

STEMCELLS INC
Form 10-Q
November 02, 2015

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934

For the quarter ended: September 30, 2015

Commission File Number: 0-19871

STEMCELLS, INC.

(Exact name of registrant as specified in its charter)

DELAWARE
(State or other jurisdiction of
incorporation or organization)

7707 Gateway Blvd

94-3078125
(I.R.S. Employer
identification No)

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Newark, CA 94560

(Address of principal executive offices including zip code)

(510) 456-4000

(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 twelve months (or for such shorter periods that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

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

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

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

At October 22, 2015, there were 108,807,706 shares of Common Stock, \$.01 par value, issued and outstanding.

STEMCELLS, INC.

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| NOTE REGARDING REFERENCES TO US AND OUR COMMON STOCK | |

Throughout this Form 10-Q, the words "we," "us," "our," and "StemCells" refer to StemCells, Inc., including our directly and indirectly wholly-owned subsidiaries. "Common stock" refers to the common stock, \$.01 par value, of StemCells, Inc.

PART I-FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS
STEMCELLS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS

(unaudited)

| | September 30, 2015 | December 31, 2014 |
|--|-------------------------------|------------------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 21,185,263 | \$ 24,987,603 |
| Trade receivables | 2,625 | 159,466 |
| Other receivables | 138,645 | 256,166 |
| Prepaid assets | 917,796 | 1,017,726 |
| Deferred financing costs, current | 4,162 | 22,082 |
| Other assets, current | 24,189 | 64,928 |
| Total current assets | 22,272,680 | 26,507,971 |
| Property, plant and equipment, net | 5,441,329 | 5,186,958 |
| Intangible assets, net | 294,329 | 356,889 |
| Deferred financing costs, non-current | | 1,224 |
| Other assets, non-current | 373,717 | 373,717 |
| Total assets | \$ 28,382,055 | \$ 32,426,759 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 1,391,716 | \$ 1,818,831 |
| Accrued expenses and other current liabilities | 5,627,486 | 4,869,710 |
| Loan payable net of discount, current | 2,453,451 | 4,686,388 |
| Deferred revenue, current | 16,826 | 16,826 |
| Capital lease obligation, current | 22,567 | 20,191 |
| Deferred rent, current | 123,333 | 85,925 |
| Total current liabilities | 9,635,379 | 11,497,871 |
| Capital lease obligations, non-current | 15,977 | 9,230 |
| Loan payable net of discount, non-current | 8,916,641 | 10,334,029 |
| Fair value of warrant liability | 615,925 | 1,684,551 |
| Deferred rent, non-current | 1,656,330 | 1,734,214 |
| Deferred revenue, non-current | 33,465 | 46,084 |
| Other long-term liabilities | 399,370 | 1,250,007 |
| Total liabilities | 21,273,087 | 26,555,986 |

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Commitments and contingencies (Note 8)

Stockholders' equity:

Common stock, \$0.01 par value; 225,000,000 shares authorized; issued and outstanding 108,589,273 at September 30, 2015 and 68,729,774 at

| | | |
|---|----------------------|----------------------|
| December 31, 2014 | 1,085,893 | 687,298 |
| Additional paid-in capital | 453,702,872 | 425,389,693 |
| Accumulated deficit | (447,726,670) | (420,271,608) |
| Accumulated other comprehensive income | 46,873 | 65,390 |
| Total stockholders' equity | 7,108,968 | 5,870,773 |
| Total liabilities and stockholders' equity | \$ 28,382,055 | \$ 32,426,759 |

See Notes to Condensed Consolidated Financial Statements.

STEMCELLS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited)

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|----------------------------------|----------------|------------------------------------|-----------------|
| | 2015 | 2014 | 2015 | 2014 |
| Revenue: | | | | |
| Revenue from licensing agreements, grants and other | \$ 37,030 | \$ 82,406 | \$ 88,158 | \$ 129,469 |
| Operating expenses: | | | | |
| Research and development | 7,719,720 | 4,396,873 | 21,250,896 | 14,865,874 |
| General and administrative | 2,305,241 | 2,065,117 | 7,058,166 | 6,444,786 |
| Total operating expenses | 10,024,961 | 6,461,990 | 28,309,062 | 21,310,660 |
| Loss from operations | (9,987,931) | (6,379,584) | (28,220,904) | (21,181,192) |
| Other income (expense): | | | | |
| Change in fair value of warrant liability | 427,589 | 4,076,360 | 1,068,626 | 95,266 |
| Interest income | 2,171 | 2,223 | 5,704 | 6,097 |
| Interest expense | (106,843) | (311,349) | (438,466) | (1,035,061) |
| Other income (expense), net | 22,367 | (7,244) | 129,978 | (38,128) |
| Total other income (expense), net | 345,284 | 3,759,990 | 765,842 | (971,826) |
| Net loss from continuing operations | (9,642,647) | (2,619,594) | (27,455,062) | (22,153,018) |
| Discontinued operations: | | | | |
| Loss from discontinued operations | | (137,592) | | (339,648) |
| Net loss | \$ (9,642,647) | \$ (2,757,186) | \$ (27,455,062) | \$ (22,492,666) |
| Basic and diluted net loss per share: | | | | |
| Basic and diluted net loss per share from continuing operations | \$ (0.09) | \$ (0.04) | \$ (0.30) | \$ (0.38) |
| Basic and diluted net loss per share from discontinued operations | | | | |
| Basic and diluted net loss per share | \$ (0.09) | \$ (0.04) | \$ (0.30) | \$ (0.38) |
| Weighted average number of common shares outstanding, basic and diluted | 108,478,361 | 66,535,000 | 91,106,853 | 59,224,989 |

See Notes to Condensed Consolidated Financial Statements.

STEMCELLS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS

(unaudited)

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|----------------------------------|----------------|------------------------------------|-----------------|
| | 2015 | 2014 | 2015 | 2014 |
| Net and comprehensive loss from continuing operations | \$ (9,642,647) | \$ (2,619,594) | \$ (27,455,062) | \$ (22,153,018) |
| Discontinued operations: | | | | |
| Net loss from discontinued operations | | (137,592) | | (339,648) |
| Foreign currency translation adjustments | (2,927) | (182,933) | (18,517) | (72,364) |
| Comprehensive loss from discontinued operations | (2,927) | (320,525) | (18,517) | (412,012) |
| Comprehensive loss | \$ (9,645,574) | \$ (2,940,119) | \$ (27,473,579) | \$ (22,565,030) |

See Notes to Condensed Consolidated Financial Statements.

STEMCELLS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

| | Nine months ended September 30, | |
|--|--|----------------------|
| | 2015 | 2014 |
| Cash flows from operating activities: | | |
| Net loss | \$ (27,455,062) | \$ (22,492,666) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Depreciation and amortization | 840,533 | 992,612 |
| Stock-based compensation | 4,086,710 | 1,543,577 |
| Amortization of debt discount and issuance costs | 98,988 | 192,117 |
| (Gain) loss on disposal of fixed assets | (168,898) | 8,845 |
| Change in fair value of warrant liability | (1,068,626) | (95,266) |
| Changes in operating assets and liabilities: | | |
| Trade receivables | 152,877 | 37,121 |
| Accrued interest and other receivables | 113,746 | 277,173 |
| Prepaid and other current assets | 213,761 | (483,178) |
| Accounts payable and accrued expenses | (511,188) | (911,327) |
| Deferred revenue | (12,619) | (52,291) |
| Deferred rent | (40,477) | 5,500 |
| Other assets non-current | | 17,207 |
| Net cash used in operating activities | (23,750,255) | (20,960,576) |
| Cash flows from investing activities: | | |
| Purchases of property, plant and equipment | (1,005,273) | (598,432) |
| Proceeds from sale of property, plant and equipment | 168,713 | |
| Net cash used in investing activities | (836,560) | (598,432) |
| Cash flows from financing activities: | | |
| Proceeds from issuance of common stock, net of issuance costs | 24,942,963 | 18,952,721 |
| Proceeds from exercise of warrants, net of issuance costs | | 1,974,931 |
| Proceeds from loan payable, net of issuance costs | | 5,775,543 |
| Repayment of loan payable | (3,730,168) | (2,996,204) |
| Repayment of capital lease obligations | (17,764) | (15,842) |
| Payments related to net share issuance of stock based awards | (392,587) | (499,333) |
| Net cash provided by financing activities | 20,802,444 | 23,191,816 |
| Increase (decrease) in cash and cash equivalents | (3,784,371) | 1,632,808 |
| Effects of foreign exchange rate changes on cash | (17,969) | (5,643) |
| Cash and cash equivalents, beginning of period | 24,987,603 | 30,585,424 |
| Cash and cash equivalents, end of period | \$ 21,185,263 | \$ 32,212,589 |

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Supplemental disclosure of cash flow information:

| | | | | |
|---|----|---------|----|---------|
| Interest paid | \$ | 191,895 | \$ | 384,545 |
| Supplemental schedule of non-cash investing and financing activities: | | | | |
| Equipment acquired under a capital lease (1) | \$ | 28,882 | \$ | |

(1) Represents the present value of future minimum capital lease payments for equipment leased.
See Notes to Condensed Consolidated Financial Statements.

Notes to Condensed Consolidated Financial Statements (Unaudited)

September 30, 2015 and 2014

Note 1. Summary of Significant Accounting Policies

Nature of Business.

StemCells, Inc., a Delaware corporation, is a biopharmaceutical company that operates in one segment, the research, development, and commercialization of stem cell therapeutics and related technologies.

The accompanying financial data as of September 30, 2015 and for the three and nine months ended September 30, 2015 and 2014 have been prepared by us, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States (U.S. GAAP) have been condensed or omitted pursuant to these rules and regulations. The unaudited condensed consolidated financial statements have been prepared on the same basis as the annual financial statements and in the opinion of management reflect all adjustments, which include only normal recurring adjustments, necessary for a fair presentation of the periods presented. The December 31, 2014 condensed consolidated balance sheet was derived from audited financial statements, but does not include all disclosures required by U.S. GAAP. However, we believe that the disclosures are adequate to make the information presented not misleading. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2014.

We have incurred significant operating losses since inception. We expect to incur additional operating losses over the foreseeable future. We have very limited liquidity and capital resources and must obtain significant additional capital and other resources in order to provide funding for our product development efforts, the acquisition of technologies, businesses and intellectual property rights, preclinical and clinical testing of our products, pursuit of regulatory approvals, acquisition of capital equipment, laboratory and office facilities, establishment of production capabilities, general and administrative expenses and other working capital requirements. We rely on our cash reserves, proceeds from equity and debt offerings, credit facilities, proceeds from the transfer or sale of intellectual property rights, equipment, facilities or investments, government grants and funding from collaborative arrangements, to fund our operations. If we exhaust our cash reserves and are unable to obtain adequate financing, we may be unable to meet our operating obligations and we may be required to initiate bankruptcy proceedings. The financial statements do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classification of liabilities that may result from the outcome of this uncertainty.

Principles of Consolidation

The condensed consolidated financial statements include the accounts of StemCells, Inc., and our wholly-owned subsidiaries, including StemCells California, Inc., Stem Cell Sciences Holdings Ltd, and Stem Cell Sciences (UK) Ltd . All significant intercompany accounts and transactions have been eliminated.

Reclassifications

Certain reclassifications have been made to the prior year financial statements in order to conform to the current year's presentation.

Use of Estimates

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The preparation of financial statements in conformity with U.S. GAAP requires management to make judgments, assumptions and estimates that affect the amounts reported in our condensed consolidated financial statements and accompanying notes. Actual results could differ materially from these estimates.

Significant estimates include the following:

the grant date fair value of stock-based awards recognized as compensation expense (see Note 6, Stock-Based Compensation); and

the fair value of warrants recorded as a liability (see Note 9, Warrant Liability).

Discontinued Operations

The results of operations of a business that either has been disposed of or is classified as held-for-sale are reported in discontinued operations if the operations and cash flows of the component have been or will be eliminated from our ongoing operations as a result of the disposal transaction and we will not have any significant continuing involvement in the operations of the component after the disposal transaction. We present the operations of a business that meet this criteria as a discontinued operation, and retrospectively reclassify operating results for all prior periods presented. In the fourth quarter of 2014, as part of our strategy to focus on our clinical operations, we sold our SC Proven reagent and cell culture business and wound-down our business operations at our Stem Cell Sciences Subsidiary in Cambridge, UK (SCS). The results of operations for this component have been classified as discontinued operations for all periods in our Consolidated Statement of Operations.

Financial Instruments

Cash and Cash Equivalents

Cash equivalents are money market accounts, money market funds and investments with maturities of 90 days or less from the date of purchase.

Receivables

Our receivables generally consist of interest income on our financial instruments and royalties due from licensing agreements.

Warrant Liability

We account for our warrants in accordance with U.S. GAAP which defines how freestanding contracts that are indexed to and potentially settled in a company's own stock should be measured and classified. Authoritative accounting guidance prescribes that only warrants issued by us under contracts that cannot be net-cash settled, and are both indexed to and settled in our common stock, can be classified as equity. As part of our December 2011 financing, we issued Series A Warrants with a five year term to purchase 8,000,000 shares at \$1.40 per share and Series B Warrants with a ninety trading day term to purchase 8,000,000 units at \$1.25 per unit. Each unit underlying the Series B Warrants consisted of one share of our common stock and one Series A Warrant. In the first and second quarter of 2012, an aggregate of 2,700,000 Series B Warrants were exercised. For the exercise of these warrants, we issued 2,700,000 shares of our common stock and 2,700,000 Series A Warrants. The remaining 5,300,000 Series B Warrants expired unexercised by their terms on May 2, 2012. The Series A Warrants contain full ratchet anti-dilution price protection so that, in most situations, upon the issuance of any common stock or securities convertible into common stock at a price below the then-existing exercise price of the Series A Warrants, the Series A exercise price will be reset to the lower common stock sales price. As a result of our April 2015 financing, the exercise price of the outstanding Series A warrants were reduced from \$1.40 per share to \$0.6999999 per share. As terms of the Series A Warrants do not meet the specific conditions for equity classification, we are required to classify the fair value of these warrants as a liability, with subsequent changes in fair value to be recorded as income (loss) due to change in fair value of warrant liability. The fair value of the Series A Warrants is determined using a Monte Carlo simulation model (see Note 9, Warrant Liability). The fair value is affected by changes in inputs to these models including our stock price, expected stock price volatility, the contractual term, and the risk-free interest rate. The use of a Monte Carlo simulation model requires input of additional assumptions including the progress of our R&D programs and its affect on potential future financings. We will continue to classify the fair value of the warrants as a liability until the warrants are exercised, expire or are amended in a way that would no longer require these warrants to be classified as a liability. The estimated fair value of our warrant liability at September 30, 2015, was approximately \$616,000.

Intangible Assets

Prior to fiscal year 2001, we capitalized certain patent costs, which are being amortized over the estimated life of the patent and would be expensed at the time such patents are deemed to have no continuing value. Since 2001, all patent costs are expensed as incurred. License costs are capitalized and amortized over the estimated life of the related license agreement.

Revenue Recognition

We currently recognize revenue resulting from the licensing and use of our technology and intellectual property. Licensing agreements may contain multiple elements, such as upfront fees, payments related to the achievement of particular milestones and royalties. Revenue from upfront fees for licensing agreements that contain multiple elements are generally deferred and recognized on a straight-line basis over the term of the agreement. Fees associated with substantive at risk performance-based milestones are recognized as revenue upon completion of the scientific or regulatory event specified in the agreement, and royalties received are recognized as earned. Revenue from licensing agreements is recognized net of a fixed percentage due to licensors as royalties.

Stock-Based Compensation

Compensation expense for stock-based payment awards to employees is based on their grant date fair value as calculated and amortized over their vesting period. See Note 6, "Stock-Based Compensation" for further information.

We use the Black-Scholes model to calculate the fair value of stock-based awards.

Per Share Data

Basic net income or loss per share is computed by dividing net income or loss by the weighted average number of shares of common stock outstanding during the period. Diluted net income or loss per share is computed based on the weighted average number of shares of common stock and other dilutive securities. To the extent these securities are anti-dilutive, they are excluded from the calculation of diluted earnings per share.

The following is a reconciliation of the numerators and denominators of the basic and diluted net loss per share computations:

| | Three months ended September 30, | | Nine months ended September 30, | |
|--|----------------------------------|----------------|------------------------------------|-----------------|
| | 2015 | 2014 | 2015 | 2014 |
| Net loss from continuing operations | \$ (9,642,647) | \$ (2,619,594) | \$ (27,455,062) | \$ (22,153,018) |
| Net loss from discontinued operations | | (137,592) | | (339,648) |
| Net loss | \$ (9,642,647) | \$ (2,757,186) | \$ (27,455,062) | \$ (22,492,666) |
| Weighted average shares outstanding used to compute basic and diluted net income or loss per share | 108,478,361 | 66,535,000 | 91,106,853 | 59,224,989 |
| Basic and diluted net loss per share from continuing operations | \$ (0.09) | \$ (0.04) | \$ (0.30) | \$ (0.38) |
| Basic and diluted net loss per share from discontinued operations | | | | |
| Basic and diluted net loss per share | \$ (0.09) | \$ (0.04) | \$ (0.30) | \$ (0.38) |

The following outstanding potentially dilutive securities were excluded from the computation of diluted net income or loss per share because the effect would have been anti-dilutive as of September 30:

| | 2015 | 2014 |
|---------|-----------|---------|
| Options | 2,794,229 | 317,729 |

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| | | |
|------------------------|------------|------------|
| Restricted stock units | 9,262,518 | 3,384,940 |
| Warrants | 44,277,849 | 23,478,181 |
| Total | 56,334,596 | 27,180,850 |

In August 2015, 9,604,520 warrants expired unexercised by their terms. These warrants were issued as part of a financing transaction in July 2014.

Comprehensive Income (Loss)

Comprehensive income (loss) is comprised of net income or loss and other comprehensive income or loss (OCL). OCL includes certain changes in stockholders' equity that are excluded from net income or loss. Specifically, when applicable, we include in OCL changes in unrealized gains and losses on foreign currency translations. Accumulated other comprehensive income was \$46,873 as of September 30, 2015, and accumulated other comprehensive income was \$65,390, as of December 31, 2014.

Recent Accounting Pronouncements

In June 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-12, *Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period* . The ASU requires that a performance target that affects vesting, and that could be achieved after the requisite service period, be treated as a performance condition. A reporting entity should apply existing guidance in Topic 718 as it relates to awards with performance conditions that affect vesting to account for such awards. In July 2015, the FASB voted to defer the effective date of this ASU for one year, revising the effective date for interim and annual periods beginning after December 15, 2016. Early adoption is permitted. The Company does not anticipate the adoption of this ASU will have a material impact on its consolidated financial statements.

In August 2014, the FASB issued ASU 2014-15, *Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern*, which provides guidance on determining when and how reporting entities must disclose going-concern uncertainties in their financial statements. The ASU requires management to perform interim and annual assessments of an entity's ability to continue as a going concern within one year of the date of issuance of the entity's financial statements (or within one year after the date on which the financial statements are available to be issued, when applicable). Further, an entity must provide certain disclosures if there is substantial doubt about the entity's ability to continue as a going concern. This ASU is effective for annual periods ending after December 15, 2017, and interim periods thereafter; early adoption is permitted.

In April 2015, the FASB issued ASU 2015-03, *Interest - Imputation of Interest*, which amends the presentation of debt issuance costs in the balance sheet as a direct deduction from the carrying amount of the related debt liability rather than as a deferred charge as presented under current guidance. ASU 2015-03 is effective for annual and interim periods beginning after December 15, 2015, and must be retrospectively applied. Early adoption is permitted. The Company does not expect the adoption of this amendment to have a material effect on its financial condition and results of operations.

Note 2. Financial Instruments

The following table summarizes the fair value of our cash and cash equivalents held in our current investment portfolio:

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized (Losses) | Fair Value |
|---------------------------------|-------------------|------------------------------|---------------------------------|---------------|
| September 30, 2015 | | | | |
| Cash | \$ 506,685 | \$ | \$ | \$ 506,685 |
| Cash equivalents | 20,678,578 | | | 20,678,578 |
| Total cash and cash equivalents | \$ 21,185,263 | \$ | \$ | \$ 21,185,263 |

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized (Losses) | Fair Value |
|---------------------------------|-------------------|------------------------------|---------------------------------|---------------|
| December 31, 2014 | | | | |
| Cash | \$ 1,398,928 | \$ | \$ | \$ 1,398,928 |
| Cash equivalents | 23,588,675 | | | 23,588,675 |
| Total cash and cash equivalents | \$ 24,987,603 | \$ | \$ | \$ 24,987,603 |

At September 30, 2015, our investments in money market accounts are through a money market fund that invests in high quality, short-term money market instruments which are classified as cash equivalents in the accompanying Condensed Consolidated Balance Sheet due to their short maturities. The investment seeks to provide the highest possible level of current income while still maintaining liquidity and preserving capital. From time to time, we carry cash balances in excess of federally insured limits.

Note 3. Fair Value Measurement

Fair value is defined as an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or a liability. As a basis for considering such assumptions, we are required to apply a three-tier value hierarchy, which prioritizes the inputs used in the valuation methodologies in measuring fair value. The three levels of the fair value hierarchy are:

Level 1 Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 Directly or indirectly observable inputs other than in Level 1, that include quoted prices for similar assets or liabilities in active markets or quoted prices for identical or similar assets or liabilities in markets that are not active.

Level 3 Unobservable inputs which are supported by little or no market activity that reflects the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability.

The fair value hierarchy also requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. Assets measured at fair value are classified below based on the three fair value hierarchy tiers described above.

Our cash equivalents are classified as Level 1 because they are valued primarily using quoted market prices.

We estimated the fair value of our loan payable using the net present value of the payments discounted at an effective interest rate. We believe the estimates used to measure the fair value of our loan payable constitute Level 3 inputs.

Our liability for warrants issued in our 2011 financing is classified as Level 3 as the liability is valued using a Monte Carlo simulation model. Some of the significant inputs used to calculate the fair value of warrant liability include our stock price on the valuation date, expected volatility of our common stock as traded on NASDAQ, and risk-free interest rates that are derived from the yield on U.S. Treasury debt securities, all of which are observable from active markets. However, the use of a Monte Carlo simulation model requires the input of additional subjective assumptions including management's assumptions regarding the likelihood of a re-pricing of these warrants pursuant to anti-dilution provisions and the progress of our R&D programs and its affect on potential future financings. While subjective, the sensitivity of the unobservable inputs is not significant and the main driver in the sensitivity of the calculation is an observable input which is the share price.

The following table presents financial assets and liabilities measured at fair value as of September 30, 2015:

| | Fair Value Measurement | | | |
|------------------------------------|-------------------------------|--------------------|----------------------|----------------------|
| | at Report Date Using | | | |
| | Quoted Prices | Significant | | |
| | in Active Markets | Other | | |
| | for | Observable | Unobservable | As of |
| | Identical | Inputs | Inputs | September 30, |
| | Assets | (Level | (Level 3) | 2015 |
| | (Level 1) | 2) | (Level 3) | |
| Financial assets: | | | | |
| Cash equivalents: | | | | |
| Money market funds | \$ 21,744 | \$ | \$ | \$ 21,744 |
| U.S. Treasury debt obligations | 20,656,834 | | | 20,656,834 |
| Total financial assets | \$ 20,678,578 | \$ | \$ | \$ 20,678,578 |
| Financial liabilities: | | | | |
| Loan payable net of discounts | | | 11,370,092 | 11,370,092 |
| Warrant liabilities | | | 615,925 | 615,925 |
| Total financial liabilities | \$ | \$ | \$ 11,986,017 | \$ 11,986,017 |

Level 3 Reconciliation

The following table presents a roll forward for liabilities measured at fair value using significant unobservable inputs (Level 3) for 2015:

| | | Warrant liabilities |
|---------------------------------------|----|--------------------------------------|
| Balance at June 30, 2015 | \$ | 1,043,514 |
| Less change in fair value of warrants | | (427,589) |
| Balance at September 30, 2015 | \$ | 615,925 |
| | | Loan payable net of discounts |
| Balance at June 30, 2015 | \$ | 12,383,018 |
| Add amortization of discount | | 19,188 |
| Less repayments of principal | | (1,032,114) |
| Balance at September 30, 2015 | \$ | 11,370,092 |
| Current portion | | 2,453,451 |
| Non-current portion | | 8,916,641 |
| Balance at September 30, 2015 | \$ | 11,370,092 |

Note 4. Property, Plant and Equipment

Property, plant and equipment balances at September 30, 2015 and December 31, 2014 are summarized below:

| | September 30, 2015 | December 31, 2014 |
|------------------------------------|---------------------------|--------------------------|
| Building and improvements | \$ 3,601,368 | \$ 6,794,556 |
| Machinery and equipment | 8,490,361 | 8,161,291 |
| Furniture and fixtures | 332,831 | 639,909 |
| | 12,424,560 | 15,595,756 |
| Less accumulated depreciation | (6,983,231) | (10,408,798) |
| Property, plant and equipment, net | \$ 5,441,329 | \$ 5,186,958 |

Depreciation expense was approximately \$274,000 and \$778,000 respectively for the three and nine month period ended September 30, 2015. For the similar periods in 2014, depreciation expense was \$246,000 and \$766,000 respectively.

Note 5. Intangible Assets

The components of our intangible assets at September 30, 2015 are summarized below:

| Intangible Asset Class | Cost | Accumulated Amortization | Net Carrying Amount | Weighted Average Amortization Period |
|-------------------------------|--------------|---------------------------------|----------------------------|---|
| Patents and licenses | \$ 1,243,612 | \$ (949,283) | \$ 294,329 | 15 years |

Amortization expense was approximately \$21,000 in the third quarter of 2015 and expected amortization expense for the year ended December 31, 2015 is approximately \$83,000.

The expected future annual amortization expense for each of the next five years based on current balances of our intangible assets is approximately as follows:

For the year ending December 31:

| | |
|------|-----------|
| 2016 | \$ 75,496 |
| 2017 | \$ 54,923 |
| 2018 | \$ 27,978 |
| 2019 | \$ 27,978 |
| 2020 | \$ 26,594 |

Note 6. Stock-Based Compensation

We currently grant stock-based compensation under two equity incentive plans (2006 and 2013 Equity Incentive Plans) approved by the Company's stockholders and one plan adopted in 2012 pursuant to NASDAQ Listing Rule

5635(c)(4) concerning inducement grants for new employees (our 2012 Commencement Incentive Plan). As of September 30, 2015, we had 4,890,558 shares available to grant under the above mentioned plans. At our annual stockholders meeting held on June 12, 2007, our stockholders approved an amendment to our 2006 Equity Incentive Plan to provide for an annual increase in the number of shares of common stock available for issuance under the plan each January 1 (beginning January 1, 2008) equal to 4% of the outstanding common shares as of that date. The amendment further provided an aggregate limit of 3,000,000 shares issuable pursuant to incentive stock option awards under the plan. At our annual stockholders meeting held on December 20, 2013, our stockholders approved our 2013 Equity Incentive Plan to grant stock-based compensation of up to an initial 6,000,000 shares, plus an increase of 4% per year of the outstanding number of shares of our common stock beginning in January 1, 2015. Under the three stockholder-approved plans we may grant incentive stock options, nonqualified stock options, stock appreciation rights, restricted stock, restricted stock units, 401(k) Plan employer match in form of shares and performance-based shares to our employees, directors and consultants, at prices determined by our Board of Directors. Incentive stock options may only be granted to employees under these plans with a grant price not less than the fair market value on the date of grant. Under our 2012 Commencement Inducement Plan, we may only award options, restricted stock units and other equity awards to newly hired employees and newly engaged directors, in each case as allowed by NASDAQ listing requirements.

Generally, stock options and restricted stock units granted to employees have a maximum term of ten years. Stock based awards may vest over a period of time from the date of grant or upon the attainment of certain performance goals established by the Compensation Committee or the Single Member Committee established under our 2006 Equity Incentive Plan and our 2013 Equity Incentive Plan. Upon employee termination of service, any unexercised vested option will be forfeited three months following termination or the expiration of the option, whichever is earlier.

Our stock-based compensation expense for the three and nine months ended September 30 was as follows:

| | Three months ended September 30, | | Nine months ended September 30, | |
|---------------------------------------|-------------------------------------|-------------------|------------------------------------|---------------------|
| | 2015 | 2014 | 2015 | 2014 |
| Research and development expense | \$ 781,791 | \$ 188,357 | \$ 2,063,499 | \$ 414,246 |
| General and administrative expense | 644,451 | 320,454 | 2,023,211 | 1,129,331 |
| Total stock-based compensation | \$ 1,426,242 | \$ 508,811 | \$ 4,086,710 | \$ 1,543,577 |

Effect on basic and diluted net loss per share \$ (0.01) \$ (0.01) \$ (0.04) \$ (0.03)
As of September 30, 2015, we had approximately \$8,154,000 of total unrecognized compensation expense related to unvested awards of stock options and restricted stock units granted under our various equity incentive plans that we expect to recognize over a weighted-average vesting period of 1.9 years.

Stock Options

A summary of our stock option activity for the three months ended September 30, 2015 is as follows:

| | Number of options | Weighted-average exercise price (\$) per share |
|--|-------------------|---|
| Outstanding options at June 30, 2015 | 2,765,229 | 2.49 |
| Granted ¹ | 105,000 | 0.43 |
| Exercised | | |
| Cancelled | (76,000) | 1.39 |
| Outstanding options at September 30, 2015 | 2,794,229 | 2.44 |

A summary of changes in unvested options for the three months ended September 30, 2015 is as follows:

| | Number of options | Weighted-average exercise price (\$) per share | Weighted-average grant date fair value (\$) per option |
|-----------------------------------|-------------------|---|---|
| Unvested options at June 30, 2015 | 2,490,000 | 0.70 | 0.46 |

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| | | | |
|---|-----------|------|------|
| Granted | 105,000 | 0.43 | 0.28 |
| Vested | | | |
| Cancelled | (75,000) | 0.71 | 0.49 |
| Unvested options at September 30, 2015 | 2,520,000 | 0.69 | 0.45 |

Restricted Stock Units

We have granted restricted stock units (RSUs) to certain employees and members of the Board of Directors which entitle the holders to receive shares of our common stock upon vesting of the RSUs. The fair value of restricted stock units granted is based upon the market price of the underlying common stock as if it were vested and issued on the date of grant.

¹ These stock awards are performance based and vest on achievement of predefined milestones.

A summary of changes in our restricted stock units for the three months ended September 30, 2015 is as follows:

| | Number of RSUs | Weighted Average Grant Date Fair Value (\$) |
|-----------------------------------|----------------|---|
| Outstanding at June 30, 2015 | 9,358,518 | 1.22 |
| Granted ² | 100,000 | 0.41 |
| Vested and exercised | (87,500) | 1.93 |
| Cancelled | (108,500) | 1.14 |
| Outstanding at September 30, 2015 | 9,262,518 | 1.20 |

Stock Appreciation Rights

In July 2006, we granted cash-settled Stock Appreciation Rights (SARs) to certain employees that give the holder the right, upon exercise, to the difference between the price per share of our common stock at the time of exercise and the exercise price of the SARs.

The SARs have a maximum term of ten years with an exercise price of \$20.00, which is equal to the market price of our common stock at the date of grant. The SARs vest 25% on the first anniversary of the grant date and 75% vest monthly over the remaining three-year service period. At September 30, 2015 and 2014, there were 110,593 SARs outstanding. All of the outstanding SARs as of September 30, 2015 are fully vested. There were no SARs granted, exercised or forfeited during the three months ended September 30, 2015. Compensation expense is based on the fair value of SARs which is calculated using the Black-Scholes option pricing model.

The stock-based compensation expense and liability are re-measured at each reporting date through the earlier of date of settlement or forfeiture of the SARs. For the three months ended September 30, 2015 and 2014, the re-measured liability and expense for the respective periods related to the SARs were not significant.

The compensation expense related to the SARs recognized for the three months ended September 30, 2015 may not be representative of compensation expense for future periods and its resulting effect on net loss and net loss per share attributable to common stockholders, due to changes in the fair value calculation which is dependent on the stock price, volatility, interest and forfeiture rates, additional grants and subsequent periods of vesting. We will continue to recognize compensation cost each period, which will be the change in fair value from the previous period through the earlier date of settlement or forfeiture of the SARs.

Note 7. Loan Payable

Loan Agreement with Silicon Valley Bank

In April 2013, we entered into a Loan Agreement with Silicon Valley Bank (SVB) and received loan proceeds of \$9,900,000, net of a \$100,000 cash discount. The loan proceeds will be used for research and development and general corporate purposes. The loan has a three-year term and bears interest at an annual rate of 6%. The loan obligations are secured by a first priority security interest on substantially all of our assets excluding intellectual property. For the first six months, payments will be interest only followed by repayment of principal and interest over a period of 30 months. There is also a final \$1,000,000 fee payable at the end of the term which is being expensed over the term of the loan using the effective interest method. In conjunction with the Loan Agreement, we issued to SVB a ten year warrant to acquire 293,531 shares of common stock at an exercise price of \$1.7034 per share. The

warrant is immediately exercisable and expires in April 2023. We estimated the fair value of the warrant to be approximately \$388,000 using the Black-Scholes option pricing model with the following assumptions:

| | |
|-------------------------|-------|
| Expected life (years) | 10 |
| Risk-free interest rate | 1.9% |
| Expected volatility | 88.1% |
| Expected dividend yield | 0% |

We applied the relative fair value method to allocate the \$9,900,000 net proceeds between the loan and warrant. The approximately \$388,000 fair value allocated to the warrant was recorded as an increase to additional paid-in capital and as a discount to loan payable. Approximately \$9,512,000 was assigned to the loan and was recorded as the initial carrying amount of the loan payable, net of discount. The approximately \$388,000 fair value of the warrant and the \$100,000 cash discount are both being amortized as additional interest expense over the term of the loan using the effective interest rate method.

We also incurred loan issuance costs of approximately \$117,000, which are recorded as deferred financing costs on the accompanying consolidated balance sheet and are being amortized to interest expense over the term of the Loan Agreement using the effective interest rate method. The effective interest rate used to amortize the deferred financing costs and the discount (including the fair value of the warrant and the cash discount), and for the accretion of the final payment, is 9.0%.

² These stock awards are performance based and vest on achievement of predefined milestones.

The following table is a summary of the changes in the carrying value of our loan payable to Silicon Valley Bank for the three months ended September 30, 2015:

| | Silicon Valley Bank Loan |
|---|-------------------------------------|
| Carrying value of loan payable at 6/30/2015 (current) | \$ 3,466,377 |
| Repayment of principal | (1,032,114) |
| Accretion of discount | 19,188 |
| Carrying value of loan payable at 9/30/2015 (current) | \$ 2,453,451 |

Loan Agreement with California Institute for Regenerative Medicine

In April 2013, we entered into an agreement with the California Institute of Regenerative Medicine (CIRM) under which CIRM would have provided up to approximately \$19.3 million as a forgivable loan, in accordance with mutually agreed upon terms and conditions and CIRM regulations. The CIRM loan helped fund preclinical development of our HuCNS-SC cells for Alzheimer's disease. Between July 2013 and August 2014, we received in aggregate, approximately \$9.6 million as disbursements of the loan provided under the CIRM loan agreement. However, in December 2014, as findings under this pre-clinical study in Alzheimer's disease did not meet certain pre-determined criteria for continued funding of this program by CIRM, the parties terminated the loan agreement and we wound down this pre-clinical study which had been funded in part by the CIRM loan agreement. In February 2015, we repaid CIRM approximately \$679,000 of the aggregate loan proceeds received. Under the terms of the CIRM loan agreement, principal amount of approximately \$8,917,000 and accrued interest of approximately \$243,000 were forgiven. However, authoritative accounting guidance requires certain conditions (which includes a legal release from the creditor) to be met before a liability can be extinguished and derecognized.

Note 8. Commitments and Contingencies

Bonds Payable

We entered into direct financing transactions with the State of Rhode Island and received proceeds from the issuance of industrial revenue bonds totaling \$5,000,000 to finance the construction of a 21,000 square-foot pilot manufacturing facility and a 3,000 square-foot cell processing facility in Lincoln, Rhode Island. The related lease agreements are structured such that lease payments fully fund all semiannual interest payments and annual principal payments through maturity in August 2014. In August 2014, we made the final principal and interest payment thereby extinguishing the debt. In March 2015, we sold the vacant 21,000 square-foot pilot manufacturing facility and the vacant 3,000 square-foot cell processing facility in Lincoln, Rhode Island to an unrelated third party net of expenses for approximately \$149,000.

Operating leases

We lease various real properties under operating leases that generally require us to pay taxes, insurance, maintenance, and minimum lease payments. Some of our leases have options to renew.

Operating Leases California

In December 2010, we entered into a commercial lease agreement with BMR-Gateway Boulevard LLC (BMR), as landlord, for office and research space at BMR's Pacific Research Center in Newark, California. The initial term of the lease is approximately eleven and one-half years and includes escalating rent payments which we recognize as lease operating expense on a straight-line basis. We will pay approximately \$17,869,000 in aggregate as rent over the term of the lease to BMR. Deferred rent for this facility was approximately \$1,395,000 as of September 30, 2015, and approximately \$1,429,000 as of December 31, 2014.

In March 2013, we entered into a commercial lease agreement with Prologis, L.P. (Prologis), as landlord, for office and research space in Sunnyvale, California. The facility is for operations that support our clinical development activities. The initial term of the lease is ten years and includes escalating rent payments which we recognize as lease operating expense on a straight-line basis. We will pay approximately \$3,497,000 in aggregate rent over the term of the lease. As part of the lease, Prologis has agreed to provide us financial allowances to build initial tenant improvements, subject to customary terms and conditions relating to landlord-funded tenant improvements. The tenant improvements are recorded as leasehold improvement assets and amortized over the term of the lease. The financial allowances are treated as a lease incentive and recorded as deferred rent which is amortized as reductions to lease expense over the lease term. Deferred rent for this facility was approximately \$385,000 as of September 30, 2015, and approximately \$391,000 as of December 31, 2014.

Operating Leases United Kingdom

In January 2011, we amended the existing lease agreements of our wholly-owned subsidiary, Stem Cell Sciences (U.K.) Ltd, effectively reducing our leased office and lab space. The lease by its terms was extended to September 30, 2013. In October 2013, we signed a new three-year lease agreement for the leased space and expect to pay rent of approximately GBP 53,000 per annum. StemCells, Inc. is the guarantor of Stem Cell Sciences (U.K.) Ltd. obligations under the existing lease. The lease includes an option for early termination of the lease agreement, which we exercised in February 2015. In December 2014, we sold our SC Proven reagent and cell culture business and as part of the wind-down of our business operations in UK, sublet our leased space from January 2015 to our opted early termination date of October 2015.

With the exception of the operating leases discussed above, we have not entered into any significant off balance sheet financial arrangements and have not established any special purpose entities. We have not guaranteed any debts or commitments of other entities or entered into any options on non-financial assets.

Note 9. Warrant Liability

We use various option pricing models, such as the Black-Scholes option pricing model and a Monte Carlo simulation model, to estimate fair value of warrants issued. In using these models, we make certain assumptions about risk-free interest rates, dividend yields, volatility, expected term of the warrants and other assumptions. Risk-free interest rates are derived from the yield on U.S. Treasury debt securities. Dividend yields are based on our historical dividend payments, which have been zero to date. Volatility is estimated from the historical volatility of our common stock as traded on NASDAQ. The expected term of the warrants is based on the time to expiration of the warrants from the date of measurement.

In November 2009, we sold 1,000,000 units to institutional investors at a price of \$12.50 per unit, for gross proceeds of \$12,500,000. The units, each of which consisted of one share of common stock and a warrant to purchase 0.40 shares of common stock at an exercise price of \$15.00 per share, were offered as a registered direct offering under a shelf registration statement previously filed with, and declared effective by, the SEC. We received total proceeds, net of offering expenses and placement agency fees, of approximately \$11,985,000. We recorded the fair value of the

warrants to purchase 400,000 shares of our common stock as a liability. The fair value of the warrant liability is revalued at the end of each reporting period, with the change in fair value of the warrant liability recorded as a gain or loss in our condensed consolidated statements of operations. The November 2009 warrants expired unexercised by their own terms in April 2015.

In December 2011, we raised gross proceeds of \$10,000,000 through a public offering of 8,000,000 units and 8,000,000 Series B Warrants. The combination of units and Series B Warrants were sold at a public offering price of \$1.25 per unit. Each Series B Warrant gave the holder the right to purchase one unit at an exercise price of \$1.25 per unit and was exercisable until May 2, 2012, the 90th trading day after the date of issuance. Each unit consisted of one share of our common stock and one Series A Warrant. Each Series A Warrant gives the holder the right to purchase one share of our common stock at an initial exercise price of \$1.40 per share. The Series A Warrants are immediately exercisable upon issuance and will expire in December 2016. In 2012, an aggregate of 2,700,000 Series B Warrants were exercised. For the exercise of these warrants, we issued 2,700,000 shares of our common stock and 2,700,000 Series A Warrants. The remaining 5,300,000 Series B Warrants expired unexercised by their terms on May 2, 2012. In 2012, 2013 and 2014, an aggregate of 2,198,571, 384,534 and 1,180,015 Series A Warrants were exercised, respectively. For the exercise of these warrants, in 2012, 2013 and 2014, we issued 2,198,571, 384,534 and 1,180,015 shares of our common stock and received gross proceeds of approximately \$3,078,000, \$538,000 and \$1,652,000, respectively. The shares were offered under our shelf

registration statement previously filed with, and declared effective by, the SEC. The Series A Warrants contain full ratchet anti-dilution price protection so that, in most situations upon the issuance of any common stock or securities convertible into common stock at a price below the then-existing exercise price of the outstanding Series A Warrants, the Series A exercise price will be reset to the lower common stock sales price. As a result of our April 2015 financing, the exercise price of the Series A warrants were reduced from \$1.40 per share to \$0.6999999 per share.

The assumptions used for the Monte Carlo simulation model to value the outstanding Series A Warrants at September 30, 2015 are as follows:

| | |
|----------------------------------|-------|
| Risk-free interest rate per year | 0.40% |
| Expected volatility per year | 66.4% |
| Expected dividend yield | 0% |
| Expected life (years) | 1.2 |

The use of the Monte Carlo simulation model requires the input of additional subjective assumptions including the progress of our R&D programs and its affect on potential future financings.

The following table is a summary of the changes in fair value of warrant liability for the Series A Warrants in 2015:

| | Series A | |
|-------------------------------|-------------------------------|----------------------|
| | Number of Warrants | Fair value \$ |
| Balance at December 31, 2014 | 6,936,880 | \$ 1,684,551 |
| Changes in fair value | | (1,068,626) |
| Balance at September 30, 2015 | 6,936,880 | \$ 615,925 |

The fair value of the warrant liability is revalued at the end of each reporting period, with the change in fair value of the warrant liability recorded as a gain or loss in our condensed consolidated statements of operations. The fair value of the warrants will continue to be classified as a liability until such time as the warrants are exercised, expire or an amendment of the warrant agreement renders these warrants to be no longer classified as a liability.

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

This report contains forward looking statements within the meaning of Section 27A of the Securities Act and Section 21E of the Securities Exchange Act that involve substantial risks and uncertainties. Such statements include, without limitation, all statements as to expectation or belief and statements as to our future results of operations; the progress of our research, product development and clinical programs; the need for, and timing of, additional capital and capital expenditures; partnering prospects; costs of manufacture of products; the protection of, and the need for, additional intellectual property rights; effects of regulations; the need for additional facilities; and potential market opportunities. Our actual results may vary materially from those contained in such forward-looking statements because of risks to which we are subject, including the fact that additional trials will be required to confirm the safety and demonstrate the efficacy of our HuCNS-SC cells for the treatment of any disease or disorder; uncertainty as to whether the U.S. Food and Drug Administration (FDA) or other regulatory authorities will permit us to proceed with clinical testing of proposed products despite the novel and unproven nature of our technologies; the risk that our clinical trials or studies could be substantially delayed beyond their expected dates or cause us to incur substantial unanticipated costs; uncertainties in our ability to obtain the capital resources needed to continue our current research and development operations and to conduct the research, preclinical development and clinical trials necessary for regulatory approvals; the uncertainty regarding our ability to obtain a corporate partner or partners, if needed, to support the development and commercialization of our potential cell-based therapeutics product; the uncertainty regarding the outcome of our clinical trials or studies we may conduct in the future; the uncertainty regarding the validity and enforceability of our issued patents; the risk that we may not be able to manufacture additional master and working cell banks when needed; the uncertainty whether any products that may be generated in our cell-based therapeutics programs will prove clinically safe and effective; the uncertainty whether we will achieve significant revenue from product sales or become profitable; obsolescence of our technologies; competition from third parties; intellectual property rights of third parties; litigation risks; and other risks to which we are subject. All forward-looking statements attributable to us or to persons acting on our behalf are expressly qualified in their entirety by the cautionary statements and risk factors set forth in "Risk Factors" in Part I, Item 1A of our Form 10-K for the year ended December 31, 2014.

Overview***The Company***

We are engaged in researching, developing, and commercializing cell-based therapeutics. Our research and development (R&D) programs are primarily focused on identifying and developing potential cell-based therapeutics which can either restore or support organ function. In particular, since we relocated our operations to California in 1999, our R&D efforts have been directed at refining our methods for identifying, isolating, culturing, and purifying the human neural stem cell and developing this cell as potential cell-based therapeutics for the central nervous system (CNS). Our HuCNS-SC[®] cells (purified human neural stem cells) are currently in clinical development for two indications – chronic spinal cord injury and dry age-related macular degeneration (AMD).

We completed our Phase I/II clinical trial for the treatment of chronic thoracic spinal cord injury, which represents the first time that neural stem cells have been transplanted as a potential therapeutic agent for spinal cord injury. The Phase I/II trial evaluated both safety and preliminary efficacy of our proprietary HuCNS-SC human neural stem cells as a treatment for chronic thoracic spinal cord injury. To accelerate patient enrollment, we expanded this trial from a single-site, single-country study to a multi-site, multi-country program. Under this trial, a total of twelve patients, seven patients with complete injury (AIS A) and five patients with an incomplete injury (AIS B), were enrolled and transplanted with our HuCNS-SC cells. We reported the results from twelve-month data that revealed sustained improvements in sensory function that emerged consistently around three months after transplantation and persisted until the end of the study. The patterns of sensory gains were confirmed to involve multiple sensory pathways and were observed more frequently in the patients with less severe injury; three of the seven AIS A patients and four of the

five AIS B patients showed signs of positive sensory gains confirming the previously reported interim results. In addition, two patients progressed during the study from the most severe classification, AIS A, to the lesser degree of injury grade, AIS B.

In October 2014, we initiated a Phase II proof of concept clinical trial to investigate our HuCNS-SC cells as a treatment for chronic cervical spinal cord injury. The phase II Pathway study is the first clinical trial designed to evaluate both the safety and efficacy of transplanting human neural stem cells into patients with cervical spinal cord injury. Traumatic injuries to the cervical (neck) region of the spinal cord, also known as tetraplegia or quadriplegia, impair sensation and motor function of the hands, arms, legs, and trunk. The trial will be conducted as a randomized, controlled, single-blind study and efficacy will be primarily measured by assessing motor function according to the International Standards for Neurological Classification of Spinal Cord Injury. The primary efficacy outcome will focus on change in upper extremity strength as measured in the hands, arms, and shoulders. The trial will follow the participants for one year and will enroll up to 52 subjects. The trial has three cohorts; the first cohort is an open-label dose escalation arm involving six patients to determine the cell dose to be used for the second and third cohort of the study; the second cohort of the study is a single-blind arm in forty patients that will assess efficacy of our HuCNS-SC cells for the treatment of cervical spinal cord injury; the third cohort is an optional open label cohort targeted to enroll 6 patients to assess safety and preliminary

efficacy in patients with less severe injuries (AIS C). We transplanted our first subject in this Phase II trial in December 2014 and completed transplanting the six patients comprising the first cohort of this trial in April 2015. We commenced enrollment of the second cohort in June 2015.

We conducted a Phase I/II clinical trial in dry AMD at five trial sites in the United States, and in June 2014, based on positive interim results, we closed enrollment for this trial in order to focus our efforts on initiating a follow-on Phase II randomized, controlled proof-of-concept study in 2015. The phase I/II trial was designed to evaluate the safety and preliminary efficacy of sub-retinal HuCNS-SC cell transplantation in geographic atrophy (GA), the most advanced form of dry AMD. Multiple safety and efficacy assessments were incorporated into the study, including various assessments of visual function and measurements of disease status by direct retinal examination. The tests in the study included best-corrected visual acuity (BCVA), contrast sensitivity (CS), microperimetry for analysis of visual function, optical coherence tomography (OCT), and fundus autofluorescence (FAF) to measure the extent of the underlying geographic atrophy. Initial assessment of data from the Phase I/II trial indicate that the BCVA and CS measurements for the majority of the patients in the study either improved or remained stable in the treated eye. OCT analysis showed increases in central subfield thickness and in macular volume in the treated eye relative to the untreated eye. For those patients enrolled in the study with lesions sizes consistent with the eligibility criteria for enrollment in our Phase II efficacy study, the study showed GA growth rates in the study eye that were lower than those seen in the control eye.

In July 2015, we transplanted our first subject in our Radiant Study. This Phase II randomized, controlled proof-of-concept study is designed to evaluate both the safety and efficacy of our proprietary HuCNS-SC cells for the treatment of GA. The study is enrolling sixty-three patients between 50-90 years of age with bi-lateral GA-AMD (geographic atrophy associated with age related macular degeneration in both eyes). Designed as a fellow eye controlled study, all subjects will receive subretinal transplantation of HuCNS-SC cells via a single injection into the eye with the inferior best-corrected visual acuity; the untreated eye will serve as a control. All patients will be followed for twelve months, with evaluations performed at predetermined intervals to assess safety, anatomic and functional changes. The objective of the trial is to demonstrate a reduction in the rate of GA disease progression in the treated eye versus the control eye.

We previously completed a Phase I clinical trial in infantile and late infantile neuronal ceroid lipofuscinosis (NCL), which showed that our HuCNS-SC cells were well tolerated and non-tumorigenic, and that there was evidence of engraftment and long-term survival of the transplanted HuCNS-SC cells. In October 2013, the results of a four-year, long-term follow up study of the patients from the initial Phase I study showed there were no long-term safety or tolerability issues associated with the cells up to five years post-transplantation.

In October 2012, we published in *Science Translational Medicine*, a peer-reviewed journal, the data from our four-patient Phase I clinical trial in Pelizeaus Merzbacher disease (PMD), which is a myelination disorder in the brain. The data showed preliminary evidence of durable and progressive donor-derived myelination in all four patients. In addition, there were measurable gains in neurological function in three of the four patients, with the fourth patient clinically stable.

In April 2013, we entered into an agreement with the California Institute for Regenerative Medicine (CIRM) under which CIRM would have provided up to approximately \$19.3 million as a forgivable loan, in accordance with mutually agreed upon terms and conditions and CIRM regulations. The CIRM loan helped fund preclinical development of our HuCNS-SC cells for Alzheimer's disease. Between July 2013 and August 2014, we received in aggregate, approximately \$9.6 million as disbursements of the loan provided under the CIRM loan agreement. However, in December 2014, as findings under this preclinical study in Alzheimer's disease did not meet certain pre-determined criteria for continued funding of this program by CIRM, the parties terminated the loan agreement and we wound down this preclinical study which had been funded in part by the CIRM loan agreement. In February 2015, we repaid CIRM approximately \$679,000 of the aggregate loan proceeds received. Under the terms of the CIRM loan

agreement, principal amount of approximately \$8,917,000 and accrued interest of approximately \$243,000 were forgiven. However, authoritative accounting guidance requires certain conditions (which includes a legal release from the creditor) to be met before a liability can be extinguished and derecognized.

As part of our strategy to focus on our clinical operations, in the fourth quarter of 2014 we sold our SC Proven reagent and cell culture business and wound-down our business operations at our Stem Cell Sciences (UK) Ltd Subsidiary in Cambridge, UK (SCS). The results of operations from these operations have been classified as discontinued operations for all periods presented.

We have not derived any revenue or cash flows from the sale or commercialization of any products except for license revenue for certain of our patented technologies and sales of products for use in stem cell research. As a result, we have incurred annual operating losses since inception and expect to incur substantial operating losses in the future. Therefore, we are dependent upon external financing, such as from equity and debt offerings, to finance our operations. Before we can derive revenue or cash inflows from the commercialization of any of our therapeutic product candidates, we will need to: (i) conduct substantial *in vitro* testing and characterization of our proprietary cell types, (ii) undertake preclinical and clinical testing for specific disease indications; (iii) develop, validate and scale-up manufacturing processes to produce these cell-based therapeutics, and (iv) obtain required regulatory approvals. These steps are risky, expensive and time consuming.

Overall, we expect our R&D expenses to be substantial and to increase for the foreseeable future as we continue the development and clinical investigation of our current and future product candidates. However, expenditures on R&D programs are subject to many uncertainties, including whether we develop our product candidates with a partner or independently. We cannot forecast with any degree of certainty which of our current product candidates will be subject to future collaboration, when such collaboration agreements will be secured, if at all, and to what degree such arrangements would affect our development plans and capital requirements. In addition, there are numerous factors associated with the successful commercialization of any of our cell-based therapeutics, including future trial design and regulatory requirements, many of which cannot be determined with accuracy at this time given the stage of our development and the novel nature of stem cell technologies. The regulatory pathways, both in the United States and internationally, are complex and fluid given the novel and, in general, clinically unproven nature of stem cell technologies. At this time, due to such uncertainties and inherent risks, we cannot estimate in a meaningful way the duration of, or the costs to complete, our R&D programs or whether, when or to what extent we will generate revenues or cash inflows from the commercialization and sale of any of our therapeutic product candidates. While we are currently focused on advancing each of our product development programs, our future R&D expenses will depend on the determinations we make as to the scientific and clinical prospects of each product candidate, as well as our ongoing assessment of the regulatory requirements and each product candidate's commercial potential.

Given the early stage of development of our therapeutic product candidates, any estimates of when we may be able to commercialize one or more of these products would not be meaningful. Moreover, any estimate of the time and investment required to develop potential products based upon our proprietary HuCNS-SC technologies will change depending on the ultimate approach or approaches we take to pursue them, the results of preclinical and clinical studies, and the content and timing of decisions made by the FDA and other regulatory authorities. There can be no assurance that we will be able to develop any product successfully, or that we will be able to recover our development costs, whether upon commercialization of a developed product or otherwise. We cannot provide assurance that any of these programs will result in products that can be marketed or marketed profitably. If certain of our development-stage programs do not result in commercially viable products, our results of operations could be materially adversely affected.

Recent Significant Events

In July 2015, we transplanted our first subject in our Radiant Study. This Phase II randomized, controlled proof-of-concept study is designed to evaluate both the safety and efficacy of our proprietary HuCNS-SC cells for the treatment of GA. The study is enrolling sixty-three patients between 50-90 years of age with bi-lateral GA-AMD (geographic atrophy associated with age related macular degeneration in both eyes). Designed as a fellow eye controlled study, all subjects will receive subretinal transplantation of HuCNS-SC cells via a single injection into the eye with the inferior best-corrected visual acuity; the untreated eye will serve as a control. All patients will be followed for 12 months, with evaluations performed at predetermined intervals to assess safety, anatomic and functional changes. The objective of the trial is to demonstrate a reduction in the rate of GA disease progression in the treated eye versus the control eye.

Critical Accounting Policies and the Use of Estimates

The accompanying discussion and analysis of our financial condition and results of operations are based on our condensed consolidated financial statements and the related disclosures, which have been prepared in accordance with U.S. GAAP. The preparation of these condensed consolidated financial statements requires management to make estimates, assumptions, and judgments that affect the reported amounts in our condensed consolidated financial statements and accompanying notes. These estimates form the basis for making judgments about the carrying values of assets and liabilities. We base our estimates and judgments on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, and we have established internal controls related to the preparation of these estimates. Actual results and the timing of the results could differ materially from

these estimates.

Stock-Based Compensation

U.S. GAAP requires us to recognize expense related to the fair value of our stock-based payment awards, including employee stock options and restricted stock units. Under the provisions of U.S. GAAP, the fair value of our employee stock-based payment awards is estimated at the date of grant using the Black-Scholes-Merton (Black-Scholes) option-pricing model and is recognized as expense ratably over the requisite service period. The Black-Scholes option-pricing model requires the use of certain assumptions, the most significant of which are our estimates of the expected volatility of the market price of our stock and the expected term of the award. Our estimate of the expected volatility is based on historical volatility. The expected term represents our estimated period during which our stock-based awards remain outstanding. We estimate the expected term based on historical experience of similar awards, giving consideration to the contractual terms of the awards, vesting requirements, and expectation of future employee behavior, including post-vesting terminations.

We review our valuation assumptions at each grant date and, as a result, our assumptions in future periods may change. As of September 30, 2015, we expect to recognize approximately \$8,154,000 of compensation expense related to unvested stock-based awards over a weighted-average period of 1.9 years. See also Note 6, *Stock-Based Compensation*, in the notes to condensed consolidated financial statements of Part I, Item 1 of this Form 10-Q for further information.

Warrant Liability

We account for our warrants in accordance with U.S. GAAP which defines how freestanding contracts that are indexed to and potentially settled in a company's own stock should be measured and classified. Authoritative accounting guidance prescribes that only warrants issued by us under contracts that cannot be net-cash settled, and are both indexed to and settled in our common stock, can be classified as equity. As part of our December 2011 financing, we issued Series A Warrants with a five year term to purchase 8,000,000 shares at \$1.40 per share and Series B Warrants with a ninety trading day term to purchase 8,000,000 units at \$1.25 per unit. Each unit underlying the Series B Warrants consisted of one share of our common stock and one Series A Warrant. In the first and second quarter of 2012, an aggregate of 2,700,000 Series B Warrants were exercised. For the exercise of these warrants, we issued 2,700,000 shares of our common stock and 2,700,000 Series A Warrants. The remaining 5,300,000 Series B Warrants expired unexercised by their terms on May 2, 2012. The Series A Warrants contain full ratchet anti-dilution price protection so that, in most situations upon the issuance of any common stock or securities convertible into common stock at a price below the then-existing exercise price of the Series A Warrants, the Series A exercise price will be reset to the lower common stock sales price. As a result of our April 2015 financing, the exercise price of the outstanding Series A warrants were reduced from \$1.40 per share to \$0.6999999 per share. As terms of the Series A Warrants, do not meet the specific conditions for equity classification, we are required to classify the fair value of these warrants as a liability, with subsequent changes in fair value to be recorded as income (loss) due to change in fair value of warrant liability. The fair value of the Series A Warrants is determined using a Monte Carlo simulation model (see Note 9, *Warrant Liability*). The fair value is affected by changes in inputs to these models including our stock price, expected stock price volatility, the contractual term, and the risk-free interest rate. The use of a Monte Carlo simulation model requires input of additional assumptions including the progress of our R&D programs and its affect on potential future financings. We will continue to classify the fair value of the warrants as a liability until the warrants are exercised, expire or are amended in a way that would no longer require these warrants to be classified as a liability. The estimated fair value of our warrant liability at September 30, 2015, was approximately \$616,000.

Revenue Recognition

We currently recognize revenue resulting from the licensing and use of our technology and intellectual property. Licensing agreements may contain multiple elements, such as upfront fees, payments related to the achievement of particular milestones and royalties. Revenue from upfront fees for licensing agreements that contain multiple elements are generally deferred and recognized on a straight-line basis over the term of the agreement. Fees associated with substantive at risk performance-based milestones are recognized as revenue upon completion of the scientific or regulatory event specified in the agreement, and royalties received are recognized as earned. Revenue from licensing agreements is recognized net of a fixed percentage due to licensors as royalties.

Results of Operations

Our results of operations have varied significantly from year to year and quarter to quarter and may vary significantly in the future due to the occurrence of material recurring and nonrecurring events, including without limitation the receipt and payment of recurring and nonrecurring licensing payments, the initiation or termination of clinical studies, research collaborations and development programs for both cell-based therapeutic products and research tools, unpredictable or unanticipated manufacturing and supply costs, unanticipated capital expenditures necessary to support our business, legal expenses to create, prosecute and protect our intellectual property, the on-going expenses

to maintain our facilities.

Revenue

Revenue for the three and nine-month periods ended September 30, 2015, as compared with the same period in 2014, is summarized in the table below:

| | Three months ended September 30, Change in 2015 versus 2014 | | | | Nine months ended September 30, Change in 2015 versus 2014 | | | |
|--|--|------|----|---|---|------|----|---|
| | 2015 | 2014 | \$ | % | 2015 | 2014 | \$ | % |

Revenue:

| | | | | | | | | |
|----------------------|-----------|-----------|----------|-------|-----------|------------|----------|-------|
| Licensing agreements | \$ 37,030 | \$ 82,406 | (45,376) | (55)% | \$ 88,158 | \$ 129,469 | (41,311) | (32)% |
|----------------------|-----------|-----------|----------|-------|-----------|------------|----------|-------|

Third quarter ended September 30, 2015 versus third quarter ended September 30, 2014. Total revenue in the third quarter of 2015 was approximately \$37,000 compared to approximately \$82,000 for the third quarter of 2014. Revenue for both years were from licensing agreements.

Nine-month period ended September 30, 2015 versus nine-month period ended September 30, 2014. Total revenue from licensing agreements in the nine-month period ended September 30, 2015 was approximately \$88,000, which was 32% lower than total revenue of approximately \$129,000 for the same period of 2014.

Licensing revenue for the third quarters and nine-month periods for 2015 and 2014 were not significant.

Operating Expenses

Operating expenses for the three and nine-month periods ended September 30, 2015, as compared with the same period in 2014, is summarized in the table below:

| | Change in 2015 versus | | | | | | | |
|----------------------------|---------------------------------------|-----------|-----------|-----|--------------------------------------|------------|-----------|-----|
| | Three months ended September 30, 2014 | | | | Nine months ended September 30, 2014 | | | |
| | 2015 | 2014 | \$ | % | 2015 | 2014 | \$ | % |
| Operating expenses: | | | | | | | | |
| Research and development | 7,719,720 | 4,396,873 | 3,322,847 | 76% | 21,250,896 | 14,865,874 | 6,385,022 | 43% |
| General and administrative | 2,305,241 | 2,065,117 | 240,124 | * | 7,058,166 | 6,444,786 | 613,380 | 10% |
| Total operating expenses | 10,024,961 | 6,461,990 | 3,562,971 | 55% | 28,309,062 | 21,310,660 | 6,998,402 | 33% |

* Calculation not meaningful

Research and Development Expenses

Our R&D expenses consist primarily of salaries and related personnel expenses, costs associated with clinical trials and regulatory submissions, costs associated with preclinical activities such as toxicology studies, costs associated with cell processing and process development, certain patent-related costs such as licensing, facilities related costs such as allocated rent and operating expenses, depreciation, lab equipment and supplies. Clinical trial expenses include payments to vendors such as clinical research organizations, contract manufacturers, clinical trial sites, laboratories for testing clinical samples and consultants. Cumulative R&D costs incurred since we refocused our activities on developing cell-based therapeutics (fiscal years 2000 through the nine months ended September 30, 2015) were approximately \$231 million. Over this period, the majority of these cumulative costs were related to: (i) characterization of our proprietary HuCNS-SC cells, (ii) expenditures for toxicology and other preclinical studies, preparation and submission of applications to regulatory agencies to conduct clinical trials and obtaining regulatory clearance to initiate such trials, all with respect to our proprietary HuCNS-SC cells, (iii) preclinical studies and development of our human liver engrafting cells, (iv) costs associated with cell processing and process development, and (v) costs associated with our clinical studies.

We use and manage our R&D resources, including our employees and facilities, across various projects rather than on a project-by-project basis for the following reasons. The allocations of time and resources change as the needs and priorities of individual projects and programs change, and many of our researchers are assigned to more than one project at any given time. Furthermore, we are exploring multiple possible uses for our proprietary HuCNS-SC cells, so much of our R&D effort is complementary to and supportive of each of these projects. Lastly, much of our R&D effort is focused on manufacturing processes, which can result in process improvements useful across cell types. We also use external service providers to assist in the conduct of our clinical trials and to provide various other R&D related products and services. Many of these costs and expenses are complementary to and supportive of each of our programs. Because we do not have a development collaborator for any of our product programs, we are currently responsible for all costs incurred with respect to our product candidates.

Third quarter ended September 30, 2015 versus third quarter ended September 30, 2014. R&D expenses totaled approximately \$7,720,000 in the third quarter of 2015 compared with \$4,397,000 in the third quarter of 2014. The increase of approximately \$3,323,000, or 76%, in 2015 compared to 2014, was primarily attributable to (i) an increase in personnel costs of approximately \$1,057,000 due to the addition of key personnel to strengthen our product development and clinical operations capabilities and an increase in stock based compensation, (ii) an increase of approximately \$857,000 in expenses related to our clinical studies; primarily attributable to expenses incurred towards initiating a follow-on Phase II randomized, controlled proof-of-concept study in dry AMD in the second-half of 2015, (iii) an increase of approximately \$823,000 in external services, (iv) an increase of approximately \$308,000 in supplies due to increased clinical and process development activities, (v) an increase in facilities expenses of \$209,000 primarily related to manufacturing activities, and (vi) an increase in other operating expenses of approximately \$69,000.

Nine-month period ended September 30, 2015 versus nine-month period ended September 30, 2014. R&D expenses totaled approximately \$21,251,000 in the nine-month period ended September 30, 2015 compared with \$14,866,000 for the same period in 2014. The increase of approximately \$6,385,000, or 43%, in 2015 compared to 2014, was primarily attributable (i) an increase in personnel costs of approximately \$3,294,000 due to the addition of key personnel to strengthen our product development and clinical operations capabilities and an increase in stock based compensation, (ii) an increase of approximately \$1,446,000 in expenses related to our clinical studies; primarily attributable to expenses incurred towards initiating a follow-on Phase II randomized, controlled proof-of-concept study in dry AMD in the second-half of 2015 and increased activities in our Phase II proof of concept clinical trial to investigate our HuCNS-SC cells as a treatment for chronic cervical spinal cord injury, (iii) an increase of approximately \$393,000 in external services, (iv) an increase of approximately \$600,000 in supplies due to increased clinical and process development activities, (v) an increase in facilities expenses of \$551,000 primarily related to

manufacturing activities, and (vi) an increase in other operating expenses of approximately \$101,000.

General and Administrative Expenses

General and administrative (G&A) expenses are primarily comprised of salaries, benefits and other staff related costs associated with sales and marketing, finance, legal, human resources, information technology, and other administrative personnel, allocated facilities and overhead costs, external legal and other external general and administrative services.

Third quarter ended September 30, 2015 versus third quarter ended September 30, 2014. G&A expenses totaled approximately \$2,305,000 in the third quarter of 2015 compared with approximately \$2,065,000 in the same period of 2014. The increase of approximately \$240,000, in 2015 compared to 2014, was primarily attributable an increase of approximately \$361,000 in payroll expenses primarily attributable to an increase in stock-based compensation awards offset by a decrease in other operating expenses of approximately \$121,000.

Nine-month period ended September 30, 2015 versus nine-month period ended September 30, 2014. G&A expenses totaled approximately \$7,058,000 in the nine-month period ended September 30, 2015 compared with approximately \$6,445,000 in the same period of 2014. The increase of approximately \$613,000, or 10%, in 2015 compared to 2014, was primarily attributable to an increase of approximately \$1,138,000 in payroll expenses due to an increase in stock-based compensation awards offset by a decrease in other operating expenses of approximately \$525,000 primarily attributable to a reduction in legal expenses.

Other Income (Expense)

Other income totaled approximately \$345,000 in the third quarter of 2015 compared with other income of approximately \$3,760,000 in the same period of 2014, and other income of approximately \$766,000 for the nine-month period ended September 30, 2015 compared with other expense of approximately \$972,000 for the nine-month period ended September 30, 2014.

| | Three months ended September 30, 2015 versus 2014 | | | | Change in 2015 versus 2014 | | | |
|---|---|-----------|-------------|--------|----------------------------|-------------|-----------|--------|
| | 2015 | 2014 | \$ | % | 2015 | 2014 | \$ | % |
| Other income (expense): | | | | | | | | |
| Change in fair value of warrant liability | 427,589 | 4,076,360 | (3,648,771) | (90)% | 1,068,626 | 95,266 | 973,360 | 10% |
| Interest income | 2,171 | 2,223 | (52) | (2)% | 5,704 | 6,097 | (393) | (6)% |
| Interest expense | (106,843) | (311,349) | 204,506 | (66)% | (438,466) | (1,035,061) | 596,595 | (58)% |
| Other income (expense), net | 22,367 | (7,244) | 29,611 | (409)% | 129,978 | (38,128) | 168,106 | (441)% |
| | 345,284 | 3,759,990 | (3,414,706) | (91)% | 765,842 | (971,826) | 1,737,668 | (179)% |

Total other
income
(expense),
net

Change in Fair Value of Warrant Liability

We record changes in fair value of warrant liability as income or loss in our Consolidated Statements of Operations. We have warrants outstanding which were issued as part of several transactions and have classified the fair value of certain warrants that did not meet the specific conditions for equity classification as a liability. The fair value of the outstanding warrants is determined using various option pricing models, such as the Black-Scholes-Merton (Black-Scholes) option pricing model and a Monte Carlo simulation model, and is affected by changes in inputs to the various models, including our stock price, expected stock price volatility, the contractual term, and the risk-free interest rate. The use of a Monte Carlo simulation model requires input of additional subjective assumptions, including the progress of our R&D programs and its affect on potential future financings. The fair value of the warrant liability is revalued at the end of each reporting period. See Note 9 Warrant Liability in the notes to condensed consolidated financial statements of Part I, Item 1 of this Form 10-Q for further information.

Interest Income

Interest income in three and nine-month period ended September 30, 2015 and 2014 were not significant and is from the investment of our cash balances in money market accounts and short-term money market instruments that are highly liquid and that preserves capital.

Interest Expense

Interest expense was approximately \$107,000 in the third quarter of 2015 compared with approximately \$311,000 for the third quarter of 2014. Interest expense was approximately \$438,000 for the nine-month period ended September 30, 2015 compared with approximately \$1,035,000 for the nine-month period ended September 30, 2014. Interest expense in the three- and nine-month period of 2015 is primarily attributable to interest due under a Loan Agreement with SVB. Interest expense for the similar periods in 2014 is primarily attributable to interest due under the Loan Agreement with SVB and interest accrued under the Loan Agreement with CIRM. See Note 7 – Loan Payable, in the notes to condensed consolidated financial statements of Part I, Item 1 of this Form 10-Q for further information.

Other income (expense), net

Other income of approximately \$22,000 in the third quarter of 2015 was primarily attributable to the gain on sale of equipment. Other income of approximately \$130,000 for the nine-month period ended September 30, 2015 was primarily attributable to the gain on sale of our Rhode Island property (see Note 8, – Commitments and Contingencies in the notes to condensed consolidated financial statements of Part I, Item 1 of this Form 10-Q for further information) and gain on sale of equipment offset by state franchise taxes paid. Other expense of approximately \$7,000 for the third quarter of 2014 and approximately \$38,000 for the nine-month period ended September 30, 2014 was primarily related to state franchise taxes.

Discontinued Operations

In the fourth quarter of 2014, as part of our strategy to focus on our clinical operations, we sold our SC Proven reagent and cell culture business and wound-down our business operations at our SCS Subsidiary in Cambridge, UK. The results of operations for this component have been classified as discontinued operations for all periods in our Consolidated Statement of Operations.

| | Three months ended September 30, | | the months ended September 30, | | | |
|---------------------------------------|---|-------------|---------------------------------------|-------------|----|-----------|
| | 2015 | 2014 | 2015 | 2014 | | |
| Revenue from product sales | \$ | \$ | 171,371 | \$ | \$ | 705,992 |
| Cost of product sales | | | 58,163 | | | 223,536 |
| Gross profit | | | 113,208 | | | 482,456 |
| Operating and other expenses | | | 266,588 | | | 838,053 |
| Net loss from discontinued operations | \$ | \$ | (153,380) | \$ | \$ | (355,597) |

Liquidity and Capital Resources

Since our inception, we have financed our operations through the sale of common and preferred stock, the issuance of long-term debt and capitalized lease obligations, credit facilities, revenue from collaborative agreements, research grants, license fees, and interest income.

| | September 30, 2015 | December 31, 2014 | Change \$ | % |
|---------------------------|-----------------------|----------------------|----------------|-------|
| Cash and cash equivalents | \$ 21,185,263 | \$ 24,987,603 | \$ (3,802,340) | (15)% |

In summary, our cash flows were:

| | Nine months ended September 30, | | Change in 2015 versus 2014 | |
|---|------------------------------------|-----------------|----------------------------|-------|
| | 2015 | 2014 | \$ | % |
| Net cash used in operating activities | \$ (23,750,255) | \$ (20,960,576) | \$ (2,789,679) | 13% |
| Net cash used in investing activities | \$ (836,560) | \$ (598,432) | \$ (238,128) | 40% |
| Net cash provided by financing activities | \$ 20,802,444 | \$ 23,191,816 | \$ (2,389,372) | (10)% |

Net Cash Used in Operating Activities

Net cash used in operating activities in the nine-month period ended September 30, 2015 increased by approximately \$2,790,000, or 13%, when compared to the same period of 2014. Cash used in operating activities is primarily driven by our net loss as adjusted for non-cash charges and differences in the timing of operating cash flows.

Net Cash Used in Investing Activities

Net cash used in investing activities of approximately \$836,000 in the nine-month period ended September 30, 2015 was primarily related to the purchase of lab equipment for approximately \$1,005,000, offset by receipts of approximately \$149,000 from the sale of our property in Rhode Island (See Note 8, Commitments and Contingencies in the notes to condensed consolidated financial statements of Part I, Item 1 of this Form 10-Q for further information) and approximately \$20,000 from the sale of lab equipment. In comparison, we used approximately \$598,000 for the purchase of lab equipment in the nine-month period ended September 30, 2014.

Net Cash Provided by Financing Activities

Net cash of approximately \$20,802,000 provided by financing activities in the nine-month period ended September 30, 2015 was primarily attributable to net proceeds of approximately \$24,943,000 from a financing transaction in April 2015 partially offset by the repayment of loan, lease and other obligations. In comparison, net cash of approximately \$23,192,000 provided by financing activities in the nine-month period ended September 30, 2014 was primarily attributable to net proceeds of approximately \$18,953,000 from a financing transaction in July 2014; the receipt of approximately \$5,776,000, net of issuance costs as a part of a loan provided under the CIRM Loan Agreement (see Note 7, Loan Payable in the notes to condensed consolidated financial statements of Part I, Item 1 of this Form 10-Q for further information); net proceeds of approximately \$1,975,000 from the exercise of warrants; offset by repayment of loan, lease and other obligations.

We have incurred significant operating losses and negative cash flows since inception. We have not achieved profitability and may not be able to realize sufficient revenue to achieve or sustain profitability in the future. We do not expect to be profitable in the next several years, but rather expect to incur additional operating losses. We have limited liquidity and capital resources and must obtain significant additional capital resources in order to sustain our product development efforts, for acquisition of technologies and intellectual property rights, for preclinical and clinical testing of our anticipated products, pursuit of regulatory approvals, acquisition of capital equipment, laboratory and office facilities, establishment of production capabilities, for general and administrative expenses and other working capital requirements. We rely on cash balances and proceeds from equity and debt offerings, proceeds from the transfer or sale of our intellectual property rights, equipment, facilities or investments, and government grants and funding from collaborative arrangements, if obtainable, to fund our operations.

We intend to pursue opportunities to obtain additional financing in the future through equity and debt financings, grants and collaborative research arrangements. In December 2013, we filed with the SEC, and the SEC declared effective, a universal shelf registration statement which permits us to issue up to \$100 million worth of registered debt and equity securities. Under this effective shelf registration, we have the flexibility to issue registered securities, from time to time, in one or more separate offerings or other transactions with the size, price and terms to be determined at the time of issuance. Registered securities issued using this shelf may be used to raise additional capital to fund our working capital and other corporate needs, for future acquisitions of assets, programs or businesses, and for other corporate purposes. As of October 21, 2015, we had approximately \$27 million under this universal shelf registration statement available for issuing debt or equity securities.

The source, timing and availability of any future financing will depend principally upon market conditions, interest rates and, more specifically, on our progress in our exploratory, preclinical and future clinical development programs. Funding may not be available when needed at all, or on terms acceptable to us. Lack of necessary funds may require us, among other things, to delay, scale back or eliminate some or all of our research and product development programs, planned clinical trials, and/or our capital expenditures or to license our potential products or technologies to third parties. In addition, a decline in economic activity, together with the deterioration of the credit and capital markets, could have an adverse impact on potential sources of future financing.

Commitments

See Note 8, *Commitments and Contingencies* in the notes to condensed consolidated financial statements of Part I, Item 1 of this Form 10-Q for further information.

Off-Balance Sheet Arrangements

We have certain contractual arrangements that create potential risk for us and are not recognized in our Consolidated Balance Sheets. Discussed below are those off-balance sheet arrangements that have or are reasonably likely to have a material current or future effect on our financial condition, changes in financial condition, revenue or expenses, results of operations, liquidity, capital expenditures or capital resources.

Operating Leases

We lease various real properties under operating leases that generally require us to pay taxes, insurance, maintenance, and minimum lease payments. Some of our leases have options to renew.

Operating Leases - California

In December 2010, we entered into a commercial lease agreement with BMR-Gateway Boulevard LLC (BMR), as landlord, for office and research space at BMR's Pacific Research Center in Newark, California. The initial term of the lease is approximately eleven and one-half years and includes escalating rent payments which we recognize as lease operating expense on a straight-line basis. We will pay approximately \$17,869,000 in aggregate as rent over the term of the lease to BMR. Deferred rent for this facility was approximately \$1,395,000 as of September 30, 2015, and approximately \$1,429,000 as of December 31, 2014.

In March 2013, we entered into a commercial lease agreement with Prologis, L.P. (Prologis), as landlord, for office and research space in Sunnyvale, California. The facility is for operations that support our clinical development activities. The initial term of the lease is ten years and includes escalating rent payments which we recognize as lease operating expense on a straight-line basis. We will pay approximately \$3,497,000 in aggregate rent over the term of the lease. As part of the lease, Prologis has agreed to provide us financial allowances to build initial tenant improvements, subject to customary terms and conditions relating to landlord-funded tenant improvements. The tenant

improvements are recorded as leasehold improvement assets and amortized over the term of the lease. The financial allowances are treated as a lease incentive and recorded as deferred rent which is amortized as reductions to lease expense over the lease term. Deferred rent for this facility was approximately \$385,000 as of September 30, 2015 and approximately \$391,000 as of December 31, 2014.

Operating Leases United Kingdom

In January 2011, we amended the existing lease agreements of our wholly-owned subsidiary, Stem Cell Sciences (U.K.) Ltd, effectively reducing our leased office and lab space. The lease by its terms was extended to September 30, 2013. In October 2013, we signed a new three-year lease agreement for the leased space and expect to pay rent of approximately GBP 53,000 per annum. StemCells, Inc. is the guarantor of Stem Cell Sciences (U.K.) Ltd. s obligations under the existing lease. The lease includes an option for early termination of the lease agreement, which we exercised in February 2015. In December 2014, we sold our SC Proven reagent and cell culture business and as part of the wind-down of our business operations in UK, sublet our leased space from January 2015 to our opted early termination date of October 2015.

With the exception of the operating leases discussed above, we have not entered into any significant off balance sheet financial arrangements and have not established any special purpose entities. We have not guaranteed any debts or commitments of other entities or entered into any options on non-financial assets.

Contractual Obligations

In the table below, we set forth our legally binding and enforceable contractual cash obligations at September 30, 2015:

| | Total Obligations at September 30, 2015 | Payable in (October to December) 2015 | Payable in 2016 | Payable in 2017 | Payable in 2018 | Payable in 2019 | Payable in 2020 and Beyond |
|---|--|--|----------------------------|----------------------------|----------------------------|----------------------------|---|
| Operating lease payments(1) | \$ 14,735,292 | \$ 493,957 | \$ 1,968,459 | \$ 2,014,706 | \$ 2,061,260 | \$ 2,108,130 | \$ 6,088,780 |
| Capital lease payment (equipment) | 40,389 | 6,537 | 19,394 | 9,941 | 4,517 | | |
| Loan Payable (principal & interest)(2) | 2,521,187 | 1,080,509 | 1,440,678 | | | | |
| Total contractual cash obligations | \$ 17,296,868 | \$ 1,581,003 | \$ 3,428,531 | \$ 2,024,647 | \$ 2,065,777 | \$ 2,108,130 | \$ 6,088,780 |

(1) See Note 8, Commitments and Contingencies in the notes to condensed consolidated financial statements of Part I, Item 1 of this Form 10-Q for further information.

(2) See Note 7, Loan Payable in the notes to condensed consolidated financial statements of Part I, Item 1 of this Form 10-Q for further information.

We periodically enter into licensing agreements with third parties to obtain exclusive or non-exclusive licenses for certain technologies. The terms of certain of these agreements require us to pay future milestone payments based upon achievement of certain developmental, regulatory or commercial milestones. We do not anticipate making any milestone payments under any of our licensing agreements for 2015. Milestone payments beyond fiscal year 2015 cannot be predicted or estimated, due to the uncertainty of achieving the required developmental, regulatory or commercial milestones.

We do not have any material unconditional purchase obligations or commercial commitments related to capital expenditures, clinical development, clinical manufacturing, or other external services contracts at September 30, 2015.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our market risks at September 30, 2015 have not changed materially from those discussed in Item 7A of our Form 10-K for the year ended December 31, 2014 on file with the U.S. Securities and Exchange Commission.

See also Note 2, Financial Instruments, in the notes to condensed consolidated financial statements in Part I, Item 1 of this Form 10-Q.

ITEM 4. CONTROLS AND PROCEDURES

In response to the requirement of the Sarbanes-Oxley Act of 2002, as of the end of the period covered by this report, our chief executive officer and chief financial officer, along with other members of management, reviewed the effectiveness of the design and operation of our disclosure controls and procedures. Such controls and procedures are designed to ensure that information required to be disclosed in the Company's Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to management, including the chief executive officer and the chief financial officer, as appropriate, to allow timely decisions regarding required disclosure. Based on this evaluation, the chief executive officer and chief financial officer have concluded that the Company's disclosure controls and procedures are effective.

During the most recent quarter, there were no changes in internal controls over financial reporting that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, these controls of the Company.

PART II-OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

None.

ITEM 1A. RISK FACTORS

There have been no material change from the risk factors disclosed in Part I, Item 1A, of our Annual Report on Form 10-K for the fiscal year ended December 31, 2014.

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

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. MINE SAFETY DISCLOSURES

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

- Exhibit 31.1** Certification of Martin McGlynn under Section 302 of the Sarbanes-Oxley Act of 2002
- Exhibit 31.2** Certification of Gregory Schiffman under Section 302 of the Sarbanes-Oxley Act of 2002
- Exhibit 32.1** Certification of Martin McGlynn Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- Exhibit 32.2** Certification of Gregory Schiffman Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- Exhibit 101.1** The following materials from the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2015 are formatted in XBRL (eXtensible Business Reporting Language): (i) the Condensed Consolidated Balance Sheets, (ii) the Condensed Consolidated Statements of Operations, (iii) the Condensed Consolidated Statements of Comprehensive Income, (iv) the Condensed Consolidated Statements of Cash Flows, and (v) Notes to Condensed Consolidated Financial Statements.

SIGNATURE

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

STEMCELLS, INC.

(name of Registrant)

November 2, 2015

/s/ Gregory Schiffman
Gregory Schiffman
Chief Financial Officer

Exhibit Index

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