Adamas Pharmaceuticals Inc
Form 10-Q
November 04, 2014
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

---

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

For the quarterly period ended September 30, 2014

or

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

For the transition period from to

Commission File No. 001-36399

ADAMAS PHARMACEUTICALS, INC.

(Exact name of registrant as specified in its charter)

Delaware	**42-1560076**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
2200 Powell Street, Suite 220 Emeryville, CA	**94608**
(Address of Principal Executive Offices)	(Zip Code)

(510) 450-3500

(Registrant s Telephone Number, Including Area Code)

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

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

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

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

Number of shares outstanding of the issuer s common stock, par value $0.001 per share, as of October 30, 2014 was 17,125,780.

Table of Contents

Adamas Pharmaceuticals, Inc.

INDEX

In this report, unless otherwise stated or the context otherwise indicates, references to the company, Adamas, we, us and our refer to Adamas Pharmaceuticals, Inc.

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Adamas Pharmaceuticals, Inc.

Unaudited Condensed Consolidated Balance Sheets

(in thousands, except share and per share data)

	September 30, 2014	December 31, 2013
Assets		
Current assets		
Cash and cash equivalents	$ 137,526	$ 85,612
Accounts receivable	120	129
Prepaid expenses and other current assets	1,284	267
Total current assets	138,930	86,008
Property and equipment, net	443	199
Other assets	70	9
Total assets	$ 139,443	$ 86,216
Liabilities, convertible preferred stock and stockholders equity		
Current liabilities		
Accounts payable	$ 3,033	$ 2,097
Accrued liabilities	3,517	2,119
Other current liabilities	146	2
Total current liabilities	6,696	4,218
Warrant liability		6,232
Non-current liabilities		12
Total liabilities	6,696	10,462
Commitments and Contingencies (Note 6)		
Convertible preferred stock, $0.001 par value - 5,000,000 shares and 6,700,000 authorized at September 30, 2014 and December 31, 2013, and zero and 4,719,174 shares issued and outstanding at September 30, 2014 and December 31, 2013, respectively; zero and $77,433 liquidation preference at September 30, 2014 and December 31,2013, respectively		19,149
Stockholders equity		
Common stock, $0.001 par value - 100,000,000 shares authorized, 16,971,385 and 9,515,528 shares issued and outstanding at September 30, 2014 and December 31, 2013, respectively	22	14
Additional paid-in capital	152,805	77,163
Accumulated deficit	(20,080)	(20,572)
Total stockholders equity	132,747	56,605
Total liabilities, convertible preferred stock and stockholders equity	$ 139,443	$ 86,216

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

Table of Contents

Adamas Pharmaceuticals, Inc.

Unaudited Condensed Consolidated Statements of Operations and Comprehensive Income

(in thousands, except per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Revenue	$ 215	$ 161	$ 25,545	$ 30,985
Operating expenses				
Research and development	5,412	1,387	13,343	5,037
General and administrative	4,353	1,571	10,724	4,054
Total operating expenses	9,765	2,958	24,067	9,091
Income (loss) from operations	(9,550)	(2,797)	1,478	21,894
Interest and other income (expense), net	(1)	(426)	(801)	(1,414)
Income (loss) before income taxes	(9,551)	(3,223)	677	20,480
Income tax expense	(6)	(216)	(185)	(503)
Net income (loss)	$ (9,557)	$ (3,439)	$ 492	$ 19,977
Net income (loss) attributable to common stockholders				
Basic	$ (9,557)	$ (3,439)	$ 53	$ 12,630
Diluted	$ (9,557)	$ (3,439)	$ 54	$ 13,294
Net income (loss) per share attributable to common stockholders				
Basic	$ (0.57)	$ (0.36)	$ 0.00	$ 1.33
Diluted	$ (0.57)	$ (0.36)	$ 0.00	$ 1.19
Weighted average number of shares used in computing net income (loss) attributable to common stockholders				
Basic	16,787	9,510	13,998	9,506
Diluted	16,787	9,510	16,769	11,194

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

Table of Contents

Adamas Pharmaceuticals, Inc.

Unaudited Consolidated Statements of Cash Flows

(in thousands)

	Nine Months Ended September 30,	
	2014	**2013**
Cash flows from operating activities		
Net income	$ 492	$ 19,977
Adjustments to reconcile net income to net cash used in operating activities		
Depreciation and amortization	99	43
Stock-based compensation	4,907	386
Change in preferred stock warrant value	983	1,073
Provision for employee notes receivable		1
Issuance of common stock and vesting of restricted common stock for services received		75
Write-off of fixed assets	80	
Changes in assets and liabilities		
Prepaid expenses and other assets	(1,077)	(364)
Accounts receivable	9	774
Accounts payable	936	(1,933)
Accrued liabilities and other liabilities	811	(193)
Deferred revenue		(29,611)
Net cash provided by (used in) operating activities	7,240	(9,772)
Cash flows from investing activities		
Purchase of property and equipment	(194)	(162)
Net cash used in investing activities	(194)	(162)
Cash flows from financing activities		
Proceeds from public offering of common stock, net of underwriters discount	45,851	
Payment of public offering costs	(3,219)	
Proceeds from issuance of common stock upon exercise of stock options	250	25
Proceeds from issuance of common and preferred stock upon exercise of warrants	1,986	
Principal payments on convertible promissory notes		(4,000)
Net cash provided by (used in) financing activities	44,868	(3,975)
Net increase (decrease) in cash and cash equivalents	51,914	(13,909)
Cash and cash equivalents at beginning of period	85,612	62,957
Cash and cash equivalents at end of period	$ 137,526	$ 49,048
Supplemental disclosure of noncash items		
Accrued capital expenditures	$ 229	$
Liability assumed in noncash stock transaction	$ 341	$

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

Table of Contents

Adamas Pharmaceuticals, Inc.

Notes to Condensed Consolidated Financial Statements

1. The Company

Adamas Pharmaceuticals, Inc. (the Company) is a specialty pharmaceutical company focused on the development and commercialization of therapeutics targeting chronic disorders of the central nervous systems (CNS). The Company achieves this by enhancing the pharmacokinetic profiles of proven drugs to create novel therapeutics for use alone and in fixed-dose combination products. The Company is developing its lead wholly owned product candidate, ADS-5102, for a complication of Parkinson s disease known as levodopa induced dyskinesia (LID) and is evaluating other potential CNS indications for which ADS-5102 may have applicability, including hyperkinetic and hypokinetic movement disorders. The Company successfully completed a Phase 2/3 clinical study in LID in 2013 and has initiated two Phase 3 registration trials and a separate open-label safety study in 2014 in support of the LID indication. Its late-stage therapeutics portfolio also includes an NDA-submitted product candidate, MDX-8704, being co-developed with Forest Laboratories, Inc. (Forest), a subsidiary of Actavis plc, (Actavis), and an approved product, Namenda XR®, which Forest developed and is marketing in the United States under a license from the Company.

The Company was incorporated in the State of Delaware on November 15, 2000. The Company s headquarters and operations are located in Emeryville, California. The Company has two subsidiaries: Adamas Pharmaceuticals Asia Pte Limited (inactive) and Adamas India Pharmaceuticals Private Limited, which ceased operations in August 2013.

Initial Public Offering

In April 2014, the Company issued and sold 3,000,000 shares of its common stock in its initial public offering (IPO) at a public offering price of $16.00 per share, for net proceeds of approximately $41.4 million after deducting underwriting discounts and commissions of approximately $3.4 million and expenses of approximately $3.2 million. In May 2014, the Company issued and sold 81,371 shares of its common stock pursuant to the underwriters partial exercise of their option to purchase additional shares, for net proceeds of approximately $1.2 million after deducting underwriting discounts and commissions of approximately $91,000. Upon the closing of the IPO, all shares of convertible preferred stock then outstanding converted into an aggregate of 4,003,225 shares of common stock. In addition, all of the Company s convertible preferred stock warrants outstanding at the close of the IPO were converted into common stock.

2. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (U.S. GAAP), and following the requirements of the Securities and Exchange Commission (SEC) for interim reporting. As permitted under those rules, certain footnotes or other financial information that are normally required by U.S. GAAP can be condensed or omitted. These financial statements have been prepared on the same basis as the Company s annual financial statements and, in the opinion of management, reflect all adjustments, consisting only of normal recurring adjustments that are necessary for a fair statement of the Company s financial information. The results of operations for the three and nine months ended September 30, 2014 are not necessarily indicative of the results to be expected for the year ending December 31, 2014 or any future interim period. The condensed consolidated balance sheet as of December 31, 2013 has been derived from audited financial statements at that date but does not include all of the information required by U.S. GAAP for complete financial statements. Accordingly, the unaudited condensed consolidated financial statements and related financial information should be read in conjunction with the audited financial statements and the related notes thereto for the year ended December 31, 2013 included in the Company s prospectus (Registration No. 333-194342) filed pursuant to Rule 424(b) on April 10, 2014 with the U.S. Securities and Exchange Commission.

Table of Contents

Forward Stock Split

In March 2014, the Board of Directors of the Company and stockholders approved a forward stock split of the Company s common and preferred stock. As a result, common and preferred stock, stock options and warrants to purchase common and preferred stock were adjusted in the ratio of 2:1, effective March 24, 2014. All common and preferred shares and per share amounts presented in these condensed consolidated financial statements for all periods have been retroactively adjusted to reflect the 2-for-1 forward stock split. No fractional shares were issued.

Use of Estimates

The preparation of condensed consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities and the reported amounts of revenues and expenses in the condensed consolidated financial statements and the accompanying notes. On an ongoing basis, management evaluates its estimates, including those related to revenue recognition, clinical trial accruals, fair value of assets and liabilities, income taxes and stock-based compensation. Management bases its estimates on historical experience and on various other market-specific and relevant assumptions that management believes to be reasonable under the circumstances. Actual results may differ from those estimates.

Cash and Cash Equivalents

The Company considers all highly liquid investments purchased with an original maturity of three months or less at time of purchase to be cash equivalents.

Revenue Recognition

The Company recognizes revenue when all four of the following criteria have been met: (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred or services have been rendered, (iii) the fee is fixed or determinable and (iv) collectability is reasonably assured. Revenue under license and collaboration arrangements is recognized based on the performance requirements of the contract. Determinations of whether persuasive evidence of an arrangement exists and whether delivery has occurred or services have been rendered are based on management s judgments regarding the fixed nature of the fees charged for deliverables and the collectability of those fees. Should changes in conditions cause management to determine that these criteria are not met for any new or modified transactions, revenue recognized could be adversely affected.

The Company generates revenue from collaboration and license agreements for the development and commercialization of products. Collaboration and license agreements may include non-refundable upfront license fees, partial or complete reimbursement of research and development costs, contingent consideration payments based on the achievement of defined collaboration objectives and royalties on sales of commercialized products. The Company s performance obligations under the collaborations may include the license or transfer of intellectual property rights, obligations to provide research and development services and related materials and obligations to participate on certain development and/or commercialization committees with the collaborators.

On January 1, 2011, the Company adopted an accounting standards update that amends the guidance on accounting for new arrangements, or those materially modified, with multiple deliverables. This guidance eliminates the requirement for objective and reliable evidence of fair value of the undelivered items in order to consider a deliverable a separate unit of accounting. It also changes the allocation method such that the relative-selling-price method must be used to allocate arrangement consideration to the units of accounting in an arrangement. This guidance establishes the following estimation hierarchy that must be used in estimating selling price under the relative-selling-price method: (i) vendor-specific objective evidence of fair value of the deliverable, if it exists, (ii) third-party evidence of selling price, if vendor-specific objective evidence is not available or (iii) vendor s best estimate of selling price, if neither vendor-specific nor third-party evidence is available.

Table of Contents

On January 1, 2011, the Company adopted an accounting standards update that provides guidance on revenue recognition using the milestone method. Payments that are contingent upon achievement of a substantive milestone are recognized in their entirety in the period in which the milestone is achieved. Milestones are defined as events that can only be achieved based on the Company s performance and there is substantive uncertainty about whether the event will be achieved at the inception of the arrangement. Events that are contingent only on the passage of time or only on counterparty performance are not considered milestones subject to this guidance. Further, the amounts received must relate solely to prior performance, be reasonable relative to all of the deliverables and payment terms within the agreement and commensurate with the Company s performance to achieve the milestone after commencement of the agreement.

Amounts related to research and development funding are recognized as the related services or activities are performed, in accordance with the contract terms. Payments may be made to or by the Company based on the number of full-time equivalent researchers assigned to the collaboration project and the related research and development expenses incurred.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to credit risk consist principally of cash and cash equivalents. Substantially all the Company s cash and cash equivalents are held at one financial institution that management believes is of high credit quality. Such deposits generally exceed federally insured limits.

Risk and Uncertainties

The Company s future results of operations involve a number of risks and uncertainties. Factors that could affect the Company s future operating results and cause actual results to vary materially from expectations include, but are not limited to, rapid technological change, uncertainty of results of clinical trials and reaching milestones, uncertainty of market acceptance of the Company s products, competition from substitute products and larger companies, protection of proprietary technology, strategic relationships and dependence on key individuals.

Products developed by the Company require approvals from the U.S. Food and Drug Administration (FDA) or other international regulatory agencies prior to commercial sales. There can be no assurance that the products will receive the necessary approvals. If the Company was denied approval, approval was delayed or the Company was unable to maintain approval, it could have a materially adverse impact on the Company.

The Company has expended and will continue to expend substantial funds to complete the research, development and clinical testing of product candidates. The Company also will be required to expend additional funds to establish commercial-scale manufacturing arrangements and to provide for the marketing and distribution of products that receive regulatory approval. The Company may require additional funds to commercialize its products. The Company is unable to entirely fund these efforts with its current financial resources. Additional funds may not be available on acceptable terms, if at all. If adequate funds are unavailable on a timely basis from operations or additional sources of financing, the Company may have to delay, reduce the scope of or eliminate one or more of its research or development programs which would materially and adversely affect its business, financial condition and operations.

Convertible Preferred Stock

The Company classifies the convertible preferred stock as temporary equity on the balance sheets due to certain change in control events that are outside the Company s control, including liquidation, sale or transfer of the Company, as holders of the convertible preferred stock can cause redemption of the shares. Shares of convertible preferred stock were converted to common stock upon close of the IPO in April 2014.

Table of Contents

Convertible Preferred Stock Warrants

The Company accounts for its convertible preferred stock warrants as a liability based upon the characteristics and provisions of each instrument. Convertible preferred stock warrants classified as a liability are recorded on the Company s balance sheet at their fair value on the date of issuance and are revalued on each subsequent balance sheet, with fair value changes recognized as increases or reductions in the statements of operations. The Company adjusts the liability for changes in fair value of these warrants until the earlier of: (i) exercise of warrants, (ii) expiration of warrants, (iii) a change of control of the Company, or (iv) the closing of the Company s IPO. At those times, the convertible preferred stock warrant liability was adjusted to fair value in the condensed consolidated statements of operations and comprehensive income (loss) and, upon the closing of the Company s IPO in April 2014, with the final fair value reclassified to additional paid-in capital.

Fair Value of Financial Instruments

The carrying value of the Company s cash and cash equivalents, accounts receivable, prepaid expenses and other current assets, other assets, accounts payable, accrued liabilities, and convertible notes payable approximate fair value due to the short-term nature of these items. The convertible preferred stock warrant liability was carried at fair value and was zero as of September 30, 2014.

Foreign Currency Translation

For non U.S. operations, the U.S. dollar is the functional currency. Monetary assets and liabilities of the foreign subsidiary are translated into U.S. dollars at current exchange rates. Nonmonetary assets such as property and equipment are translated at historical rates. Income and expense items are translated at average rates of exchange prevailing during the period of the related transactions, except that depreciation charged to operations is translated at historical rates.

Income Taxes

The Company accounts for income taxes under the asset and liability approach. Under this method, deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to affect taxable income. Valuation allowances are established when necessary to reduce deferred tax assets to the amounts expected to be realized.

The Company assesses all material positions taken in any income tax return, including all significant uncertain positions, in all tax years that are still subject to assessment or challenge by relevant taxing authorities. Assessing an uncertain tax position begins with the initial determination of the position s sustainability and is measured at the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. As of each balance sheet date, unresolved uncertain tax positions must be reassessed, and the Company will determine whether (i) the factors underlying the sustainability assertion have changed and (ii) the amount of the recognized tax benefit is still appropriate. The recognition and measurement of tax benefits requires significant judgment. Judgments concerning the recognition and measurement of a tax

benefit might change as new information becomes available.

Net Income (Loss) Per Share Attributable to Common Stockholders

Basic net loss per common share is calculated by dividing the net loss attributable to common stockholders by the weighted-average number of common shares outstanding during the period, without consideration for potentially dilutive securities. Diluted net loss per share is computed by dividing the net loss attributable to common stockholders by the weighted-average number of common shares and potentially dilutive securities outstanding for the period. For purposes of the diluted net income per share calculation, stock options and convertible preferred stock warrants are considered to be potentially dilutive securities.

Table of Contents

Prior to April 10, 2014 the Company calculated its basic and diluted net income (loss) per share attributable to common stockholders in conformity with the two-class method required for companies with participating securities. Under the two-class method, the Company determines whether it has net income attributable to common stockholders, which includes the results of operations less current period convertible preferred stock non-cumulative dividends. If it is determined that the Company does have net income attributable to common stockholders during a period, the related undistributed earnings are then allocated between common stock and the convertible preferred stock based on the weighted average number of shares outstanding during the period to determine the numerator for the basic net income per share attributable to common stockholders. In computing diluted net income attributable to common stockholders, undistributed earnings are re-allocated to reflect the potential impact of dilutive securities to determine the numerator for the diluted net income per share attributable to common stockholders.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, Revenue from Contracts with Customers . The amendment in this ASU provide guidance on the revenue recognition to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The core principle of this update provides guidance to identify the performance obligations under the contract(s) with a customer and how to allocate the transaction price to the performance obligations in the contract. It further provide guidance to recognize revenue when (or as) the entity satisfies a performance obligation. The Company is evaluating the impact of this standard.

3. Fair Value Measurements

Fair value is defined as the exchange price that would be received for an asset or an exit price paid to transfer a liability in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Valuation techniques used to measure fair value must maximize the use of observable inputs and minimize the use of unobservable inputs.

The fair value hierarchy has three levels that prioritize the inputs used in fair value measurements:

Level 1	Unadjusted quoted prices in active markets for identical assets or liabilities;
Level 2	Inputs other than quoted prices included within Level 1 that are observable, unadjusted quoted prices in markets that are not active, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the related assets or liabilities; and
Level 3	Unobservable inputs that are supported by little or no market activity for the related assets or liabilities.

The categorization of a financial instrument within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

The Company s financial instruments consist of Level 1 assets and Level 3 liabilities. Level 1 securities include highly liquid money market funds. Level 3 liabilities that are measured at fair value on a recurring basis consist of the convertible preferred stock warrant liability.

The following table summarizes, for financial assets and liabilities recorded at fair value, the respective fair value and the classification by level of input within the fair value hierarchy defined above (in thousands):

	Fair Value Measurements at September 30, 2014			
	Total	Level 1	Level 2	Level 3
Assets				
Money market fund	$ 134,693	$ 134,693	$	$

	Fair Value Measurements at December 31, 2013			
	Total	Level 1	Level 2	Level 3
Assets				
Money market fund	$ 83,700	$ 83,700	$	$
Liabilities				
Preferred stock warrant liability	$ 6,232	$	$	$ 6,232

Table of Contents

Upon issuance of the convertible preferred stock warrants, the Company estimates the fair value of the liability and subsequent remeasurement using the option pricing model at each reporting date, using the following inputs: the risk-free interest rates; the expected dividend rates; the remaining expected life of the warrants; and the expected volatility of the price of the underlying stock. The estimates are based, in part, on subjective assumptions and could differ materially in the future.

The following table includes a roll forward of the financial instruments classified within Level 3 of the fair value hierarchy (in thousands):

Fair Value Using Level 3 Inputs	**Amounts**
Balance at December 31, 2012	$ 1,706
Change in fair value recorded in Other (income)/expense, net	4,526
Balance at December 31, 2013	6,232
Change in fair value recorded in Other (income)/expense, net	983
Exercise of warrants	(7,215)
Balance at September 30, 2014	$

4. Collaboration and License Agreements

In November 2012, the Company entered into a license agreement with a wholly owned subsidiary of Forest, which granted Forest an exclusive license with right to sublicense certain of the Company s intellectual property rights in the United States in connection with the development and commercialization of MDX-8704 and marketing of Forest s approved product Namenda XR for the treatment of moderate to severe dementia related to Alzheimer s disease. Pursuant to the agreement, Forest made an upfront payment of $65.0 million. The Company was eligible to receive additional cash payments totaling up to $95.0 million upon achievement by Forest of certain development and regulatory milestones in addition to tiered royalty payments based on future net sales of the product upon commercialization.

The Company identified the following two non-contingent performance deliverables under the license agreement: (i) transfer of intellectual property rights, inclusive of the related technology know-how conveyance (license and know-how or license) and (ii) the obligation to participate on the Joint Development Committee (JDC). The Company concluded that the license and the know-how together represent a single deliverable, and therefore the two together have been accounted for as a single unit of accounting. There was no separate consideration identified in the agreement for the deliverables and there was no right of return under the agreement. The Company considered the provisions of the multiple-element arrangement guidance in determining whether the deliverables outlined above have standalone value. The transfer of license and know-how has standalone value separate from the obligation to participate on the JDC, as the agreement allows Forest to sublicense its rights to the acquired license to a third party. Further, the Company believes that Forest has research and development expertise with compounds similar to those licensed under the agreement and has the ability to engage other third parties to develop these compounds allowing Forest to realize the value of the license and know-how without receiving the JDC participation.

The Company developed its best estimates of selling prices (BESP) for each deliverable in order to allocate the non-contingent arrangement consideration to the two units of accounting. Based on BESP analysis, value assigned to the obligation to participate on the JDC was a negligible amount. Accordingly, the entire upfront license fee of $65.0 million was allocated to the transfer of license and technical know-how. Revenue recognition commenced upon delivery of the license and was recognized on a straight-line basis through the period of the transfer of

the know-how. Forest was able to derive value from the license as the know-how was transferred. A straight-line pattern of revenue recognition is only acceptable when a more precise pattern cannot be discerned. The way in which the transfer of know-how occurred did not give rise to a more precise pattern of recognition and the Company therefore recognized revenue on a straight-line basis over the period of the transfer of the know-how (November 2012 to February 2013).

Table of Contents

In November and December 2013, the Company received a total of $40.0 million in milestone payments under its license agreement with Forest. The milestone payments were for the successful completion of studies that support the planned New Drug Application (NDA) filing with the FDA for MDX-8704 by Forest. In May 2014, the Company received an additional $25.0 million milestone payment under the license agreement. This milestone payment was a result of the FDA s acceptance of the NDA for MDX-8704. These amounts have been recorded as revenue in the condensed consolidated statement of operations and comprehensive income during 2013 and 2014, respectively.

5. Warrants to Purchase Common or Preferred Stock

Common stock warrants

In conjunction with the sale of convertible promissory notes issued in November 2002 and September 2003, the Company issued warrants to purchase 22,220 shares and 88,884 shares, respectively, of the Company s Series A convertible preferred stock. The warrants expire ten years from issuance. The relative fair value of these warrants was determined to be approximately $49,000 and $205,000, respectively, and was amortized to interest expense over the term of each loan. These preferred stock warrants converted to warrants to purchase common stock as part of the Company s recapitalization transaction during 2011. The warrants to purchase 22,220 shares of common stock expired in November 2012 while the warrants to purchase 88,884 shares were scheduled to expire in September 2013, but were subsequently modified to extend their term by one additional year. As such, the Company recorded an additional expense of $52,000. In June 2014, a portion of these warrants were exercised for 3,556 shares of common stock. In September 2014, the remaining warrants were exercised for 85,328 shares of common stock. As of September 30, 2014 and December 31, 2013, warrants to purchase zero and 88,884 shares of common stock were outstanding, respectively.

In conjunction with the convertible promissory notes issued in November 2004, the Company issued warrants to purchase 114,448 shares of common stock at $0.53 per share. The warrants expire on November 26, 2014. The relative fair value of these warrants was determined to be $53,496 and is being amortized to interest expense over the term of the convertible note. To induce payment of the note in cash rather than the holder exercising their conversion option, the warrant holder relinquished the right to purchase 28,616 shares of the Company s common stock provided for under the original warrant. Upon modification of the warrants, the Company recorded a gain of $29,149 during the year ended December 31, 2006 which was equal to the fair market value of the relinquished share purchase right. The gain was recorded in interest and other income and as a reduction in additional paid-in capital. In September 2014, the warrants were exercised for 85,832 shares of common stock. As of September 30, 2014 and December 31, 2013, warrants to purchase zero and 85,832 shares of common stock were outstanding, respectively.

In 2006, the Company issued a warrant to purchase 13,332 shares of common stock at an exercise price of $1.88 per share to a consultant in consideration for the provision of third-party consulting services. The common stock warrant was exercisable for a period of 10 years. The Company recorded $13,000 in additional paid in capital at the time of issuance. In March 2014 the warrant was exercised for 13,332 shares of common stock. As of September 30, 2014 and December 31, 2013, warrants to purchase zero and 13,332 shares of common stock were outstanding, respectively.

In connection with the first two draw-downs pertaining to the 2006 term loan, both made in 2006 for a total of $1.5 million, the Company issued warrants to purchase a total of 13,586 shares of the Company s Series B preferred stock. Using the Black-Scholes model with a volatility of 84%, a term of ten years, and a risk-free interest rate of 4.72%, the fair value of the warrants was determined to be $121,000 and was recorded as warrant liability and discount against the borrowings and is being amortized to interest expense over the term of the loan. These preferred stock warrants converted to warrants to purchase common stock as part of the Company s recapitalization transaction during 2011. In May 2014 the

warrants were exercised for 13,586 shares of common stock. As of September 30, 2014 and December 31, 2013, warrants to purchase zero and 13,586 shares of common stock were outstanding, respectively.

Table of Contents

In connection with the third draw-down pertaining to the 2006 term loan, made in 2007 for $500,000, the Company issued a warrant to purchase 4,528 shares of the Company s Series B preferred stock. Using the Black-Scholes model with a volatility of 73%, a term of ten years, and a risk free interest rate of 4.72%, the fair value of the warrant was determined to be $47,000 and was recorded as warrant liability and discount against the borrowings and is being amortized to interest expense over the term of the loan. This preferred stock warrant converted into a warrant to purchase common stock as part of the Company s recapitalization transaction during 2011. In May 2014 the warrant was exercised for 4,528 shares of common stock. As of September 30, 2014 and December 31, 2013, a warrant to purchase zero and 4,528 shares of common stock was outstanding, respectively.

Convertible preferred stock warrants

In connection with the issuance of convertible promissory notes pursuant to the Note and Warrant Purchase Agreement in April 2011, the Company issued warrants to purchase 55,848 shares of Series AA preferred stock. Using the Black-Scholes model with a volatility of 90%, an expected term of 3 years, and a risk-free interest rate of 0.82%, the fair value of the warrant liability was determined to be $13,000 and was recorded as a debt discount and amortized in 2011. In March 2014 warrants were exercised for 26,284 shares of Series AA preferred stock. In April 2014 and in connection with the IPO, the remaining warrants were exercised for 29,564 of Series AA preferred stock. As of September 30, 2014 and December 31, 2013, warrants to purchase zero and 55,848 shares of Series AA preferred stock were outstanding, respectively.

In connection with the issuance of Series AA preferred stock in June 2011, the Company issued warrants to purchase 462,762 shares of Series AA preferred stock. Using the Black-Scholes model with a volatility of 90%, an expected term of 3 years and a risk-free interest rate of 0.82%, the fair value of the warrant liability was determined to be $65,000 and was recorded as a reduction against the value of Series AA preferred stock. In March 2014 warrants were exercised for 211,012 shares of Series AA preferred stock. In April 2014 and in connection with our IPO, the remaining warrants were exercised for 251,750 shares of Series AA preferred stock. As of September 30, 2014 and December 31, 2013, warrants to purchase zero and 462,762 shares of Series AA preferred stock were outstanding, respectively.

In conjunction with the issuance of convertible promissory notes pursuant to a Series AA Preferred Stock and Secured Note and Warrant Purchase Agreement, or the 2012 Notes, the Company issued warrants to purchase equity securities (the 2012 Warrants). The 2012 Warrants become exercisable on the date the 2012 Notes are converted into the Company s equity securities (or upon cash settlement of the strategic financing put option) and expire on March 22, 2019, or, if there is a Corporate Transaction prior to the date the 2012 Notes are converted, the 2012 Warrants will be automatically net exercised immediately prior to the closing of a Corporate Transaction.

The number and class of shares into which the 2012 Warrants are exercisable were determined as follows:

- *Number of shares*

- If the 2012 Notes convert into shares of the Company s equity securities through the financing put options, then the 2012 Warrants are exercisable into a number of shares equal to: (1) 10% of the principal amount of the 2012 Notes issued to the warrant holder divided by (2) the Conversion Price, which is the greater of (a) $3.81 and (b) 80% of the price paid by subsequent investors.

- Upon a Corporate Transaction or in the event the Company elects to settle the strategic financing put option in cash, then the 2012 warrants are exercisable into a number of shares of Series AA preferred stock equal to: (1) 10% of the principal of the 2012 Notes issued to the warrant holder divided by (2) $3.81.

- *Class of shares*

- If the conversion price is equal to $3.81, the 2012 Warrants become exercisable into shares of Series AA preferred stock.

- If the conversion price is greater than $3.81, the 2012 Warrants convert into the class of equity securities issued through the exercise of the financing put options.

Table of Contents

In order to determine a fair value for the 2012 Warrants upon issuance of the 2012 Notes, the Company evaluated multiple potential outcomes using the option pricing model value depending on the scenario while applying estimated probabilities to each scenario value. These scenarios included potential subsequent financing, strategic financing and corporate transaction at different times during 2012. Accordingly, the Company determined the fair value of the warrants to be $269,000, which was recorded as a convertible preferred stock warrant liability and a debt discount. Upon repayment of the 2012 Notes in 2013, the warrants became exercisable to purchase 104,050 shares of Series AA convertible preferred stock at $3.81 per share.

The Company remeasured the value of its preferred stock warrants at each reporting period and recorded the change in fair value in the condensed consolidated statement of operations and comprehensive income. The Company remeasured the value of their preferred warrants at April 9, 2014 and December 31, 2013 and recorded a change in fair value of $1.8 million and $4.5 million, respectively, in the consolidated statement of operations and comprehensive income under interest and other income (expense), net. In March 2014, warrants were exercised for 22,382 shares of Series AA convertible preferred stock. In April 2014, in connection with our IPO, the remaining warrants were exercised for 81,668 shares of Series AA preferred stock. As of September 30, 2014 and December 31, 2013, warrants to purchase zero and 104,050 shares of Series AA preferred stock were outstanding, respectively.

The following table summarizes the outstanding warrants as of:

	Number of shares outstanding	
	September 30, 2014	December 31, 2013
Series AA convertible preferred stock warrants issued in 2011		518,610
Series AA convertible preferred stock warrants issued in 2012		104,050
Common stock warrants	7,116	213,278

6. Commitments and Contingencies

Lease Commitments

In June 2014, the Company amended its facility lease agreement to increase the square footage to 12,492 square feet for a term of 65 months.

As of September 30, 2014, future minimum lease payments under a non-cancelable facility operating lease were as follows (in thousands):

	September 30, 2014
Remainder of 2014	$ 84
2015	550
2016	599

2017		617
2018 and thereafter		1,456
Total	$	3,306

Contingencies

In the normal course of business, the Company enters into contracts and agreements that contain a variety of representations and warranties and provide for general indemnifications. The Company s exposure under these agreements is unknown because it involves claims that may be made against the Company in the future, but have not yet been made. The Company accrues a liability for such matters when it is probable that future expenditures will be made and such expenditures can be reasonably estimated.

Table of Contents

Indemnification

In accordance with the Company s amended and restated certificate of incorporation and amended and restated bylaws, the Company has indemnification obligations to its officers and directors for certain events or occurrences, subject to certain limits, while they are serving in such capacity. There have been no claims to date and the Company has a directors and officers liability insurance policy that may enable it to recover a portion of any amounts paid for future claims.

Litigation

Several companies have submitted Abbreviated New Drug applications, or ANDAs, to the FDA requesting permission to manufacture and market generic versions of Namenda XR, on which we are entitled to receive royalties from Forest beginning in June 2018. In the notices, these companies allege that the patents associated with Namenda XR, some of which are owned by Forest or licensed by Forest from Merz Pharma GmbH & Co. KGaA and others of which are owned by us and licensed by us exclusively to Forest in the United States, are invalid, unenforceable and/or will not be infringed by the companies manufacture, use, or sale of generic versions of Namenda XR. In January, February, and April 2014, we, Forest, Forest Laboratories Holdings Ltd., Merz Pharma GmbH & Co. KGaA, and Merz Pharmaceuticals GmbH (together Merz) filed lawsuits in the U.S. District Court for the District of Delaware for infringement of the relevant patents against all of these companies. We are seeking judgment that (i) the defendants have infringed the patents at issue, (ii) the effective date of any approval of the defendants ANDAs shall not be earlier than the expiration date of the last to expire of the relevant patents, including any extensions or exclusivities, (iii) the defendants be enjoined from commercially manufacturing, using, offering for sale, or selling in the United States, or importing into the United States, any products that infringe or induce or contribute to the infringement of the patents at issue prior to the expiration date of the last to expire of the patents, including extensions and exclusivities, and (iv) we, Forest, Forest Laboratories Holdings Ltd., and Merz be awarded monetary relief, in addition to any attorneys fees, costs, and expenses relating to the actions. Because these lawsuits were filed within the requisite 45 day period provided in the U.S. Food, Drug and Cosmetic Act, there are stays preventing FDA approval of the ANDAs for 30 months or until a court decision adverse to the patents. The 30 month stays for these ANDAs will begin to expire in June 2016.

In early November 2014, we, Forest, and Merz entered into a Settlement Agreement with Wockhardt Limited, one of the parties sued by us and Forest for infringement of our patents. Pursuant to this agreement, Worckhardt received a non-exclusive license to make and sell its generic versions of Namenda XR starting March 23, 2026, which is two months prior to the expiration of the last to expire of our relevant patents.

From time to time, the Company may be party to legal proceedings, investigations, and claims in the ordinary course of its business. Other than the matters described above, the Company is not presently a party to any material legal proceedings.

7. Convertible Preferred Stock

The Company s amended and restated certificate of incorporation filed on April 15, 2014, authorizes 5,000,000 shares of convertible preferred stock, of which there were zero shares outstanding as of September 30, 2014.

At December 31, 2013, the convertible preferred stock consisted of the following (in thousands except share and per share data):

Series	Shares Authorized	Shares Outstanding	Per Share Liquidation Preference	Carrying Value
Series AA	5,000,000	3,431,620	$ 3.81	$ 6,521
Series AA-1	1,700,000	1,287,554	50.00	12,628
	6,700,000	4,719,174		$ 19,149

Table of Contents

8. Shareholders Equity

Common Stock

The amended and restated certificate of incorporation authorizes the Company to issue 100,000,000 shares of common stock. Common stockholders are entitled to dividends as and when declared by the board of directors, subject to the rights of holders of all classes of stock outstanding having priority rights as to dividends. There have been no dividends declared to date. Each share of common stock is entitled to one vote.

The Company has classified all unvested shares of common stock issued upon the early exercise of stock options as employee deposits (a liability) as these options are not considered to be substantively exercised until vested. At September 30, 2014 and December 31, 2013, 13,000 and zero shares of common stock, respectively, from early exercised options were unvested.

Shares reserved for Future Issuance

Shares of Company s common stock reserved for future issuance are as follows:

	September 30, 2014	December 31, 2013
Conversion of convertible preferred stock		3,432,908
Common stock options outstanding	5,394,880	3,567,858
Common stock options available for grant	1,931,398	1,771,212
Warrants to purchase common stock	7,116	213,290
Warrants to purchase convertible preferred stock		622,660
Total	7,333,394	9,607,928

9. Stock Option Plans

In October 2002 the Company established its 2002 Employee, Director and Consultant Stock Plan (the 2002 Plan) which provides for the granting of stock options to employees and consultants of the Company and issuance of restricted shares of common stock. Options granted under the 2002 Plan could be either incentive stock options (ISOs) or nonqualified stock options (NSOs). ISOs could be granted only to Company employees. NSOs could be granted to Company employees and consultants.

In December 2007 the Company established its 2007 Stock Plan. No further grants will be made under the 2002 Plan. The 2007 Stock Plan provides both for the direct award or sale of shares and for the grant of options to purchase shares. Options granted under the 2007 Stock Plan could either be ISOs or NSOs. ISOs could be granted only to Company employees. NSOs could be granted to Company employees and consultants.

Options granted under the 2007 Stock Plan may have terms of up to ten years. All options issued to date have had a ten year life. The exercise price of an ISO shall not be less than 100% of the estimated fair value of the shares on the date of grant, as determined by the board of directors. The exercise price of an ISO and NSO granted to a 10% shareholder shall not be less than 110% of the estimated fair value of the shares on the date of grant, respectively, as determined by the board of directors. The exercise price of a NSO shall not be less than the par value per share of common stock. The options granted generally vest over five years and vest at a rate of 20% upon the first anniversary of the issuance date and 1/60th per month thereafter.

Table of Contents

In February 2014 the Company s board of directors adopted, and in March 2014 the Company s stockholders approved, the 2014 Equity Incentive Plan (the 2014 Plan), which became effective on the completion of the IPO. No further grants will be made under the 2007 Plan. Under the 2014 Plan 1,993,394 shares of the Company s common stock were made available for issuance, plus an additional number of shares that will be added to the 2014 Plan as of the effective time equal to the sum of (i) all shares that, as of the effective time, were reserved for issuance pursuant to the 2007 Plan, plus (ii) all shares that are subject to outstanding options under the 2007 Plan and the 2002 Plan as of the effective time that thereafter expire, terminate, or otherwise are forfeited or reacquired. The number of shares of the Company s common stock reserved for issuance pursuant to the 2014 Plan will automatically increase on the first day of each fiscal year for a period of up to 10 years, commencing on the first day of the fiscal year following 2014, in an amount equal to 4% of the total number of shares of the Company s capital stock outstanding on the last day of the preceding fiscal year, or a lesser number of shares as determined by our board of directors.

Options granted under the 2014 Stock Plan may have terms of up to ten years. All options issued to date have had a ten year life. The exercise price of an ISO shall not be less than 100% of the estimated fair value of the shares on the date of grant, as determined by the board of directors. The exercise price of an ISO and NSO granted to a 10% shareholder shall not be less than 110% of the estimated fair value of the shares on the date of grant, respectively, as determined by the board of directors. The exercise price of a NSO shall not be less than the par value per share of common stock. The options granted generally vest over four years and vest at a rate of 25% upon the first anniversary of the issuance date and 1/48th per month thereafter.

Under the terms of the 2002 Plan and 2007 Stock Plan, all options are fully exercisable on the grant date, subject to the Company s repurchase right, which under the 2002 Plan is at the original exercise price and under the 2007 Stock Plan is at the lower of original exercise price or fair value. The repurchase rights lapse over the options vesting period of generally five years.

In February 2014, the Company s board of directors adopted and, in March 2014 the Company s stockholders approved, the 2014 Employee Stock Purchase Plan (the ESPP), which became effective on the completion of the Company s IPO. Under the ESPP, an aggregate of 262,762 shares of the Company s common stock are reserved for future grant or issuance.

Activity under the Company s stock option plans is set forth below:

		Outstanding Options		
	Shares Available for Grant	Number of Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value (thousands)
Balances, December 31, 2013	1,771,212	3,567,858	$ 1.45	$ 26,932
Additional shares reserved	2,161,944			
Options granted	(2,222,550)	2,222,550	10.77	
Options exercised		(171,424)	1.73	
Options cancelled	220,792	(224,104)	2.77	
Balances, September 30, 2014	1,931,398	5,394,880	$ 5.22	$ 72,289

The aggregate intrinsic value of options exercised was $2.2 million and $25,000 for the nine months ended September 30, 2014 and 2013, respectively.

Stock-Based Compensation

During the three and nine months ended September 30, 2014, the Company granted stock options to employees to purchase 273,000 and 2,023,000 shares of common stock, respectively, with a weighted-average grant date fair value of $13.48 and $10.60 per share, respectively. During the three and nine months ended September 30, 2013, the Company granted stock options to employees to purchase zero and 73,000 shares of common stock, respectively, with a weighted-average grant date fair value for the nine months ended September 30, 2013, of $2.72 per share. As of September 30, 2014, there was total unrecognized compensation cost of $19.5 million. This cost is expected to be recognized over a period of 4.03 years. The total fair value of employee stock options vested for the three and nine months ended September 30, 2014 was $0.2 million and $0.3 million, respectively. The total fair value of employee stock options vested for the three and nine months ended September 30, 2013 was $74,000 and $0.2 million, respectively.

Table of Contents

Stock-based compensation expense related to employee options for the three and nine months ended September 30, 2014 was $1.2 million and $2.8 million, respectively. Stock-based compensation expense related to employee options for the three and nine months ended September 30, 2013 was $61,000 and $0.2 million, respectively.

The Company estimated the fair value of stock options using the Black-Scholes option pricing model. The fair value of employee stock options is being amortized on a straight-line basis over the requisite service period of the awards.

The fair value of employee stock options was estimated using the following assumptions:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Expected volatility	90% - 91%	89%	90% - 96%	89%
Risk-free interest rate	2.00% - 2.18%	1.45%	2.00% - 2.20%	1.45%
Dividend yield	0%	0%	0%	0%
Contractual life (in years)	6.75	7.25	6.75 - 7.00	7.25

Determining Fair Value of Stock Options

The fair value of each grant of stock options was determined by the Company using the methods and assumptions discussed below. Each of these inputs is subjective and generally requires significant judgment to determine.

Weighted-Average Expected Term: The expected term of options granted is determined using the average period the stock options are expected to remain outstanding and is based on the options vesting term, contractual terms and historical exercise and vesting information used to develop reasonable expectations about future exercise patterns and post-vesting employment termination behavior.

Volatility: The expected stock price volatility assumption was determined by examining the historical volatilities of a group of industry peers, as the Company had limited trading history for the Company s common stock due to the recent IPO. The Company will continue to analyze the historical stock price volatility and expected term assumptions as more historical data for the Company s common stock becomes available.

Risk-Free Interest Rate: The risk-free rate is based on U.S. Treasury zero-coupon issues with remaining terms similar to the expected term on the options.

Dividend Yield: The expected dividend assumption was based on the Company s history and expectation of dividend payouts.

Forfeitures: Forfeitures were estimated based on historical experience.

Fair Value of Common Stock: The fair value of the shares of common stock underlying the stock options has historically been the responsibility of and determined by the Company s board of directors. Subsequent to the IPO in April 2014, the fair value of common stock is determined based on the closing price of the NASDAQ Global Market exchange.

Non-employee Stock-Based Compensation

During the three and nine months ended September 30, 2014, the Company granted options to purchase 29,000 and 199,550 shares of common stock to consultants, respectively. During the three and nine months ended September 30, 2013, the Company granted options to purchase zero and 15,000 shares of common stock to consultants. These options are granted in exchange for consulting services to be rendered and vest over the term of the consulting agreement.

Table of Contents

The Company has estimated fair value of common stock options granted to non-employees using the Black-Scholes option pricing model with the following assumptions:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Expected volatility	85% - 96%	88% - 89%	72% - 98%	88%-92%
Risk-free interest rate	1.66% - 2.41%	1.70% - 2.72%	0.81% - 2.75%	1.02%-1.94%
Dividend yield	0%	0%	0%	0%
Contractual life (in years)	5.50 - 10.00	5.50 - 9.75	3.25 - 10.00	5.75- 10.00

Compensation expense related to non-employee options for the three and nine months ended September 30, 2014 was $0.8 million and $2.1 million, respectively. Compensation expense related to non-employee options for the three and nine months ended September 30, 2013 was $72,000 and $0.2 million, respectively.

Total stock-based compensation expense was allocated as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Research and development	$ 642	$ 61	$ 1,737	$ 165
General and administrative	1,395	72	3,170	221
	$ 2,037	$ 133	$ 4,907	$ 386

Table of Contents

10. Net Income per Share

A reconciliation of the numerator and denominator used in the calculation of the basic and diluted net income per share is as follows (in thousands, except per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
Historical net income (loss) per share	**2014**	**2013**	**2014**	**2013**
Numerator:				
Net income (loss)	$ (9,557)	$ (3,439)	$ 492	$ 19,977
Noncumulative dividend on preferred stock			(432)	(1,077)
Undistributed earnings allocated to preferred stock holders			(7)	(6,270)
Basic net income (loss) attributable to common stockholders	(9,557)	(3,439)	53	12,630
Adjustment to net income for dilutive securities			1	664
Diluted net income (loss) attributable to common stockholders	$ (9,557)	$ (3,439)	$ 54	$ 13,294
Denominator:				
Basic common shares outstanding:				
Basic common shares outstanding: weighted average common shares outstanding	16,801	9,514	14,009	9,510
Less: weighted average unvested common shares subject to repurchase	(14)	(4)	(11)	(4)
Weighted average number of common shares used in calculating net income (loss) per share basic	16,787	9,510	13,998	9,506
Dilutive securities:				
Common stock options			2,606	1,664
Warrants to purchase common stock			165	24
Warrants to purchase preferred stock				
Weighted average number of common shares used in calculating net income (loss) per share diluted	16,787	9,510	16,769	11,194
Net income (loss) per share to attributable to common stockholders				
Basic	$ (0.57)	$ (0.36)	$ 0.00	$ 1.33
Diluted	$ (0.57)	$ (0.36)	$ 0.00	$ 1.19

The following outstanding shares of potentially dilutive securities were excluded from the computation of diluted net income per share of common stock for the periods presented, because including them would have been anti-dilutive (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	**2013**	**2014**	**2013**
Convertible preferred stock				4,719
Options to purchase common stock			198	
Warrants to purchase convertible preferred stock				213
Warrants to purchase common stock				623
Total			198	5,555

Table of Contents

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

You should read the following discussion and analysis of our financial condition and results of operations together with the section of this report entitled Selected financial data and our financial statements and related notes included elsewhere in this report. This discussion and other parts of this report contain forward-looking statements that involve risks and uncertainties, such as statements of our plans, objectives, expectations and intentions. Our actual results could differ materially from those discussed in these forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in the section of this report entitled Risk factors.

Overview

We are a specialty pharmaceutical company driven to improve the lives of those affected by chronic disorders of the central nervous system, or CNS. We achieve this by enhancing the pharmacokinetic profiles of proven drugs to create novel therapeutics for use alone and in fixed-dose combination products. We are developing our lead wholly owned product candidate, ADS-5102, for a complication of Parkinson s disease known as levodopa induced dyskinesia, or LID, and are evaluating other potential CNS indications for which ADS-5102 may have applicability, including hyperkinetic and hypokinetic movement disorders. We successfully completed a Phase 2/3 clinical study in LID in 2013 and have initiated two Phase 3 registration trials and a separate open-label safety study in support of our LID indication in 2014.

The first of our two Phase 3 registration trials in support of our LID indication was initiated in June 2014. The study is planned to enroll approximately 130 subjects in a 26-week multi-center, randomized, double-blind, placebo-controlled trial and will assess the efficacy of a once daily 340 mg dose of ADS-5102 administered at bedtime for the treatment of LID in individuals with Parkinson s disease. The primary endpoint of this study is a reduction in LID as assessed by changes in the Unified Dyskinesia Rating Scale (UDysRS) along with supporting data from secondary endpoints. The second of our two Phase 3 registration trials in support of our LID indication was initiated in October 2014. The study is planned to enroll approximately 70 subjects in a 13-week multi-center, randomized, double-blind, placebo-controlled trial and will assess the efficacy of a once daily 340 mg dose of ADS-5102 administered at bedtime for the treatment of LID in individuals with Parkinson s disease. The primary endpoint of this study is a reduction in LID as assessed by changes in the Unified Dyskinesia Rating Scale (UDysRS) along with supporting data from secondary endpoints.

Our late-stage therapeutics portfolio also includes an NDA-submitted product candidate, MDX-8704, being co-developed with Forest Laboratories, Inc., a subsidiary of Actavis plc, referred to herein as Forest and Actavis, respectively, and an approved product, Namenda XR, which Forest developed and is marketing in the United States under a license from us.

Prior to November 2012, we were developing ADS-8704, a fixed-dose combination of controlled-release memantine and donepezil. Pursuant to our license agreement with Forest, we exclusively licensed to Forest certain U.S. intellectual property rights relating to controlled-release memantine and therapies including memantine. Forest has continued the ADS-8704 program under the name MDX-8704. Under our license agreement with Forest, we received a $65.0 million upfront payment in November 2012, two $20.0 million milestone payments in the fourth quarter of 2013 and a $25.0 million milestone payment in May 2014. We are eligible to receive up to an additional $30.0 million in payments based upon the first U.S. Food and Drug Administration, or FDA, approval of MDX-8704.

Financial operations overview

Summary

Our revenue to date has been generated primarily from license, milestone and development revenue pursuant to our license agreement with Forest. We have not generated any commercial product revenue. As of September 30, 2014, we had an accumulated deficit of $20.1 million. Although we reported net income for the nine months ended September 30, 2014 and in each of the years ending December 31, 2013 and 2012, this was primarily due to the recognition of revenue pursuant to our license agreement with Forest. We incurred significant losses prior to 2012 and expect to incur significant and increasing losses in the foreseeable future as we advance our product candidates into later stages of development and, if approved, commercialization. We cannot assure you that we will receive additional collaboration revenue in the future.

Table of Contents

In 2010, we suspended further activities on our influenza product candidate, ADS-8902, due to the expected length of the clinical trial and a change in our strategic focus. At the same time, we entered into an agreement with the National Institute of Allergy and Infectious Diseases, a division of the National Institutes of Health, or NIH, and its subcontractor under which we provided clinical trials supply, protocols, and operational support for further clinical development. We retained the rights to any clinical study data generated by the NIH with respect to clinical studies conducted by the NIH. We had supplied clinical operations support through a subcontract with the independent third-party subcontractor that was cancelled as of March 31, 2014.

We were awarded a continuation of an NIH grant for $1.0 million in August 2014, which we will administer, but conduct through subcontractors. The focus of work under this grant, which has not yet commenced, is in non-core areas to the Company.

We expect our research and development expenses to increase as we continue to advance our product candidates through clinical development. In addition, if any of our product candidates receive regulatory approval for commercial sale in the United States, we expect to incur significant expenses associated with the establishment of a specialty sales force. Because of the numerous risks and uncertainties associated with drug development, we are unable to predict the timing or amount of expenses incurred or when, or if, we will be able to achieve sustained profitability.

Prior to our initial public offering of our common stock, or IPO, in April 2014, we had raised an aggregate of approximately $87.2 million through the sale of convertible preferred stock and $1.0 million through the exercise of preferred stock warrants. On April 15, 2014, we completed our IPO pursuant to which we issued 3,000,000 shares of common stock and received net proceeds of approximately $41.4 million, after underwriting discounts, commissions and offering expenses. On May 6, 2014, we issued and sold an additional 81,371 shares of common stock pursuant to the underwriters partial exercise of their option to purchase additional shares, for net proceeds of approximately $1.2 million, after deducting underwriting discounts and commissions of approximately $91,000. In connection with the completion of our IPO, all convertible preferred stock converted into common stock.

Under our agreement with Forest we received a non-refundable upfront license fee of $65.0 million in 2012, $40.0 million in development milestone fees in 2013, and $25.0 million in milestone fees related to acceptance of Forest s New Drug Application, or NDA, submission by the FDA in May 2014, and we may receive up to an additional $30.0 million in future milestone fees upon FDA approval. Forest has stated that it projects FDA approval and commercial launch of MDX-8704 in the first half of 2015. Beginning in 2018 we will be entitled to receive royalties in the low to mid-single digits from Forest for sales of Namenda XR in the United States and, five years after commercial launch, in the low double digits to the mid-teens for sales of MDX-8704 in the United States, if approved.

As of September 30, 2014, we had cash and cash equivalents of $137.5 million.

Revenue

We have not generated any revenue from commercial product sales to date. Our revenue to date has been generated primarily from non-refundable upfront license payments, milestone payments, and reimbursements for research and development expenses under our license agreement with Forest.

Table of Contents

The following table summarizes the sources of our revenue for the three and nine months ended September 30, 2014 and 2013 (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Forest:				
Recognition of upfront license fee and milestones	$	$	$ 25,000	$ 29,611
Reimbursement of development expenses	215	74	390	1,055
Forest total	215	74	25,390	30,666
NIH grants		46	109	159
Government contracts		41	46	160
Total revenue	$ 215	$ 161	$ 25,545	$ 30,985

We recognized collaboration revenue of zero and $25.0 million for the three and nine months ended September 30, 2014, respectively, and zero and $29.6 million for the three and nine months ended September 30, 2013, respectively, pursuant to our license agreement with Forest. We also recognized revenue from Forest of approximately $0.2 million and $0.4 million in development funding for the three and nine months ended September 30, 2014, respectively, as well as $74,000 and $1.1 million for the three and nine months ended September 30, 2013, respectively. We expect that our revenue will continue to fluctuate in future periods.

Research and development expenses

Research and development expenses represent costs incurred to conduct research, such as the discovery and development of our wholly owned product candidates, as well as the development of product candidates pursuant to our agreement with Forest. We recognize all research and development costs as they are incurred. We began tracking our external costs by project beginning January 1, 2006.

Research and development expenses consist of:

- fees paid to clinical consultants, clinical trial sites and vendors, including clinical research organizations, or CROs, in conjunction with implementing and monitoring our clinical trials and acquiring and evaluating clinical trial data, including all related fees, such as for investigator grants, patient screening fees, laboratory work and statistical compilation and analysis;

- expenses related to production of clinical supplies, including fees paid to contract manufacturing organizations, or CMOs;

- other consulting fees paid to third parties; and

- employee-related expenses, which include salaries, benefits and stock-based compensation.

We anticipate our research and development expenses will increase as we continue our Phase 3 registration trials for ADS-5102, during 2014 and 2015.

Table of Contents

The following table summarizes our research and development expenses incurred during the three and nine months ended September 30, 2014 and 2013 (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013