,092 | 27,932 | 31,119 |
| Amortization of intangible assets | 3,081 | 1,504 | 8,830 | 4,241 |
| Litigation award | | 101,200 | | 101,200 |
| Total operating expenses | 98,066 | 198,278 | 310,431 | 390,585 |
| Interest and other expense, net: | | | | |
| Interest income | 249 | 257 | 661 | 591 |
| Interest expense | (6,885) | (7,276) | (20,682) | (10,962) |
| Other income, net | 260 | 1,726 | 146 | 2,303 |
| Total interest and other expense, net | (6,376) | (5,293) | (19,875) | (8,068) |
| Income (loss) before income tax expense | 6,203 | (96,706) | 12,982 | (83,390) |
| Income tax expense (benefit) | 4,064 | (29,031) | 7,764 | (22,715) |
| Consolidated net income (loss) | $ 2,139 | $ (67,675) | $ 5,218 | $ (60,675) |
| Net loss attributable to noncontrolling interests | $ (215) | $ (123) | $ (672) | $ (862) |
| Net income (loss) attributable to NuVasive, Inc. | $ 2,354 | $ (67,552) | $ 5,890 | $ (59,813) |
| Net income (loss) per share attributable to NuVasive, Inc.: | | | | |
| Basic | $ 0.05 | $ (1.69) | $ 0.14 | $ (1.50) |
| Diluted | $ 0.05 | $ (1.69) | $ 0.13 | $ (1.50) |
| Weighted average shares outstanding: | | | | |
| Basic | 43,488 | 39,892 | 43,227 | 39,766 |
| Diluted | 44,735 | 39,892 | 44,151 | 39,766 |

See accompanying notes to unaudited condensed consolidated financial statements.

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**NUVASIVE, INC.**

**UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**

***(in thousands)***

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Consolidated net income (loss) | $ 2,139 | $ (67,675) | $ 5,218 | $ (60,675) |
| Other comprehensive income (loss): | | | | |
| Unrealized gain (loss) on investments | 102 | 11 | (43) | 36 |
| Translation adjustments | 1,029 | (1,763) | 732 | (707) |
| Total consolidated comprehensive income (loss) | 3,270 | (69,427) | 5,907 | (61,346) |
| Plus: Net loss attributable to noncontrolling interests | 215 | 123 | 672 | 862 |
| Comprehensive income (loss) attributable to NuVasive, Inc. | $ 3,485 | $ (69,304) | $ 6,579 | $ (60,484) |

See accompanying notes to unaudited condensed consolidated financial statements.

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**NUVASIVE, INC.**

**UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

***(in thousands)***

| | Nine Months Ended September 30, 2012 | Nine Months Ended September 30, 2011 |
|---|---|---|
| **Operating activities:** | | |
| Consolidated net income (loss) | $ 5,218 | $ (60,675) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | |
| Depreciation and amortization | 38,237 | 24,847 |
| Amortization of debt discount | 9,435 | 3,076 |
| Amortization of debt issuance costs | 1,386 | 2,588 |
| Stock-based compensation | 20,400 | 23,789 |
| Allowance for excess and obsolete inventory, net of write-offs | 2,000 | 4,642 |
| Allowance for doubtful accounts and sales return reserves | 816 | 1,261 |
| Accretion of contingent consideration | 708 | 587 |
| Gain recognized on change in fair value of derivatives | | (2,387) |
| Deferred income tax expense | | 6,238 |
| Other non-cash adjustments | 4,294 | 3,545 |
| Changes in operating assets and liabilities, net of effects of acquisitions: | | |
| Accounts receivable | 8,421 | (3,152) |
| Inventory | (14,222) | (19,933) |
| Prepaid expenses and other current assets | 13,582 | (1,061) |
| Accounts payable and accrued liabilities | 4,474 | 504 |
| Litigation liability | | 101,200 |
| Accrued payroll and related expenses | (269) | 584 |
| Income taxes payable | 5,006 | (32,237) |
| Net cash provided by operating activities | 99,486 | 53,416 |
| **Investing activities:** | | |
| Cash paid for business and asset acquisitions | (9,838) | (1,100) |
| Purchases of property and equipment | (35,706) | (39,435) |
| Purchases of marketable securities | (192,759) | (244,209) |
| Sales of marketable securities | 193,035 | 124,205 |
| Purchases of restricted investments | (113,331) | (4,535) |
| Payment for specific rights in connection with supply agreement, net of refund received | | (5,000) |
| Net cash used in investing activities | (158,599) | (170,074) |
| **Financing activities:** | | |
| Proceeds from the sale of warrants | | 47,898 |
| Proceeds from the issuance of convertible debt, net of issuance costs | | 391,334 |
| Purchase of convertible note hedges | | (80,097) |
| Repurchase of 2013 Senior Convertible Notes | | (118,702) |
| Proceeds from the issuance of common stock | 3,183 | 4,461 |
| Other assets | 132 | (349) |
| Tax benefits related to stock-based compensation awards | | 638 |
| Net cash provided by financing activities | 3,315 | 245,183 |
| Effect of exchange rate changes on cash | 37 | (179) |
| (Decrease) increase in cash and cash equivalents | (55,761) | 128,346 |

| | | |
|---|---|---|
| Cash and cash equivalents at beginning of period | 163,492 | 92,597 |
| Cash and cash equivalents at end of period | $ 107,731 | $ 220,943 |
| **Supplemental disclosure of non-cash transactions:** | | |
| Issuance of common stock in connection with asset acquisitions | $ 7,560 | $ |

See accompanying notes to unaudited condensed consolidated financial statements.

**NuVasive, Inc.**

**Notes to Unaudited Condensed Consolidated Financial Statements**

***1. Description of Business and Basis of Presentation***

***Description of Business***

NuVasive, Inc. (the Company or NuVasive) was incorporated in Delaware on July 21, 1997, and began commercializing its products in 2001. The Company is focused on developing minimally disruptive surgical products and procedurally integrated solutions for the spine. NuVasive s principal product offering is based on its Maximum Access Surgery, or MAS® platform. The MAS platform combines several categories of solutions that collectively minimize soft tissue disruption during spine fusion surgery with maximum visualization and safe, easy reproducibility for the surgeon. The platform includes a proprietary software-driven nerve avoidance system and intra-operative monitoring (IOM) support; MaXcess®, a unique split-blade retractor system; a wide variety of specialized implants; and several biologic fusion options. MAS significantly reduces surgery time and returns patients to activities of daily living much faster than conventional approaches. The Company continues to focus significant research and development efforts to expand its MAS product platform and advance the applications of its unique technology into procedurally integrated surgical solutions. The Company dedicates significant resources toward training spine surgeons on its unique technology and products.

The Company s primary business model is to loan its MAS systems to surgeons and hospitals who purchase disposables and implants for use in individual procedures. In addition, for larger customers, the Company s proprietary nerve monitoring systems, MaXcess and surgical instrument sets are placed with hospitals for an extended period at no up-front cost to them. The Company also offers a range of bone allograft in patented saline packaging, disposables and spine implants, which include its branded CoRoent® products and fixation devices such as rods, plates and screws. Implants and disposables are shipped from the Company s inventories. The Company sells an immaterial quantity of MAS instrument sets, MaXcess and nerve monitoring systems to hospitals.

On October 7, 2011, the Company completed the acquisition of Impulse Monitoring, Inc. (Impulse Monitoring), a company which provides IOM services of the nervous system during spine and other surgeries. The acquisition complements the Company s existing nerve monitoring systems, which are designed for discreet and directional nerve avoidance and detection, making lateral access to the spine during the eXtreme lateral interbody fusion (XLIF®) procedure safe and reproducible.

***Basis of Presentation***

The accompanying unaudited condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Pursuant to these rules and regulations, the Company has condensed or omitted certain information and footnote disclosures it normally includes in its annual consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States (GAAP). In the opinion of management, the consolidated financial statements include all adjustments necessary, which are of a normal and recurring nature, for the fair presentation of the Company s financial position and of the results of operations and cash flows for the periods presented.

The accompanying unaudited condensed consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. Additionally, the unaudited condensed consolidated financial statements as of September 30, 2012 and December 31, 2011 and for three and nine months ended September 30, 2012 and 2011 include the accounts of a variable interest entity, Progentix Orthobiology, B.V. (Progentix), which is consolidated pursuant to existing guidance issued by the Financial Accounting Standards Board (FASB). All significant intercompany balances and transactions have been eliminated in consolidation.

As a result of the October 2011 acquisition of Impulse Monitoring, the Company maintains a contractual relationship with several physician practices (PCs) whereby the PCs provide the physician oversight service associated with the IOM services. Pursuant to such contractual arrangements, the Company provides management services to the PCs. As of September 30, 2012 and December 31, 2011, the associated PCs are American Neuromonitoring Associates, P.C.; Pacific Neuromonitoring Associates, Inc.; Keystone Neuromonitoring Associates, P.C.; North Pacific Neuromonitoring Associates, P.C.; and Midwest Neuromonitoring Associates, Inc. Under the management services agreements, the Company provides all non-medical services to the PCs in return for a management fee that is settled on a monthly basis. The management services include management reporting, billing and collections of all charges for medical services provided and all administrative support to the PCs. Pursuant to existing guidance issued by the FASB, these represent variable interest entities for which the Company is the primary beneficiary, and the accompanying unaudited condensed consolidated financial statements include the accounts of the PCs from the date of acquisition.

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These financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto for the year ended December 31, 2011 included in NuVasive s Annual Report on Form 10-K filed with the SEC. Operating results for the three and nine months ended September 30, 2012 are not necessarily indicative of the results that may be expected for any other interim period or for the full year. The balance sheet at December 31, 2011 has been derived from the audited financial statements at that date, but does not include all of the information and footnotes required by GAAP for complete financial statements.

***Reclassifications***

Certain reclassifications have been made to prior period condensed consolidated financial statements and notes to conform to the current year presentation.

***2. Recently Adopted Accounting Standards***

Effective January 1, 2012, the Company adopted the FASB s updated accounting guidance related to annual and interim goodwill impairment tests. The updated accounting guidance allows entities to first assess qualitative factors before performing a quantitative assessment of the fair value of a reporting unit. If it is determined on the basis of qualitative factors, that the fair value of the reporting unit is more-likely-than-not less than the carrying amount, the existing quantitative impairment test is required. Otherwise, no further impairment testing is required. The adoption of this accounting guidance did not have a material impact on the Company s condensed consolidated financial statements.

Additionally, effective January 1, 2012, the Company adopted the FASB s amended requirements for the presentation of comprehensive income. The amended guidance requires companies to disclose the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The updated guidance does not affect how earnings per share is calculated or presented. The adoption of this authoritative guidance did not have an impact on the Company s financial position or results of operations.

***3. Impulse Monitoring, Inc. Acquisition***

On October 7, 2011 (the Closing Date), the Company completed the purchase of all of the outstanding shares of Impulse Monitoring pursuant to an Agreement and Plan of Merger dated September 28, 2011 for an initial payment of approximately $79.7 million consisting of cash totaling approximately $40.5 million and the issuance of 2,336,200 shares of NuVasive common stock to certain stockholders of Impulse Monitoring. During the three months ended March 31, 2012, the Company made an additional cash payment of approximately $1.2 million related to a working capital adjustment, resulting in a total purchase price of approximately $80.9 million and a corresponding adjustment to goodwill. Impulse Monitoring provides IOM services of the nervous system during spine and other surgeries. The acquisition complements the Company s existing nerve monitoring systems, which are designed for discreet and directional nerve avoidance and detection, making lateral access to the spine during the XLIF procedure safe and reproducible.

***Purchase Price***

The acquisition of Impulse Monitoring has been recorded using the acquisition method of accounting in accordance with the authoritative guidance for business combinations.

The purchase price is as follows (*in thousands*):

| | |
|---|---|
| Cash paid to sellers | $ 41,700 |
| Market value of NuVasive common stock issued on Closing Date | 39,200 |
| Total purchase price | $ 80,900 |

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The allocation of the purchase price was based on management s valuation of the fair value of tangible and identifiable intangible assets acquired and liabilities assumed as of the Closing Date. The following table summarizes the allocation of the purchase price (*in thousands*):

| | Estimated Fair Value | Estimated Useful Life |
|---|---|---|
| Cash | $ 5,100 | |
| Total other current assets | 7,300 | |
| Property, plant and equipment | 1,100 | |
| Developed technology | 700 | 4 years |
| Non-compete agreement | 300 | 1 year |
| Trade name | 500 | 3 years |
| Customer relationships | 25,100 | 10 years |
| Goodwill | 57,700 | |
| Current liabilities | (8,900) | |
| Deferred income tax liabilities, net | (8,000) | |
| Total purchase price allocation | $ 80,900 | |

Goodwill totaling $57.7 million represents the excess of the purchase price over the fair value of tangible and identifiable intangible assets acquired and is due primarily to increased market penetration from customers and synergies expected from combining the assembled workforce with the Company s existing IOM workforce. This acquisition was nontaxable and, as a result, there is no tax basis in goodwill. Accordingly, none of the goodwill associated with the Impulse Monitoring acquisition is deductible for tax purposes.

As a result of the acquisition, the Company maintains a contractual relationship with several PCs whereby the PCs provide the physician oversight service associated with the IOM services. Pursuant to such contractual arrangements, the Company provides management services to the PCs in return for a management fee that is settled on a monthly basis. In accordance with authoritative guidance, the Company has determined that the PC s are variable interest entities. Additionally, pursuant to this guidance, the Company is considered the primary beneficiary of the PCs as the Company has both (1) the power to direct the economically significant activities of the PCs and (2) the obligation to absorb losses of, or the right to receive benefits from, the PCs. Accordingly, the financial position and results of operations of the PCs have been included in the Company s consolidated financial statements from the Impulse Closing Date. The liabilities recognized as a result of consolidating the PCs, which are not material, do not represent additional claims on the Company s general assets. The creditors of the PCs have claims only on the assets of the PCs, which are not material, and the assets of the PCs are not available to the Company.

***Results of Operations***

The accompanying condensed consolidated statement of operations for the three and nine months ended September 30, 2012 reflect the operating results of Impulse Monitoring since the date of the acquisition. The Company has prepared the following unaudited pro forma financial statement information to compare results of the periods presented assuming the Impulse Monitoring acquisition had occurred as of January 1, 2010. These unaudited pro forma results have been prepared for comparative purposes only and do not purport to be an indicator of the results of operations that would have actually resulted had the acquisition occurred as of January 1, 2010, or of future results of operations. Assuming the Impulse Monitoring acquisition occurred as of January 1, 2010, the pro forma unaudited results of operations would have been as follows (*in thousands, except per share data*):

| | Three Months Ended September 30, 2011 | Nine Months Ended September 30, 2011 |
|---|---|---|
| Revenue | $ 143,211 | $ 419,401 |
| Net loss attributable to NuVasive, Inc. | (66,426) | (57,882) |
| Net loss per share basic and diluted | (1.57) | (1.37) |

The above pro forma unaudited results of operations do not include pro forma adjustments relating to costs of integration or post-integration cost reductions that may be incurred or realized by the Company in excess of actual amounts incurred or realized through September 30, 2011.

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***4. Investment in Progentix Orthobiology, B.V.***

In 2009, the Company completed the purchase of forty percent (40%) of the capital stock of Progentix, a company organized under the laws of the Netherlands, from existing shareholders (the Progentix Shareholders) pursuant to a Preferred Stock Purchase Agreement for $10 million in cash (the Initial Investment). Concurrent with the Initial Investment, NuVasive and Progentix also entered into a Senior Secured Facility Agreement, whereby Progentix may borrow up to $5.0 million from NuVasive to fund ongoing clinical and regulatory efforts (the Loan). At September 30, 2012, the Company had advanced Progentix the full $5.0 million in accordance with the Loan Agreement. The Loan accrues interest at a rate of six percent (6%) per year. Other than its obligations under the Loan Agreement, NuVasive is not obligated to provide additional funding, nor has any additional funding been provided, to Progentix.

Also concurrent with the Preferred Stock Purchase Agreement, NuVasive, Progentix and the Progentix Shareholders entered into an Option Purchase Agreement, as amended (the Option Agreement), whereby NuVasive may be obligated (the Put Option), upon the achievement of an annual sales run rate on Progentix products in excess of a specified amount between June 14, 2011 and June 13, 2013 (the Option Period), to purchase the remaining sixty percent (60%) of capital stock of Progentix from its shareholders (the Remaining Shares) for an amount up to $35.0 million, subject to certain reductions, payable in a combination of cash and NuVasive common stock, at NuVasive s sole discretion. In accordance with the Option Agreement, NuVasive has the right to purchase the Remaining Shares (the Call Option) during the Option Period for an amount up to $35.0 million, subject to certain reductions, payable in a combination of cash and NuVasive common stock, at NuVasive s sole discretion. NuVasive and Progentix also entered into a Distribution Agreement, as amended, whereby Progentix appointed NuVasive as its exclusive distributor for certain Progentix products. The Distribution Agreement will be in effect for a term of ten years unless terminated earlier in accordance with its terms.

In accordance with authoritative guidance issued by the FASB, the Company has determined that Progentix is a variable interest entity as it does not have the ability to finance its activities without additional subordinated financial support and its equity investors will not absorb their proportionate share of expected losses and will be limited in the receipt of the potential residual returns of Progentix. Additionally, pursuant to this guidance, NuVasive is considered its primary beneficiary as NuVasive has both (1) the power to direct the economically significant activities of Progentix and (2) the obligation to absorb losses of, or the right to receive benefits from, Progentix. Accordingly, the financial position and results of operations of Progentix have been included in the consolidated financial statements from the date of the Initial Investment. The liabilities recognized as a result of consolidating Progentix do not represent additional claims on the Company s general assets. The creditors of Progentix have claims only on the assets of Progentix, which are not material, and the assets of Progentix are not available to NuVasive.

Pursuant to authoritative guidance, the equity interests in Progentix not owned by the Company, which includes shares of both common and preferred stock, are reported as noncontrolling interests on the consolidated balance sheet of the Company. The preferred stock represents 18% of the noncontrolling equity interests and provides for a cumulative 8% dividend, if and when declared by Progentix s Board of Directors. As the rights and conversion features of the preferred stock are substantially the same as those of the common stock, the preferred stock is classified as noncontrolling interest and shares in the allocation of the losses incurred by Progentix. Losses incurred by Progentix are charged to the Company and to the noncontrolling interest holders based on their ownership percentage. The Remaining Shares and the Option Agreement that was entered into between NuVasive, Progentix and the Progentix Shareholders are not considered to be freestanding financial instruments as defined by authoritative guidance. Therefore the Remaining Shares and the Option Agreement are accounted for as a combined unit on the consolidated financial statements as a redeemable noncontrolling interest that was initially recorded at fair value and classified as mezzanine equity.

Pursuant to authoritative guidance, when the embedded Put Option is exercisable and therefore the Remaining Shares considered currently redeemable (i.e., at the option of the holder), the instrument will be adjusted to its maximum redemption amount. If the embedded Put Option is considered not currently exercisable (e.g., because a contingency has not been met), and it is not probable that the embedded Put Option will become exercisable, an adjustment is not necessary until it is probable that the embedded Put Option will become exercisable. At September 30, 2012, the embedded Put Option was not deemed currently exercisable and therefore the Remaining Shares were not redeemable because the milestones referred to previously had not been met. Furthermore, at September 30, 2012, the Company concluded it is not probable that the milestones will be met, therefore the Remaining Shares are not expected to become redeemable. The probability of redemption is reevaluated at each reporting period.

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Total assets and liabilities of Progentix included in the accompanying condensed consolidated balance sheet are as follows *(in thousands):*

| | September 30, 2012 | December 31, 2011 |
|---|---|---|
| Total current assets | $ 623 | $ 640 |
| Identifiable intangible assets, net | 14,988 | 15,338 |
| Goodwill | 12,654 | 12,654 |
| Other long-term assets | 48 | 53 |
| Accounts payable & accrued expenses | 359 | 411 |
| Other long-term liabilities | 86 | |
| Deferred tax liabilities, net | 3,318 | 3,318 |
| Noncontrolling interests | 10,033 | 10,705 |

The following is a reconciliation of equity (net assets) attributable to the noncontrolling interests (*in thousands*):

| | Nine Months Ended September 30, | |
|---|---|---|
| | 2012 | 2011 |
| Noncontrolling interests at beginning of period | $ 10,705 | $ 11,877 |
| Net loss attributable to the noncontrolling interests | (672) | (862) |
| Noncontrolling interests at end of period | $ 10,033 | $ 11,015 |

***5. Balance Sheet Reserves***

The balances of the reserves for accounts receivable and inventory are as follows *(in thousands)*:

| | September 30, 2012 | December 31, 2011 |
|---|---|---|
| Reserves for accounts receivable and sales returns | $ 4,093 | $ 3,430 |
| Reserves for excess and obsolete inventory | 14,763 | 12,710 |

The Company s inventory consists primarily of purchased finished goods, which includes specialized implants and disposables, and is stated at the lower of cost or market determined by a weighted average cost method. The Company reviews the components of its inventory on a periodic basis for excess, obsolete or impaired inventory, and records a reserve for the identified items.

***6. Marketable Securities and Fair Value Measurements***

Marketable securities consist of certificates of deposit, corporate notes, commercial paper, U.S. government treasury securities and securities of government sponsored entities. The Company classifies all securities as available-for-sale, as the sale of such securities may be required prior to maturity to implement management strategies. These securities are carried at fair value, with the unrealized gains and losses reported as a component of other comprehensive income in stockholders equity until realized. A decline in the market value of any marketable security below cost that is determined to be other-than-temporary will result in a revaluation of its carrying amount to fair value. The impairment is charged to earnings and a new cost basis for the security is established. No such impairment charges were recorded for any period presented.

Realized gains and losses from the sale of marketable securities, if any, are determined on a specific identification basis. Realized gains and losses and declines in value judged to be other-than-temporary, if any, on available-for-sale securities are included in other income or expense on the consolidated statements of operations. Realized gains and losses during the periods presented were immaterial. Premiums and discounts are amortized or accreted over the life of the related security as an adjustment to yield using the straight-line method and are included in interest income on the condensed consolidated statements of operations. Interest and dividends on securities classified as available-for-sale are included in interest income on the condensed consolidated statements operations.

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The composition of marketable securities is as follows (*in thousands, except years*):

| | Contractual Maturity (in Years) | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|---|
| September 30, 2012: | | | | | |
| Classified as current assets: | | | | | |
| Certificates of deposit | Less than 1 | $ 1,299 | $ | $ | $ 1,299 |
| Corporate notes | Less than 1 | 27,777 | 7 | (1) | 27,783 |
| Commercial paper | Less than 1 | 14,986 | 1 | | 14,987 |
| U.S. government treasury securities | Less than 1 | 5,009 | 1 | | 5,010 |
| Securities of government-sponsored entities | Less than 1 | 85,800 | 21 | (1) | 85,820 |
| Short-term marketable securities | | 134,871 | 30 | (2) | 134,899 |
| Classified as non-current assets: | | | | | |
| Certificates of deposit | 1 to 2 | 142 | | | 142 |
| Corporate notes | 1 to 2 | 10,162 | 3 | (6) | 10,159 |
| U.S. government treasury securities | 1 to 2 | 2,547 | | | 2,547 |
| Securities of government-sponsored entities | 1 to 2 | 29,568 | 3 | (3) | 29,568 |
| Long-term marketable securities | | 42,419 | 6 | (9) | 42,416 |
| Classified as restricted investments: | | | | | |
| U.S. government treasury securities | Less than 2 | 49,894 | 6 | (1) | 49,899 |
| Securities of government-sponsored entities | Less than 2 | 98,684 | 32 | (4) | 98,712 |
| Restricted investments | | 148,578 | 38 | (5) | 148,611 |
| Total marketable securities at September 30, 2012 | | $ 325,868 | $ 74 | $ (16) | $ 325,926 |

| | Contractual Maturity (in Years) | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|---|
| December 31, 2011: | | | | | |
| Classified as current assets: | | | | | |
| Certificates of deposit | Less than 1 | $ 526 | $ | $ | $ 526 |
| Corporate notes | Less than 1 | 21,153 | 16 | (1) | 21,168 |
| Commercial paper | Less than 1 | 5,000 | | | 5,000 |
| U.S. government treasury securities | Less than 1 | 32,131 | 11 | | 32,142 |
| Securities of government-sponsored entities | Less than 1 | 87,353 | 39 | | 87,392 |
| Short-term marketable securities | | 146,163 | 66 | (1) | 146,228 |
| Classified as non-current assets: | | | | | |
| Securities of government-sponsored entities | 1 to 2 | 32,502 | 5 | (4) | 32,503 |
| Long-term marketable securities | | 32,502 | 5 | (4) | 32,503 |
| Classified as restricted investments: | | | | | |
| U.S. government treasury securities | Less than 2 | 12,017 | 9 | | 12,026 |
| Securities of government-sponsored entities | Less than 2 | 50,880 | 27 | (1) | 50,906 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Restricted investments | 62,897 | | 36 | | (1) | 62,932 |
| Total marketable securities at December 31, 2011 | $ 241,562 | $ | 107 | $ | (6) | $ 241,663 |

As of September 30, 2012, the Company had no significant investment positions that were in an unrealized loss position. The Company reviews its investments to identify and evaluate investments that have an indication of possible other-than-temporary impairment. Factors considered in determining whether a loss is other-than-temporary include the length of time and extent to which fair value has been less than the cost basis, the financial condition and near-term prospects of the investee, and the Company s intent and ability to hold the investment for a period of time sufficient to allow for any anticipated recovery in market value. The Company maintains an investment portfolio of various holdings, types and maturities. The Company does not hold derivative financial investments. The Company places its cash investments in instruments that meet high credit quality standards, as specified in its investment policy guidelines. These guidelines also limit the amount of credit exposure to any one issue, issuer or type of instrument.

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The Company measures certain assets and liabilities in accordance with authoritative guidance which requires fair value measurements be classified and disclosed in one of the following three categories:

Level 1: Quoted prices (unadjusted) in active markets that are accessible at the measurement date for assets or liabilities.

Level 2: Observable prices that are based on inputs not quoted on active markets, but corroborated by market data.

Level 3: Unobservable inputs are used when little or no market data is available.

Assets and liabilities are classified based on the lowest level of input that is significant to the fair value measurements. The Company reviews the fair value hierarchy classification on a quarterly basis. Changes in the ability to observe valuation inputs may result in a reclassification of levels for certain securities within the fair value hierarchy. The Company did not have any transfers of assets and liabilities between Level 1 and Level 2 and no transfers to or from Level 3 of the fair value measurement hierarchy during the three and nine months ended September 30, 2012 and 2011, respectively.

The fair values of the Company s assets and liabilities, which are measured at fair value on a recurring basis, were determined using the following inputs (*in thousands*):

| | Total | Quoted Price in Active Market (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---|---|---|---|
| September 30, 2012: | | | | |
| Cash Equivalents, Marketable Securities and Restricted Investments: | | | | |
| Money market funds | $ 71,077 | $ 71,077 | $ | $ |
| Certificates of deposit | 1,441 | 1,441 | | |
| Corporate notes | 37,942 | | 37,942 | |
| Commercial paper | 14,987 | | 14,987 | |
| U.S government treasury securities | 57,456 | 57,456 | | |
| Securities of government-sponsored entities | 214,100 | | 214,100 | |
| Total cash equivalents, marketable securities and restricted investments | $ 397,003 | $ 129,974 | $ 267,029 | $ |
| Contingent Consideration: | | | | |
| Acquisition-related liabilities, current | $ (32,389) | $ | $ | $ (32,389) |
| Acquisition-related liabilities, non-current | (1,029) | | | (1,029) |
| Total contingent consideration | $ (33,418) | $ | $ | $ (33,418) |
| December 31, 2011: | | | | |
| Cash Equivalents, Marketable Securities and Restricted Investments: | | | | |
| Money market funds | $ 121,666 | $ 121,666 | $ | $ |
| Certificates of deposit | 526 | 526 | | |
| Corporate notes | 21,168 | | 21,168 | |
| Commercial paper | 5,000 | | 5,000 | |
| U.S government treasury securities | 44,168 | 44,168 | | |
| Securities of government-sponsored entities | 170,801 | | 170,801 | |
| Total cash equivalents, marketable securities and restricted investments | $ 363,329 | $ 166,360 | $ 196,969 | $ |

| | | | | |
|---|---|---|---|---|
| Contingent Consideration: | | | | |
| Acquisition-related liabilities | $ (32,221) | $ | $ | $ (32,221) |

The carrying amounts of financial instruments such as cash equivalents, accounts receivable, prepaid expenses, other current assets, accounts payable, accrued expenses, and other current liabilities approximate the related fair values due to the short-term maturities of these instruments. The estimated fair value of the Company s capital lease obligations approximated their carrying values as of September 30, 2012. The fair and carrying value of the Company s Senior Convertible Notes is discussed in Note 8.

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***Contingent Consideration Liability***

In connection with the acquisition of Cervitech®, Inc. (Cervitech) in May 2009, the Company is required to pay an additional amount not to exceed $33.0 million in the event that the PCM® cervical total disc replacement device receives U.S. Food and Drug Administration approval. The fair value of the contingent consideration is determined using a probability-weighted discounted cash flow model, the significant inputs of which are not observable in the market. The key assumptions in applying this approach are the interest rate, the timing of expected approval and the probability assigned to the milestone being achieved. Based on the expected timing of the milestone being achieved, the estimated fair value of the contingent consideration was $32.4 million and $31.7 million at September 30, 2012 and December 31, 2011, respectively. Changes in fair value are recorded in the condensed consolidated statements of operations as sales, marketing and administrative expenses.

In connection with an immaterial acquisition during the three months ended September 30, 2012, the Company is required to pay an amount not to exceed 2.0 million in the event two specified revenue-based milestones are met. The fair value of the contingent consideration was determined using a discounted cash flow model, the significant inputs of which are not observable in the market. The key assumptions in applying this approach are the revenue projections, the interest rate and the probabilities assigned to the milestones being achieved. Based on these assumptions, the estimated fair value of the contingent consideration totaled $1.0 million at September 30, 2012 and is included in other long-term liabilities in the September 30, 2012 condensed consolidated balance sheet. Changes in fair value are recorded in the condensed consolidated statements of operations as sales, marketing and administrative expenses.

In addition, during the nine months ended September 30, 2012 and 2011, the Company settled approximately $1.8 million and $0.5 million, respectively, related to contingent consideration recorded in connection with an immaterial acquisition which occurred in 2010.

***Derivative Financial Instruments***

In June 2011, the Company issued $402.5 million principal amount of 2.75% Senior Convertible Notes due 2017 (the 2017 Notes). Prior to September 28, 2011, the 2017 Notes could only be settled in cash. On September 28, 2011, stockholder approval was obtained to increase the number of the Company s authorized shares of common stock from 70 million to 120 million. Prior to obtaining stockholder approval, in accordance with authoritative guidance, the cash conversion feature of the 2017 Notes (the 2017 Notes Embedded Conversion Derivative) required bifurcation from the 2017 Notes and was accounted for as a derivative liability.

In connection with the issuance of the 2017 Notes, the Company entered into convertible note hedge transactions (the 2017 Hedge) entitling the Company to purchase up to 9,553,096 shares of the Company s common stock at an initial stock price of $42.13 per share, each of which is subject to adjustment. Prior to obtaining the stockholder approval to increase the number of the Company s authorized shares of common stock discussed above, the 2017 Hedge could only be settled in cash. In accordance with authoritative guidance, the 2017 Hedge was accounted for as a derivative asset.

Prior to their reclassification to stockholders equity on September 28, 2011, the 2017 Hedge and the 2017 Notes Embedded Conversion Derivative were classified as Level 3 because these assets and liabilities were not actively traded and were valued using significant unobservable inputs. Significant inputs to these models were the Company s stock price, risk free interest rate, credit rating, bond yield, and expected volatility of the Company s stock price. During the three and nine months ended September 30, 2011, the Company recognized non-cash income of approximately $2.4 million related to the net change in the fair values of the derivative liability and asset. This $2.4 million consists of a $39.5 million gain related to the change in the fair value of the derivative liability and a loss of $37.1 million related to the change in fair value of the derivative asset. Gains and losses were recorded in the statement of operations as other income, net.

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The following table sets forth the changes in the estimated fair value for the Company s assets and liabilities measured on a recurring basis using significant unobservable inputs (Level 3) (*in thousands*):

| | Three Months Ended September 30, 2012 | Three Months Ended September 30, 2011 | Nine Months Ended September 30, 2012 | Nine Months Ended September 30, 2011 |
|---|---|---|---|---|
| Assets: | | | | |
| Fair value measurement at beginning of period | $ | $ 80,098 | $ | $ |
| Derivative asset purchased | | | | 80,098 |
| Change in fair value measurement included in operating expenses and other income (expense) | | (37,124) | | (37,124) |
| Derivative asset reclassified to stockholders equity | | (42,974) | | (42,974) |
| Fair value measurement at end of period | $ | $ | $ | $ |
| Liabilities: | | | | |
| Fair value measurement at beginning of period | $ 32,290 | $ 122,855 | $ 32,221 | $ 33,041 |
| Derivative liability recorded in connection with 2017 Notes | | | | 88,900 |
| Contingent consideration liability recorded upon acquisition | 1,019 | | 1,019 | |
| Change in fair value measurement included in operating expenses and other income (expense) | 109 | (39,837) | 708 | (38,923) |
| Derivative liability reclassified to stockholders equity | | (49,390) | | (49,390) |
| Contingent consideration settled | | (1,800) | (530) | (1,800) |
| Fair value measurement at end of period | $ 33,418 | $ 31,828 | $ 33,418 | $ 31,828 |

***7. Goodwill and Intangible Assets***

Goodwill and intangible assets as of September 30, 2012 consisted of the following *(in thousands, except years*):

| | Weighted-Average Amortization Period (in years) | Gross Amount | Accumulated Amortization | Intangible Assets, net |
|---|---|---|---|---|
| **Intangible Assets Subject to Amortization:** | | | | |
| Purchased technology: | | | | |
| Developed technology | 11 | $ 38,178 | $ (13,594) | $ 24,584 |
| Manufacturing know-how and trade secrets | 12 | 21,685 | (7,530) | 14,155 |
| Trade name and trademarks | 11 | 9,450 | (2,088) | 7,362 |
| Customer relationships | 9 | 39,321 | (8,176) | 31,145 |
| | 11 | $ 108,634 | $ (31,388) | $ 77,246 |
| **Intangible Assets Not Subject to Amortization:** | | | | |
| In-process research and development | | | | 27,840 |
| Goodwill | | | | 162,333 |
| Total intangible assets, net | | | | $ 267,419 |

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Goodwill and intangible assets as of December 31, 2011 consisted of the following *(in thousands, except years)*:

| | Weighted-Average Amortization Period (in years) | Gross Amount | Accumulated Amortization | Intangible Assets, net |
|---|---|---|---|---|
| **Intangible Assets Subject to Amortization:** | | | | |
| Purchased technology: | | | | |
| Developed technology | 11 | $ 37,535 | $ (10,589) | $ 26,946 |
| Manufacturing know-how and trade secrets | 12 | 21,389 | (6,007) | 15,382 |
| Trade name and trademarks | 12 | 6,700 | (1,449) | 5,251 |
| Customer relationships | 9 | 37,234 | (4,513) | 32,721 |
| | 11 | $ 102,858 | $ (22,558) | $ 80,300 |
| **Intangible Assets Not Subject to Amortization:** | | | | |
| In-process research and development | | | | 27,840 |
| Goodwill | | | | 159,349 |
| Total intangible assets, net | | | | $ 267,489 |

Total expense related to the amortization of intangible assets was $3.1 million and $1.5 million for the three months ended September 30, 2012 and 2011, respectively and $8.8 million and $4.2 million for the nine months ended September 30, 2012 and 2011, respectively. In-process research and development will be amortized beginning on the regulatory approval date of the respective acquired products and will be amortized over the estimated useful life determined at that time.

Total future amortization expense related to intangible assets subject to amortization at September 30, 2012 is set forth in the table below *(in thousands)*:

| | |
|---|---|
| Remaining 2012 | $ 3,254 |
| 2013 | 12,974 |
| 2014 | 10,649 |
| 2015 | 10,122 |
| 2016 | 9,730 |
| 2017 | 7,387 |
| Thereafter through 2026 | 23,130 |
| Total future amortization expense | $ 77,246 |

***8. Senior Convertible Notes***

The carrying values of the Company s Senior Convertible Notes are as follows (*in thousands*):

| | September 30, 2012 | December 31, 2011 |
|---|---|---|
| 2.75% Senior Convertible Notes due 2017: | | |
| Principal amount | $ 402,500 | $ 402,500 |

| | | |
|---|---|---|
| Unamortized debt discount | (73,357) | (82,792) |
| | 329,143 | 319,708 |
| 2.25% Senior Convertible Notes due 2013 | 74,311 | 74,311 |
| Total Senior Convertible Notes | $ 403,454 | $ 394,019 |

***2.75% Senior Convertible Notes due 2017***

In June 2011, the Company issued $402.5 million principal amount of the 2017 Notes, which includes the issuance of $52.5 million principal amount for the exercise of the initial purchasers option to purchase additional notes. The net proceeds from the offering, after deducting initial purchasers discounts and costs directly related to the offering, were approximately $359.2 million. The 2017 Notes have a stated interest rate of 2.75% and mature on July 1, 2017. Prior to September 28, 2011, the date on which stockholder approval to increase the number of the Company s authorized shares of common stock from 70 million to 120 million was obtained, the 2017 Notes could only be settled in cash. Subsequent to the receipt of this approval, the 2017 Notes may be settled in cash, stock, or a combination thereof, solely at the Company s election. It is the Company s current intent and policy to settle all conversions through combination settlement, which involves repayment of an amount of cash equal to the principal amount and any excess of the conversion value over the principal amount in shares of common stock. The initial conversion rate of the 2017 Notes is 23.7344 shares per $1,000 principal amount, subject to adjustment (which represents an initial conversion price of approximately $42.13 per share).

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Interest on the 2017 Notes began accruing in June 2011 and is payable semi-annually each January 1st and July 1st, beginning January 1, 2012. The fair value, based on inputs quoted on active markets, or Level 1 inputs, of the outstanding 2017 Notes at September 30, 2012 is approximately $383.9 million.

Prior to January 1, 2017, holders may convert their notes only under the following conditions: a) During any calendar quarter beginning October 1, 2011, if the reported sale price of the Company s common stock for at least 20 days of 30 consecutive trading days ending on the last trading day of the immediately preceding calendar quarter is greater than 130% of the conversion price on each applicable trading day; b) During the five business day period in which the trading price of the 2017 Notes falls below 98% of the product of (i) the last reported sale price of the Company s common stock and (ii) the conversion rate on that date; and c) Upon the occurrence of specified corporate events, as defined in the 2017 Notes. From January 1, 2017 and until the close of business on the second scheduled trading day immediately preceding the July 1, 2017, holders may convert their 2017 Notes at any time, regardless of the foregoing circumstances. The Company may not redeem the 2017 Notes prior to maturity. As of September 30, 2012, the if-converted value of the 2017 Notes did not exceed its principal amount and none of the conditions allowing holders of the 2017 Notes to convert had been met.

Other than restrictions relating to certain fundamental changes and consolidations, mergers or asset sales and customary anti-dilution adjustments, the 2017 Notes do not contain any financial covenants and do not restrict the Company from paying dividends or issuing or repurchasing any of its other securities.

In accordance with authoritative guidance, the 2017 Notes Embedded Conversion Derivative required bifurcation from the 2017 Notes and was initially accounted for as a derivative liability. The fair value of the 2017 Notes Embedded Conversion Derivative at the time of issuance of the 2017 Notes was $88.9 million, and was recorded as the original debt discount for purposes of accounting for the debt component of the 2017 Notes. On September 28, 2011, upon obtaining stockholder approval of the additional authorized shares of the Company s common stock, in accordance with authoritative literature, the derivative liability was marked to fair value and reclassified to stockholders equity. The original debt discount is being recognized as interest expense using an effective interest rate of 8.0% over the term of the 2017 Notes. At September 30, 2012, the net carrying value of the equity component is $49.3 million.

The interest expense recognized on the 2017 Notes during the three months ended September 30, 2012 includes $2.8 million and $3.2 million for the contractual coupon interest and the accretion of the debt discount, respectively. The interest expense recognized on the 2017 Notes during the nine months ended September 30, 2012 includes $8.3 million and $9.4 million for the contractual coupon interest and the accretion of the debt discount, respectively.

In connection with the offering of the 2017 Notes, the Company entered into the 2017 Hedge with the initial purchasers and/or their affiliates (the 2017 Counterparties) entitling the Company to purchase up to 9,553,096 shares of the Company s common stock at an initial stock price of $42.13 per share, each of which is subject to adjustment. Prior to obtaining the stockholder approval to increase the number of the Company s authorized common shares discussed above, the 2017 Hedge could only be settled in cash and was accounted for as a derivative asset. The cost of the 2017 Hedge was $80.1 million. On September 28, 2011, upon obtaining stockholder approval of the additional authorized shares of the Company s common stock, in accordance with authoritative literature, the derivative asset was marked to fair value and reclassified to stockholders equity. The 2017 Hedge expires on July 1, 2017. The 2017 Hedge is expected to reduce the potential equity dilution upon conversion of the 2017 Notes if the daily volume-weighted average price per share of the Company s common stock exceeds the strike price of the 2017 Hedge.

In addition, the Company sold warrants to the 2017 Counterparties to acquire up to 477,654 shares of the Company s Series A Participating Preferred Stock (the 2017 Warrants), at an initial strike price of $988.51 per share, subject to adjustment. Each share of Series A Participating Preferred Stock is initially convertible into 20 shares of the Company s common stock. The 2017 Warrants expire on various dates from September 2017 through January 2018 and may be settled in cash or net shares. The Company received $47.9 million in cash proceeds from the sale of the 2017 Warrants, which has been recorded as an increase in additional paid-in-capital. The 2017 Warrants could have a dilutive effect on the Company s earnings per share to the extent that the price of the Company s common stock during a given measurement period (the quarter or year-to-date period) exceeds the strike price of the 2017 Warrants.

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*2.25% Senior Convertible Notes due 2013*

In March 2008, the Company issued $230.0 million principal amount of 2.25% unsecured Senior Convertible Notes due 2013 (the 2013 Notes), which includes the subsequent exercise of the initial purchasers option to purchase an additional $30.0 million aggregate principal amount of the 2013 Notes. The net proceeds from the offering, after deducting the initial purchasers discounts and costs directly related to the offering, were approximately $208.4 million. At September 30, 2012, approximately $74.3 million of the 2013 Notes original aggregate principal amount of $230.0 million remains outstanding.

The Company pays 2.25% interest per annum on the principal amount of the 2013 Notes, payable semi-annually in arrears in cash on March 15 and September 15 of each year. Any of the 2013 Notes not converted prior to March 15, 2013, the Maturity Date, will be paid in cash. The fair value, based on inputs not quoted on active markets, but corroborated by market data, or Level 2 inputs, of the outstanding 2013 Notes at September 30, 2012 is approximately $74.0 million.

The 2013 Notes are convertible into shares of the Company s common stock, based on an initial conversion rate, subject to adjustment, of 22.3515 shares per $1,000 principal amount of the 2013 Notes (which represents an initial conversion price of approximately $44.74 per share). Holders may convert their 2013 Notes at their option on any day up to and including the second scheduled trading day immediately preceding the Maturity Date. If a fundamental change to the Company s business occurs, as defined in the 2013 Notes, holders of the 2013 Notes have the right to require that the Company repurchase the 2013 Notes, or a portion thereof, at the principal amount plus accrued and unpaid interest.

In connection with the offering of the 2013 Notes, the Company entered into convertible note hedge transactions (the 2013 Hedge) with the initial purchasers and/or their affiliates (the 2013 Counterparties) entitling the Company to purchase up to 5.1 million shares of the Company s common stock at an initial stock price of $44.74 per share, each of which is subject to adjustment. In addition, the Company sold to the 2013 Counterparties warrants to acquire up to 5.1 million shares of the Company s common stock (the 2013 Warrants), at an initial strike price of $49.13 per share, subject to adjustment. The cost of the 2013 Hedge that was not covered by the proceeds from the sale of the 2013 Warrants was approximately $14.0 million and was recorded as a reduction of additional paid-in capital as of December 31, 2008. The impact of the 2013 Hedge is to raise the effective conversion price of the 2013 Notes to approximately $49.13 per share (or approximately 20.3542 shares per $1,000 principal amount of the 2013 Notes). The 2013 Hedge is expected to reduce the potential equity dilution upon conversion of the 2013 Notes if the daily volume-weighted average price per share of the Company s common stock exceeds the strike price of the 2013 Hedge. The 2013 Warrants could have a dilutive effect on the Company s earnings per share to the extent that the price of the Company s common stock during a given measurement period (the quarter or year to date period) exceeds the strike price of the 2013 Warrants.

*9. Net Income (Loss) Per Share*

The Company computes basic net income (loss) per share using the weighted-average number of common shares outstanding during the period. Diluted net income (loss) per share assumes the conversion, exercise or issuance of all potential common stock equivalents, unless the effect of inclusion would be anti-dilutive. For purposes of this calculation, common stock equivalents include the Company s stock options, unvested restricted stock units (RSUs), unvested performance-based restricted stock units (PRSUs), warrants, and the shares to be issued upon the conversion of the Senior Convertible Notes. No shares related to the assumed conversion of the Senior Convertible Notes were included in the diluted net income (loss) calculation for the three and nine months ended September 30, 2012 and 2011 because the inclusion of such shares would have had an anti-dilutive effect. The shares to be issued upon exercise of all outstanding warrants were excluded from the diluted net income (loss) calculation for the three and nine months ended September 30, 2012 and 2011 because the inclusion of such shares would have had an anti-dilutive effect.

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The following table sets forth the computation of basic and diluted earnings per share *(in thousands, except per share data)*:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Numerator: | | | | |
| Net income (loss) attributable to NuVasive, Inc. | $ 2,354 | $ (67,552) | $ 5,890 | $ (59,813) |
| Denominator for basic and diluted net income (loss) per share: | | | | |
| Weighted average common shares outstanding for basic | 43,488 | 39,892 | 43,227 | 39,766 |
| Dilutive potential common stock outstanding: | | | | |
| Stock options and Employee Stock Purchase Plan (ESPP) | 317 | | 215 | |
| RSUs and PRSUs | 930 | | 709 | |
| Weighted average common shares outstanding for diluted | 44,735 | 39,892 | 44,151 | 39,766 |
| Basic net income (loss) per share attributable to NuVasive, Inc. | $ 0.05 | $ (1.69) | $ 0.14 | $ (1.50) |
| Diluted net income (loss) per share attributable to NuVasive, Inc. | $ 0.05 | $ (1.69) | $ 0.13 | $ (1.50) |

The following weighted outstanding common stock equivalents were not included in the calculation of net income (loss) per diluted share because their effects were anti-dilutive *(in thousands)*:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Stock options and RSUs | 5,921 | 6,223 | 6,047 | 6,076 |
| Warrants | 14,694 | 5,141 | 14,694 | 5,141 |
| Senior Convertible Notes | 11,214 | 13,172 | 11,214 | 7,917 |
| Total | 31,829 | 24,536 | 31,955 | 19,134 |

***10. Stock-Based Compensation***

The Company estimates the fair value of stock options and shares issued to employees under the ESPP using a Black-Scholes option-pricing model on the date of grant. The fair value of RSUs and PRSUs is based on the stock price on the date of grant. The fair value of equity instruments that are expected to vest are recognized and amortized on an accelerated basis over the requisite service period.

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The weighted-average assumptions used to estimate the fair value of stock options granted and stock purchase rights under the ESPP are as follows:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| **Stock Options** | | | | |
| Volatility | | 49% | | 49% |
| Expected term (years) | | 5.0 | | 5.3 |
| Risk free interest rate | | 1.8% | | 2.1% |
| Expected dividend yield | | 0.0% | | 0.0% |
| **ESPP** | | | | |
| Volatility | 55% | 55% | 55% | 58% |
| Expected term (years) | 1.6 | 1.4 | 1.5 | 1.2 |
| Risk free interest rate | 0.2% | 0.3% | 0.2% | 0.2% |
| Expected dividend yield | 0.0% | 0.0% | 0.0% | 0.0% |

The Company did not issue any stock options during the three or nine months ended September 30, 2012.

The Company issued 6,000 and 38,000 shares of common stock upon exercise of stock options during the three and nine months ended September 30, 2012, respectively, and issued 204,000 shares of common stock upon exercise of stock options during the year ended December 31, 2011. The Company issued 58,000 and 308,000 shares of common stock upon the vesting of RSUs during the three and nine months ended September 30, 2012, respectively, and issued 158,000 shares of common stock upon the vesting of RSUs during the year ended December 31, 2011.

***Performance-Based Restricted Stock Units***

In February 2012, the Compensation Committee of the Board of Directors (the Compensation Committee) granted PRSUs to certain senior Company executives that are earned based on the achievement of pre-defined Company-specific performance criteria (Performance Conditions) for the year ended December 31, 2012. Each recipient is eligible to receive between zero and 250% of the target number of shares of Company common stock subject to the applicable award based on the Company s actual performance in 2012 as measured against the Performance Conditions.

In the first quarter of 2013, the Compensation Committee will determine the number of PRSUs, if any, that will be issued to the recipients based on actual performance in 2012. The PRSUs that are issued in the first quarter of 2013 pursuant to the terms of the applicable award agreements will vest one-third on March 1, 2013, one-third on March 1, 2014 and one-third on March 1, 2015, so long as the recipient is employed by the Company on each such date.

A summary of the Company s PRSUs award activity for the nine months ended September 30, 2012 is as follows:

| | Number of Shares | Maximum Shares Eligible to Be Issued | Average Grant-Date Fair Value |
|---|---|---|---|
| Outstanding at December 31, 2011 | | | $ |
| Awarded | 314,167 | 785,418 | 15.61 |
| Outstanding at September 30, 2012 | 314,167 | 785, | |