

STEMCELLS INC  
Form 10-Q  
August 08, 2012  
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**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: June 30, 2012

Commission File Number: 0-19871

**STEMCELLS, INC.**

(Exact name of registrant as specified in its charter)

**DELAWARE**  
(State or other jurisdiction of

**94-3078125**  
(I.R.S. Employer

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incorporation or organization)

identification No)

7707 Gateway Blvd

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 August 6, 2012, there were 30,410,399 shares of Common Stock, \$.01 par value, issued and outstanding.

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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.

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## ITEM 1. FINANCIAL STATEMENTS

STEMCELLS, INC.

## CONDENSED CONSOLIDATED BALANCE SHEETS

(unaudited)

|                                                                                                                                                      | June 30,<br>2012 | December 31,<br>2011 |
|------------------------------------------------------------------------------------------------------------------------------------------------------|------------------|----------------------|
| <b>ASSETS</b>                                                                                                                                        |                  |                      |
| Current assets:                                                                                                                                      |                  |                      |
| Cash and cash equivalents                                                                                                                            | \$ 7,203,428     | \$ 13,311,261        |
| Marketable securities, current                                                                                                                       | 1,699,814        | 3,280,591            |
| Trade receivables                                                                                                                                    | 120,858          | 54,527               |
| Other receivables                                                                                                                                    | 191,159          | 213,500              |
| Prepaid assets                                                                                                                                       | 403,673          | 506,464              |
| Other assets, current                                                                                                                                | 790,308          | 22,063               |
| Total current assets                                                                                                                                 | 10,409,240       | 17,388,406           |
| Property, plant and equipment, net                                                                                                                   | 1,683,142        | 2,054,563            |
| Other assets, non-current                                                                                                                            | 1,050,550        | 1,856,057            |
| Goodwill                                                                                                                                             | 1,913,173        | 1,895,000            |
| Other intangible assets, net                                                                                                                         | 1,897,395        | 2,011,473            |
| Total assets                                                                                                                                         | \$ 16,953,500    | \$ 25,205,499        |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                                                                                                          |                  |                      |
| Current liabilities:                                                                                                                                 |                  |                      |
| Accounts payable                                                                                                                                     | \$ 758,968       | \$ 1,066,495         |
| Accrued expenses and other current liabilities                                                                                                       | 1,793,824        | 2,970,251            |
| Accrued wind-down expenses, current                                                                                                                  | 1,497,741        | 1,360,766            |
| Deferred revenue, current                                                                                                                            | 27,272           | 43,910               |
| Capital lease obligation, current                                                                                                                    |                  | 17,979               |
| Deferred rent, current                                                                                                                               | 651              | 2,603                |
| Bonds payable, current                                                                                                                               | 198,750          | 191,250              |
| Total current liabilities                                                                                                                            | 4,277,206        | 5,653,254            |
| Bonds payable, non-current                                                                                                                           | 231,250          | 331,250              |
| Fair value of warrant liability                                                                                                                      | 5,396,170        | 6,042,315            |
| Deposits and other long-term liabilities                                                                                                             | 246,437          | 281,807              |
| Accrued wind-down expenses, non-current                                                                                                              |                  | 774,020              |
| Deferred rent, non-current                                                                                                                           | 1,349,615        | 1,301,167            |
| Deferred revenue, non-current                                                                                                                        | 88,149           | 96,562               |
| Total liabilities                                                                                                                                    | 11,588,827       | 14,480,375           |
| Commitments and contingencies (Note 7)                                                                                                               |                  |                      |
| Stockholders' equity:                                                                                                                                |                  |                      |
| Common stock, \$0.01 par value; 75,000,000 shares authorized; issued and outstanding 25,377,631 at June 30, 2012 and 22,427,955 at December 31, 2011 | 1,502,272        | 1,472,776            |
| Additional paid-in capital                                                                                                                           | 345,787,856      | 341,811,657          |
| Accumulated deficit                                                                                                                                  | (341,995,939)    | (332,600,022)        |

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|                                            |               |               |
|--------------------------------------------|---------------|---------------|
| Accumulated other comprehensive income     | 70,484        | 40,713        |
| Total stockholders' equity                 | 5,364,673     | 10,725,124    |
| Total liabilities and stockholders' equity | \$ 16,953,500 | \$ 25,205,499 |

See Notes to Condensed Consolidated Financial Statements.

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STEMCELLS, INC.

### CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited)

|                                                                         | Three months ended June 30, |                | Six months ended June 30, |                |
|-------------------------------------------------------------------------|-----------------------------|----------------|---------------------------|----------------|
|                                                                         | 2012                        | 2011           | 2012                      | 2011           |
| Revenue:                                                                |                             |                |                           |                |
| Revenue from licensing agreements and grants                            | \$ 38,085                   | \$ 49,257      | \$ 410,762                | \$ 121,349     |
| Revenue from product sales                                              | 210,749                     | 184,840        | 482,108                   | 334,215        |
| Total revenue                                                           | 248,834                     | 234,097        | 892,870                   | 455,564        |
| Cost of product sales                                                   | 64,277                      | 52,365         | 136,236                   | 106,889        |
| Gross profit                                                            | 184,557                     | 181,732        | 756,634                   | 348,675        |
| Operating expenses:                                                     |                             |                |                           |                |
| Research and development                                                | 3,749,066                   | 5,053,834      | 7,687,457                 | 10,579,511     |
| Selling, general and administrative                                     | 1,775,342                   | 2,103,262      | 3,699,667                 | 4,178,991      |
| Wind-down expenses                                                      | 9,902                       | 114,918        | 45,057                    | 190,055        |
| Total operating expenses                                                | 5,534,310                   | 7,272,014      | 11,432,181                | 14,948,557     |
| Loss from operations                                                    | (5,349,753)                 | (7,090,282)    | (10,675,547)              | (14,599,882)   |
| Other income (expense):                                                 |                             |                |                           |                |
| Change in fair value of warrant liability                               | 6,205,957                   | 3,020,228      | 1,264,780                 | 4,803,183      |
| Realized gain on sale of marketable securities                          |                             | 83,750         |                           | 83,750         |
| Interest income                                                         | 2,811                       | 6,446          | 7,021                     | 7,818          |
| Interest expense                                                        | (14,175)                    | (19,793)       | (28,622)                  | (40,000)       |
| Other income (expense)                                                  | (11,318)                    | (35,542)       | 36,451                    | (37,297)       |
| Total other income, net                                                 | 6,183,275                   | 3,055,089      | 1,279,630                 | 4,817,454      |
| Net income (loss)                                                       | \$ 833,522                  | \$ (4,035,193) | \$ (9,395,917)            | \$ (9,782,428) |
| Basic and diluted net income (loss) per share                           | \$ 0.03                     | \$ (0.29)      | \$ (0.39)                 | \$ (0.71)      |
| Weighted average number of common shares outstanding, basic and diluted | 24,806,769                  | 13,802,372     | 23,882,634                | 13,741,481     |
| See Notes to Condensed Consolidated Financial Statements.               |                             |                |                           |                |

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STEMCELLS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(unaudited)

|                                                    | Three months ended<br>June 30, |                | Six months ended<br>June 30, |                |
|----------------------------------------------------|--------------------------------|----------------|------------------------------|----------------|
|                                                    | 2012                           | 2011           | 2012                         | 2011           |
| Net income (loss)                                  | \$ 833,522                     | \$ (4,035,193) | \$ (9,395,917)               | \$ (9,782,428) |
| Other comprehensive income (loss)                  |                                |                |                              |                |
| Foreign currency translation adjustments           | (68,738)                       | (101,793)      | 27,148                       | (118,492)      |
| Unrealized gains (losses) on marketable securities | (130)                          | 6,704          | 2,623                        | 200,034        |
| Other comprehensive income (loss)                  | (68,868)                       | (95,089)       | 29,771                       | 81,542         |
| Comprehensive income (loss)                        | \$ 764,654                     | \$ (4,130,282) | \$ (9,366,146)               | \$ (9,700,886) |

See Notes to Condensed Consolidated Financial Statements.

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STEMCELLS, INC.

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(unaudited)

|                                                                                    | <b>Six months ended<br/>June 30,</b> |                     |
|------------------------------------------------------------------------------------|--------------------------------------|---------------------|
|                                                                                    | <b>2012</b>                          | <b>2011</b>         |
| <b>Cash flows from operating activities:</b>                                       |                                      |                     |
| Net loss                                                                           | \$ (9,395,917)                       | \$ (9,782,428)      |
| <b>Adjustments to reconcile net loss to net cash used in operating activities:</b> |                                      |                     |
| Depreciation and amortization                                                      | 521,142                              | 612,233             |
| Stock-based compensation                                                           | 1,459,990                            | 1,948,727           |
| Gain on sale of marketable securities                                              |                                      | (83,750)            |
| Loss on disposal of fixed assets                                                   |                                      | 32,093              |
| Change in fair value of warrant liability                                          | (1,264,780)                          | (4,803,183)         |
| <b>Changes in operating assets and liabilities:</b>                                |                                      |                     |
| Other receivables                                                                  | 46,425                               | (281,680)           |
| Trade receivables                                                                  | (64,672)                             | 42,834              |
| Prepaid and other current assets                                                   | 103,666                              | (77,282)            |
| Other assets, non-current                                                          | 15,581                               | 3,187               |
| Accounts payable and accrued expenses                                              | (1,520,862)                          | (896,382)           |
| Accrued wind-down expenses                                                         | (637,045)                            | (530,553)           |
| Deferred revenue                                                                   | (25,075)                             | (30,807)            |
| Deferred rent                                                                      | 46,495                               | 716,024             |
| <b>Net cash used in operating activities</b>                                       | <b>(10,715,052)</b>                  | <b>(13,130,967)</b> |
| <b>Cash flows from investing activities:</b>                                       |                                      |                     |
| Purchase of marketable securities                                                  | (2,078,600)                          | (9,725,332)         |
| Proceeds from the sale and maturity of marketable securities                       | 3,662,000                            | 758,206             |
| Purchases of property, plant and equipment                                         | (17,481)                             | (116,582)           |
| Proceeds from sale of property, plant and equipment                                |                                      | 42,427              |
| <b>Net cash provided by (used in) investing activities</b>                         | <b>1,565,919</b>                     | <b>(9,041,281)</b>  |
| <b>Cash flows from financing activities:</b>                                       |                                      |                     |
| Proceeds from issuance of common stock, net of issuance costs                      |                                      | 9,524,758           |
| Proceeds from the exercise of stock options                                        |                                      | 2,386               |
| Proceeds from the exercise of warrants, net of issuance costs                      | 3,194,202                            |                     |
| Payments related to net share issuance of stock based awards                       | (29,865)                             | (394,096)           |
| Repayment of capital lease obligations                                             | (17,979)                             | (33,078)            |
| Repayment of bonds payable                                                         | (92,500)                             | (85,000)            |
| <b>Net cash provided by financing activities</b>                                   | <b>3,053,858</b>                     | <b>9,014,970</b>    |
| <b>Decrease in cash and cash equivalents</b>                                       | <b>(6,095,275)</b>                   | <b>(13,157,278)</b> |
| Effects of foreign exchange rate changes on cash                                   | (12,558)                             | (16,898)            |
| <b>Cash and cash equivalents, beginning of period</b>                              | <b>13,311,261</b>                    | <b>19,707,821</b>   |
| <b>Cash and cash equivalents, end of period</b>                                    | <b>\$ 7,203,428</b>                  | <b>\$ 6,533,645</b> |
| <b>Supplemental disclosure of cash flow information:</b>                           |                                      |                     |
| Interest paid                                                                      | \$ 28,622                            | \$ 40,000           |

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See Notes to Condensed Consolidated Financial Statements.

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### **Notes to Condensed Consolidated Financial Statements (Unaudited)**

**June 30, 2012 and 2011**

#### **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 June 30, 2012 and for the three and six months ended June 30, 2012 and 2011 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 December 31, 2011 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, 2011.

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, selling, general and administrative expenses and other working capital requirements. We rely on our cash reserves, proceeds from equity and debt offerings, 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.

##### **Reverse Stock Split**

We effected a 1-for-10 reverse stock split on July 6, 2011. As a result of the reverse stock split, the outstanding shares of common stock issued and outstanding were reduced from approximately 139 million to 13.9 million. Concurrent with the reverse stock split, we reduced the authorized number of common shares from 250 million to 75 million. The reverse stock split proportionately reduced all issued and outstanding shares of our common stock, as well as common stock underlying stock options, warrants and other common stock based equity grants outstanding immediately prior to the effectiveness of the reverse stock split. The exercise price on outstanding equity-based grants was proportionately increased, and the number of shares available under our equity-based plans was proportionately reduced. Share and per share data (except par value) for the periods presented reflect the effects of this reverse stock split. References to numbers of shares of common stock and per share data in the accompanying financial statements and notes thereto have been adjusted to reflect the reverse stock split on a retroactive basis.

##### **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.

##### **Use of Estimates**

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 5, [Stock-Based Compensation](#) );

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accrued wind-down expenses (see Note 6, *Wind-Down Expenses* );

the fair value of warrants recorded as a liability (see Note 8, *Warrant Liability* ); and

the fair value of goodwill and other intangible assets (see Note 4, *Goodwill and Other Intangible Assets* ).

## **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.

### *Marketable Securities*

Our existing marketable securities are designated as available-for-sale securities. These securities are carried at fair value (see Note 2, *Financial Instruments* ), with the unrealized gains and losses reported as a component of stockholders' equity. Management determines the appropriate designation of its investments (current or non-current) in marketable securities at the time of purchase and reevaluates such designation as of each balance sheet date. The cost of securities sold is based upon the specific identification method.

If the estimated fair value of a security is below its carrying value, we evaluate whether we have the intent and ability to retain our investment for a period of time sufficient to allow for any anticipated recovery to the cost of the investment, and whether evidence indicating that the cost of the investment is recoverable within a reasonable period of time outweighs evidence to the contrary. Other-than-temporary declines in estimated fair value of all marketable securities are charged to Other income (expense), net in the accompanying condensed consolidated statements of operations. No such impairment was recognized during the three and six months ended June 30, 2012 or 2011.

### *Trade and Other Receivables*

Our receivables generally consist of interest income on our financial instruments, revenue from licensing agreements and grants, revenue from product sales, and rent from our sub-lease tenants.

### *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 under contracts that cannot be net-cash settled, and are both indexed to and settled in the Company's common stock, can be classified as equity. As part of both our November 2008 and November 2009 financings, we issued warrants with five year terms to purchase 1,034,483 and 400,000 shares of our common stock at \$23.00 and \$15.00 per share, respectively. 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 with an exercise price of \$1.40 per share. The remaining unexercised 5,300,000 Series B Warrants expired by their terms on May 2, 2012. As terms of the warrants issued in 2008 and 2009, as well as the Series A and Series B 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) on change in fair value of warrant liability. The fair value of the warrants issued in the 2008 and 2009 financings is determined using the Black-Scholes-Merton (Black-Scholes) option pricing model and the fair value of the Series A and Series B Warrants is determined using the Monte Carlo simulation model (see Note 8, *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 the 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.

**Table of Contents****Goodwill and Other Intangible Assets**

Goodwill and intangible assets deemed to have indefinite lives are not amortized but are subject to annual impairment tests. If the assumptions and estimates used to allocate the purchase price are not correct, or if business conditions change, purchase price adjustments or future asset impairment charges could be required. We test goodwill for impairment on an annual basis or more frequently if we believe indicators of impairment exist. Impairment evaluations involve management estimates of asset useful lives and future cash flows. Significant management judgment is required in the forecasts of future operating results that are used in the evaluations, and it is possible, even likely, that the plans and estimates used may be incorrect. If our actual results, or the plans and estimates used in future impairment analysis are lower than the original estimates used to assess the recoverability of these assets, we could incur additional impairment charges in a future period. We completed our annual impairment testing during the fourth quarter of 2011, and determined that there was no impairment of goodwill.

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, from government grants, and from product sales. 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. Grant revenue from government agencies are funds received to cover specific expenses and are recognized as earned upon either the incurring of reimbursable expenses directly related to the particular research plan or the completion of certain development milestones as defined within the terms of the relevant collaborative agreement or grant. Revenue from product sales are recognized when the product is shipped and the order fulfilled.

**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 5, 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 income or loss per share computations:

|                                                                                                    | Three months ended June 30, |                | Six months ended June 30, |                |
|----------------------------------------------------------------------------------------------------|-----------------------------|----------------|---------------------------|----------------|
|                                                                                                    | 2012                        | 2011           | 2012                      | 2011           |
| Net income (loss)                                                                                  | \$ 833,522                  | \$ (4,035,193) | \$ (9,395,917)            | \$ (9,782,428) |
| Weighted average shares outstanding used to compute basic and diluted net income or loss per share | 24,806,769                  | 13,802,372     | 23,882,634                | 13,741,481     |
| Basic and diluted net income (loss) per share                                                      | \$ 0.03                     | \$ (0.29)      | \$ (0.39)                 | \$ (0.71)      |

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

|                        | 2012       | 2011      |
|------------------------|------------|-----------|
| Options                | 854,958    | 996,463   |
| Restricted stock units | 1,513,400  | 341,874   |
| Warrants               | 12,134,483 | 1,434,483 |
| Total                  | 14,502,841 | 2,772,820 |

**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, we include in OCL changes in unrealized gains and losses on our marketable securities and unrealized gains and losses on foreign currency translations. Accumulated other comprehensive income was \$70,484, as of June 30, 2012, and \$40,713, as of December 31, 2011.

**Note 2. Financial Instruments**

The following table summarizes the fair value of our cash, cash equivalents and available-for-sale marketable securities held in our current investment portfolio:

|                                                         | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>(Losses) | Fair Value    |
|---------------------------------------------------------|-------------------|------------------------------|---------------------------------|---------------|
| <b>June 30, 2012</b>                                    |                   |                              |                                 |               |
| Cash                                                    | \$ 192,843        | \$                           | \$                              | \$ 192,843    |
| Cash equivalents                                        | 7,010,586         |                              |                                 | 7,010,586     |
| Marketable debt securities, current                     | 1,699,885         |                              | (71)                            | 1,699,814     |
| Total cash, cash equivalents, and marketable securities | \$ 8,903,314      | \$                           | \$ (71)                         | \$ 8,903,243  |
| <b>December 31, 2011</b>                                |                   |                              |                                 |               |
| Cash                                                    | \$ 291,093        | \$                           | \$                              | \$ 291,093    |
| Cash equivalents                                        | 13,020,168        |                              |                                 | 13,020,168    |
| Marketable debt securities, current                     | 3,283,209         |                              | (2,618)                         | 3,280,591     |
| Total cash, cash equivalents, and marketable securities | \$ 16,594,470     | \$                           | \$ (2,618)                      | \$ 16,591,852 |

Gross unrealized gains and losses on cash equivalents were not significant at June 30, 2012 and December 31, 2011. At June 30, 2012, our investment in money market accounts are composed primarily of U.S. Treasury debt securities, which are classified as cash equivalents in our Consolidated Balance Sheet due to their short maturities. Our investment in short-term marketable debt securities are composed primarily of commercial paper and corporate debt securities.

**Note 3. Fair Value Measurement**

The following tables present our assets and liabilities that are measured at fair value on a recurring basis and are categorized using the fair value hierarchy. The fair value hierarchy has three levels based on the reliability of the inputs used to determine fair value.

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

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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 us to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

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

Our bonds payable, marketable debt securities, and liability for warrants issued in our 2008 and 2009 financing, are classified within Level 2 as they are valued using alternative pricing sources and models utilizing market observable inputs.

Our liability for warrants issued in our 2011 financing classified within Level 3 is valued using the Monte Carlo simulation model. Significant Level 3 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. In addition to using the afore mentioned observable inputs, the use of the 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.

The following table presents financial assets and liabilities measured at fair value:

|                                    | <b>Fair Value Measurement<br/>at Report Date Using</b>                                        |                                                                      |                                              |                                    |
|------------------------------------|-----------------------------------------------------------------------------------------------|----------------------------------------------------------------------|----------------------------------------------|------------------------------------|
|                                    | <b>Quoted Prices<br/>in Active<br/>Markets<br/>for<br/>Identical<br/>Assets<br/>(Level 1)</b> | <b>Significant<br/>Other<br/>Observable<br/>Inputs<br/>(Level 2)</b> | <b>Unobservable<br/>Inputs<br/>(Level 3)</b> | <b>As of<br/>June 30,<br/>2012</b> |
| <b>Financial assets</b>            |                                                                                               |                                                                      |                                              |                                    |
| Cash equivalents:                  |                                                                                               |                                                                      |                                              |                                    |
| Money market funds                 | \$ 470,600                                                                                    | \$                                                                   | \$                                           | \$ 470,600                         |
| U.S. Treasury debt obligations     | 6,539,986                                                                                     |                                                                      |                                              | 6,539,986                          |
| <b>Marketable securities:</b>      |                                                                                               |                                                                      |                                              |                                    |
| Debt securities                    |                                                                                               | 1,699,814                                                            |                                              | 1,699,814                          |
| <b>Total financial assets</b>      | <b>\$ 7,010,586</b>                                                                           | <b>\$ 1,699,814</b>                                                  | <b>\$</b>                                    | <b>\$ 8,710,400</b>                |
| <b>Financial liabilities:</b>      |                                                                                               |                                                                      |                                              |                                    |
| Bond obligation                    | \$                                                                                            | \$ 430,000                                                           | \$                                           | \$ 430,000                         |
| Warrant liabilities                |                                                                                               | 6,152                                                                | 5,390,018                                    | 5,396,170                          |
| <b>Total financial liabilities</b> | <b>\$</b>                                                                                     | <b>\$ 436,152</b>                                                    | <b>\$ 5,390,018</b>                          | <b>\$ 5,826,170</b>                |

**Table of Contents****Level 2 Reconciliation**

The following table presents a roll forward for financial assets and liabilities measured at fair value using significant other observable inputs (Level 2) for 2012.

|                            | Level 2<br>Beginning<br>Balance 12/31/11<br>\$ | Transfers to<br>Level 1<br>\$ | Change<br>included<br>in<br>earnings<br>\$ | Settled<br>\$ | Level 2<br>Ending<br>Balance 06/30/12<br>\$ |
|----------------------------|------------------------------------------------|-------------------------------|--------------------------------------------|---------------|---------------------------------------------|
| Marketable debt securities | 3,280,591                                      | (1,580,777)                   |                                            |               | 1,699,814                                   |
| Bond obligation            | 522,500                                        |                               |                                            | 92,500        | 430,000                                     |
| Warrant liabilities        | 31,195                                         |                               | (25,043)                                   |               | 6,152                                       |

Transfers from Level 2 to Level 1 are maturities of short term marketable debt securities into cash and cash equivalents.

**Level 3 Reconciliation**

The following table presents a roll forward for liabilities measured at fair value using significant unobservable inputs (Level 3) for 2012.

|                                       | Warrant<br>Liabilities |
|---------------------------------------|------------------------|
| Balance at December 31, 2011          | \$ 6,011,120           |
| Less fair value of warrants exercised | (1,095,801)            |
| Less fair value of warrants expired   | (3,560,063)            |
| Add fair value of warrants issued     | 1,714,436              |
| Add change in fair value of warrants  | 2,320,326              |
| Balance at June 30, 2012              | \$ 5,390,018           |

**Note 4. Goodwill and Other Intangible Assets**

On April 1, 2009, we acquired the operations of Stem Cell Sciences Plc (SCS) for an aggregate purchase price of approximately \$5,135,000. The acquired operations includes proprietary cell technologies relating to embryonic stem cells, induced pluripotent stem (iPS) cells, and tissue-derived (adult) stem cells; expertise and infrastructure for providing cell-based assays for drug discovery; a cell culture products business; and an intellectual property portfolio with claims relevant to cell processing, reprogramming and manipulation, as well as to gene targeting and insertion.

The purchase price was allocated as follows:

|                                                 | Allocated purchase<br>Price | Estimated life of<br>intangible assets<br>in years |
|-------------------------------------------------|-----------------------------|----------------------------------------------------|
| Net tangible assets                             | \$ 36,000                   |                                                    |
| Intangible assets:                              |                             |                                                    |
| Customer relationships and developed technology | 1,310,000                   | 6 to 9                                             |
| In-process research and development             | 1,340,000                   | N/A                                                |
| Trade name                                      | 310,000                     | 15                                                 |
| Goodwill                                        | 2,139,000                   | N/A                                                |

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|       |              |
|-------|--------------|
| Total | \$ 5,135,000 |
|-------|--------------|

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In-process research and development assets relate to: 1) the acquisition of certain intellectual property rights not expected to expire until 2027 related to our program focused on developing genetically engineered rat models of human disease (our Transgenic Rat Program); and 2) the acquisition of certain technology related to the commercialization of our SC Proven cell culture products and the development and commercialization of cell-based assay platforms for use in drug discovery and development (our Assay Development Program).

At the time of valuation (April 2009), the technology related to our Transgenic Rat Program was in its nascent stage and we expected to achieve proof of concept by 2012 for our Assay Development Program. These technologies were not expected to begin generating revenue until 2011-2012. In December 2011, in part because of management's decision to focus on our therapeutic product development programs and not to allocate time and resources to the assays technology, we determined that we could not predict the future cash flows from the intangible IPR&D asset related to the assays technology. Therefore, at December 31, 2011, we determined that the intangible asset was impaired and wrote off the approximately \$655,000 carrying value of the asset.

Trade name relates to the SC Proven trademark of our cell culture products which we expect to market for 15 years from the date of acquisition, based on which, we estimated a remaining useful life of 15 years from the valuation date.

The following table presents changes in goodwill:

|                                    |                     |
|------------------------------------|---------------------|
| Balance as of December 31, 2011    | \$ 1,895,000        |
| Foreign currency translation       | 18,173              |
| <b>Balance as of June 30, 2012</b> | <b>\$ 1,913,173</b> |

The components of our other intangible assets at June 30, 2012 are summarized below:

| <b>Other Intangible Asset Class</b>             | <b>Net Carrying Amount</b> |
|-------------------------------------------------|----------------------------|
| Customer relationships and developed technology | \$ 832,900                 |
| In-process research and development             | 530,965                    |
| Trade name                                      | 264,484                    |
| Patents                                         | 269,046                    |
| <b>Total other intangible assets</b>            | <b>\$ 1,897,395</b>        |

Amortization expense was approximately \$66,000 in the second quarter of 2012.

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

|                                         |            |
|-----------------------------------------|------------|
| <b>For the year ending December 31:</b> |            |
| 2012                                    | \$ 261,048 |
| 2013                                    | \$ 261,048 |
| 2014                                    | \$ 260,837 |
| 2015                                    | \$ 260,532 |
| 2016                                    | \$ 254,942 |

**Note 5. Stock-Based Compensation**

We currently grant stock-based awards under two equity incentive plans. As of June 30, 2012, we had 503,342 shares authorized to be granted under the two plans. Under these plans we may grant various types of equity awards to our employees, directors and consultants, at prices determined by our Board of Directors, including incentive stock options, nonqualified stock options, stock appreciation rights, restricted stock, restricted stock units, and performance-based shares. Incentive stock options may only be granted to employees under these plans with a grant

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price not less than the fair market value of the stock on the date of grant. We also use these plans to grant shares to employees for the employer match of employee 401(k) plan contributions.

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

|                                                         | Three months ended<br>June 30, |                     | Six months ended<br>June 30, |                     |
|---------------------------------------------------------|--------------------------------|---------------------|------------------------------|---------------------|
|                                                         | 2012                           | 2011                | 2012                         | 2011                |
| Research and development expense                        | \$ 320,303                     | \$ 522,958          | \$ 652,177                   | \$ 961,001          |
| Selling, general and administrative expense             | 403,142                        | 491,305             | 807,813                      | 987,726             |
| <b>Total employee stock-based compensation</b>          | <b>\$ 723,445</b>              | <b>\$ 1,014,263</b> | <b>\$ 1,459,990</b>          | <b>\$ 1,948,727</b> |
| Effect on basic and diluted net income (loss) per share | \$ (0.03)                      | \$ (0.07)           | \$ (0.06)                    | \$ (0.14)           |

As of June 30, 2012, we had approximately \$3,394,000 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 2.0 years.

*Stock Options*

Generally, stock options granted to employees have a maximum term of ten years, and vest over a four year period from the date of grant; 25% vest at the end of one year, and 75% vest monthly over the remaining three-year service period. We may grant options with different vesting terms from time to time. 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. Unvested options are forfeited on termination.

A summary of our stock option activity for the three months ended June 30, 2012 is as follows:

|                                             | Number of options | Weighted-average<br>exercise price<br>(\$) |
|---------------------------------------------|-------------------|--------------------------------------------|
| Balance at March 31, 2012                   | 872,032           | 20.12                                      |
| Granted                                     |                   |                                            |
| Exercised                                   |                   |                                            |
| Cancelled                                   | (17,074)          | 13.22                                      |
| <b>Outstanding options at June 30, 2012</b> | <b>854,958</b>    | <b>20.26</b>                               |

A summary of changes in unvested options for the three months ended June 30, 2012 is as follows:

|                                          | Number of options | Weighted-average<br>exercise price<br>(\$) | Weighted-average<br>grant<br>date fair value (\$) |
|------------------------------------------|-------------------|--------------------------------------------|---------------------------------------------------|
| Unvested options at March 31, 2012       | 133,904           | 11.66                                      | 9.34                                              |
| Granted                                  |                   |                                            |                                                   |
| Vested                                   | (18,079)          | 12.13                                      | 9.79                                              |
| Cancelled                                | (11,832)          | 11.96                                      | 9.12                                              |
| <b>Unvested options at June 30, 2012</b> | <b>103,993</b>    | <b>11.54</b>                               | <b>9.28</b>                                       |

The estimated fair value of options vested was approximately \$177,000 in the three months ended June 30, 2012.

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### *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.

A summary of changes in unvested restricted stock units for the three months ended June 30, 2012 is as follows:

|                                                   | Number of RSUs | Weighted-average<br>grant<br>date fair value (\$) |
|---------------------------------------------------|----------------|---------------------------------------------------|
| Unvested restricted stock units at March 31, 2012 | 1,542,675      | 2.95                                              |
| Granted(1)                                        | 54,000         | 0.82                                              |
| Vested                                            | (118,862)      | 11.45                                             |
| Cancelled                                         | (10,280)       | 12.17                                             |
| Balance unvested at June 30, 2012                 | 1,467,533      | 2.12                                              |

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- (1) 34,000 of these restricted stock units vest and convert into shares of our common stock after one year from the date of grant. 20,000 of these restricted stock units will vest and convert into shares of our common stock over a four year period from the date of grant; one-fourth of the award will vest on each grant date anniversary following the grant.

*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. All of the outstanding SARs as of June 30, 2012 are fully vested. 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.

A summary of the changes in SARs for the three months ended June 30, 2012 is as follows:

|                                   | Number of SARs |
|-----------------------------------|----------------|
| Outstanding at March 31, 2012     | 115,187        |
| Granted                           |                |
| Exercised                         |                |
| Forfeited and expired             |                |
| Outstanding SARs at June 30, 2012 | 115,187        |

|                                   |         |
|-----------------------------------|---------|
| SARs exercisable at June 30, 2012 | 115,187 |
|-----------------------------------|---------|

For the three months ended June 30, 2012, the re-measured liability and expense for the period related to the SARs were not significant. For the same period in 2011, we reduced compensation expense by approximately \$71,000.

The compensation expense recognized for the three months ended June 30, 2012 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 6. Wind-Down Expenses***Rhode Island*

In October 1999, we relocated to California from Rhode Island and established a wind down reserve for the estimated lease payments and operating costs of our scientific and administrative facility in Rhode Island. Even though we intend to dispose of the facility at the earliest possible time, we cannot determine with certainty a fixed date by which such disposal will occur. In light of this uncertainty, we periodically re-evaluate and adjust the reserve. We consider various factors such as our lease payments through to the end of the lease, operating expenses, the current real estate market in Rhode Island, and estimated subtenant income based on actual and projected occupancy.

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The summary of the changes to our wind-down reserve related to this facility for 2012 and 2011 were as follows:

|                                                                           | January 1<br>to<br>March 31,<br>2012 | April 1 to<br>June 30,<br>2012 | January 1<br>to<br>June 30,<br>2012 | January 1 to<br>December 31,<br>2011 |
|---------------------------------------------------------------------------|--------------------------------------|--------------------------------|-------------------------------------|--------------------------------------|
| Accrued wind-down reserve at beginning of period                          | \$ 1,683,000                         | \$ 1,418,000                   | \$ 1,683,000                        | \$ 2,644,000                         |
| Less actual expenses recorded against estimated reserve during the period | (300,000)                            | (280,000)                      | (580,000)                           | (1,248,000)                          |
| Additional expense recorded to revise estimated reserve at period-end     | 35,000                               | 10,000                         | 45,000                              | 287,000                              |
| Revised reserve at period-end                                             | 1,418,000                            | 1,148,000                      | 1,148,000                           | 1,683,000                            |
| Add deferred rent at period-end                                           | 401,000                              | 350,000                        | 350,000                             | 452,000                              |
| Total accrued wind-down expenses at period-end (current and non-current)  | \$ 1,819,000                         | \$ 1,498,000                   | \$ 1,498,000                        | \$ 2,135,000                         |
| Accrued wind-down expenses, current                                       | \$ 1,428,000                         | \$ 1,498,000                   | \$ 1,498,000                        | \$ 1,361,000                         |
| Accrued wind-down expenses, non-current                                   | 391,000                              |                                |                                     | 774,000                              |
| Total accrued wind-down expenses                                          | \$ 1,819,000                         | \$ 1,498,000                   | \$ 1,498,000                        | \$ 2,135,000                         |

**Note 7. Commitments and Contingencies****Leases***Capital Leases*

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 our pilot manufacturing facility in 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. The interest rate for the remaining bond series is 9.5%. The bond contains certain restrictive covenants which limit, among other things, the payment of cash dividends and the sale of the related assets. The outstanding principal was approximately \$430,000 at June 30, 2012 and \$523,000 at December 31, 2011.

*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 September 2010, we entered into a two-year sublease agreement with Caliper Life Sciences, Inc., for approximately 13,200 square feet in a facility located in Mountain View, California. In June 2012, the sublease term was extended to September 30, 2013. We will pay approximately \$1,081,000 in aggregate as rent over the term of the lease. The lease contains escalating rent payments, which we recognize as operating lease expense on a straight-line basis. Deferred rent was approximately \$1,600, as of June 30, 2012, and approximately \$2,600, as of December 31, 2011.

In December 2010, we entered into a commercial lease agreement with BMR-Gateway Boulevard LLC ( "BMR" ), as landlord, for approximately 43,000 square feet of 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 we relocated our corporate headquarters and core research activities from a facility located at the Stanford Research Park in Palo Alto, California, to this facility in July 2011. The lease for the Palo Alto facility expired on August 31, 2011. We will pay approximately \$17,869,000 in aggregate as rent over the term of the lease, which we recognize as operating lease expense on a straight-line basis. Deferred rent was approximately \$1,350,000 as of June 30, 2012, and approximately \$1,301,000 as of December 31, 2011. We constructed laboratories, offices and related infrastructure within the leased space during the first several months of the lease. As part of the

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lease, BMR has agreed to provide various financial allowances so that we can build initial and future laboratories, offices and other improvements, subject to customary terms and conditions relating to landlord-funded tenant improvements. As part of the lease, we have, until January 2013, an option to lease up to an additional 30,000 square feet in the building.

### *Operating Leases   Rhode Island*

We entered into a fifteen-year lease agreement for a scientific and administrative facility (SAF) in Rhode Island in connection with a sale and leaseback arrangement in 1997. The lease term expires June 30, 2013 and includes escalating rent payments which we recognize on a straight-line basis. Deferred rent expense for this facility was approximately \$350,000 at June 30, 2012 and \$452,000 at

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December 31, 2011, and is included as part of the wind-down accrual on the accompanying condensed consolidated balance sheets. For the year 2012, we expect to pay approximately \$1,172,000 in operating lease payments and estimated operating expenses of approximately \$690,000, before receipt of sub-tenant income and we expect to receive, in aggregate, approximately \$439,000 in sub-tenant rent and operating expenses. As a result of the above transactions, our estimated cash outlay net of sub-tenant rent for the SAF will be approximately \$1,423,000 for 2012.

### *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 space from approximately 5,000 square feet to approximately 1,900 square feet of office and lab space. The lease by its terms was extended to September 30, 2013. We expect to pay approximately 61,000 GBP as rental payments for 2012. StemCells, Inc. is the guarantor of Stem Cell Sciences (U.K.) Ltd's obligations under the existing lease.

With the exception of the operating leases discussed above, we have not entered into any 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.

### *Contingencies*

In July 2006, we filed suit against Neuralstem, Inc. in the Federal District Court for the District of Maryland, alleging that Neuralstem's activities violate claims in four of the patents we exclusively licensed from NeuroSpheres, specifically U.S. Patent No. 6,294,346 (claiming the use of human neural stem cells for drug screening), U.S. Patent No. 7,101,709 (claiming the use of human neural stem cells for screening biological agents), U.S. Patent No. 5,851,832 (claiming methods for proliferating human neural stem cells), and U.S. Patent No. 6,497,872 (claiming methods for transplanting human neural stem cells). In May 2008, we filed a second patent infringement suit against Neuralstem and its two founders, Karl Johe and Richard Garr. In this suit, which we filed in the Federal District Court for the Northern District of California, we allege that Neuralstem's activities infringe claims in two patents we exclusively license from NeuroSpheres, specifically U.S. Patent No. 7,361,505 (claiming composition of matter of human neural stem cells derived from any source material) and U.S. Patent No. 7,115,418 (claiming methods for proliferating human neural stem cells). In addition, we allege various state law causes of action against Neuralstem arising out of its repeated derogatory statements to the public about our patent portfolio. Also in May 2008, Neuralstem filed suit against us and NeuroSpheres in the Federal District Court for the District of Maryland seeking a declaratory judgment that the 505 and 418 patents are either invalid or are not infringed by Neuralstem and that Neuralstem has not violated California state law. In August 2008, the California court transferred our lawsuit against Neuralstem to Maryland for resolution on the merits. In July 2009, the Maryland District Court granted our motion to consolidate these two cases with the litigation we initiated against Neuralstem in 2006. Discovery is ongoing in these cases and we anticipate a trial date in 2013.

In addition to the actions described above, in April 2008, we filed an opposition to Neuralstem's European Patent No. 0 915 968 (methods of isolating, propagating and differentiating CNS stem cells), because the claimed invention is believed by us to be unpatentable over prior art, including the patents exclusively licensed by us from NeuroSpheres. In December 2010, the European Patent Office ruled that all composition claims in Neuralstem's 968 European patent were invalid and unpatentable over prior art including several of the NeuroSpheres patents licensed to us. Neuralstem has appealed this decision.

Effective 2008, as part of an indemnification agreement with NeuroSpheres, we are entitled to offset all litigation costs incurred in this patent infringement suit, against amounts that would otherwise be owed to NeuroSpheres under our exclusive license agreements with NeuroSpheres, such as annual maintenance fees, milestones and royalty payments. Under the terms of our license agreements, we are required to make annual payments of \$50,000 to NeuroSpheres, and we expect to make these annual payments through the remaining life of the patent which, at December 31, 2010, was approximately 14 years. We have therefore capitalized \$700,000 (14 years at \$50,000 per year) to offset litigation costs. The amount capitalized is not dependent on the achievement of any milestones or related to any other contingent payments which may become due under the arrangement. We will reduce this asset by \$50,000 per year in lieu of the cash payments due to NeuroSpheres. As the \$50,000 annual payments are fully creditable against royalties due to NeuroSpheres, we have classified the capitalized amount as prepaid royalties under Other assets, non-current on our accompanying Consolidated Balance Sheets. We have concluded that the estimated balance of \$650,000, as of June 30, 2012, is a fair estimate and realizable against future milestone and royalty payments to NeuroSpheres, and that litigation costs incurred above this amount will be expensed as incurred. Management will reevaluate this estimate on a quarterly basis based on actual costs and other relevant factors.

**Table of Contents****Note 8. Warrant Liability**

We use various option pricing models, such as the Black-Scholes option pricing model and the 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 2008, we sold 1,379,310 units to institutional investors at a price of \$14.50 per unit, for gross proceeds of \$20,000,000. The units, each of which consisted of one share of common stock and a warrant to purchase 0.75 shares of common stock at an exercise price of \$23.00 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 \$18,637,000. We recorded the fair value of the warrants to purchase 1,034,483 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 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.

The assumptions used for the Black-Scholes option pricing model are as follows:

|                         | <b>To Calculate<br/>Fair Value of Warrant<br/>Liability at</b> |                          |
|-------------------------|----------------------------------------------------------------|--------------------------|
|                         | <b>June 30, 2012</b>                                           | <b>December 31, 2011</b> |
| Expected life (years)   | 1.9                                                            | 2.4                      |
| Risk-free interest rate | 0.3%                                                           | 0.3%                     |
| Expected volatility     | 81.0%                                                          | 74.1%                    |
| Expected dividend yield | 0%                                                             | 0%                       |

|                                                     | <b>At June 30,<br/>2012</b> | <b>At December 31,<br/>2011</b> | <b>Change in Fair Value<br/>of Warrant<br/>Liability</b> |
|-----------------------------------------------------|-----------------------------|---------------------------------|----------------------------------------------------------|
| Fair value of liability for warrants issued in 2008 | \$ 1,552                    | \$ 2,224                        | \$ (672)                                                 |

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 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.

The assumptions used for the Black-Scholes option pricing model are as follows:

|                         | <b>To Calculate<br/>Fair Value of Warrant Liability at</b> |                              |
|-------------------------|------------------------------------------------------------|------------------------------|
|                         | <b>June 30,<br/>2012</b>                                   | <b>December 31,<br/>2011</b> |
| Expected life (years)   | 2.8                                                        | 3.3                          |
| Risk-free interest rate | 0.4%                                                       | 0.5%                         |
| Expected volatility     | 73.5%                                                      | 90.8%                        |
| Expected dividend yield | 0%                                                         | 0%                           |



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|                                                     | At June 30,<br>2012 | At December 31,<br>2011 | Change in Fair Value<br>of Warrant<br>Liability |
|-----------------------------------------------------|---------------------|-------------------------|-------------------------------------------------|
| Fair value of liability for warrants issued in 2009 | \$ 4,600            | \$ 28,971               | \$ (24,371)                                     |

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 consists 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 on the fifth anniversary of the closing date of the initial financing transaction in December 2011. The shares were offered under our shelf registration statement previously filed with previously filed with, and declared effective by, the SEC.

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 with an initial exercise price of \$1.40 per share and received gross proceeds of \$3,375,000. The remaining unexercised 5,300,000 Series B Warrants expired by their terms on May 2, 2012.

The assumptions used for the Monte Carlo simulation model to value the Series A Warrants at June 30, 2012 are as follows:

|                                  |       |
|----------------------------------|-------|
| Risk-free interest rate per year | 0.6%  |
| Expected volatility per year     | 86.6% |
| Expected dividend yield          | 0%    |
| Expected life in years           | 4.5   |

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 and Series B Warrants for the three-month period ended June 30, 2012:

|                           | Series A              |               | Series B              |               |
|---------------------------|-----------------------|---------------|-----------------------|---------------|
|                           | Number of<br>Warrants | Fair value \$ | Number of<br>Warrants | Fair value \$ |
| Balance at March 31, 2012 | 8,900,000             | \$ 6,234,984  | 7,100,000             | \$ 4,769,140  |
| Add Issued                | 1,800,000             | 1,106,618     |                       |               |
| Less exercised            |                       |               | (1,800,000)           | (527,799)     |
| Less expired              |                       |               | (5,300,000)           | (3,560,063)   |
| Changes in fair value     |                       | (1,951,584)   |                       | (681,278)     |
| Balance at June 30, 2012  | 10,700,000            | \$ 5,390,018  |                       | \$            |

The following table is a summary of our outstanding warrants and fair value of our warrant liability as of June 30, 2012:

| Warrants                | Number Outstanding | Exercise Price \$ | Fair value \$ |
|-------------------------|--------------------|-------------------|---------------|
| Warrants issued in 2008 | 1,034,483          | 23.00             | 1,552         |
| Warrants issued in 2009 | 400,000            | 15.00             | 4,600         |
| Series A Warrants       | 10,700,000         | 1.40              | 5,390,018     |
| Total                   | 12,134,483         |                   | 5,396,170     |



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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.

### **Note 9. Common Stock**

In the second quarter of 2012, an aggregate of 1,800,000 Series B Warrants were exercised and we received gross proceeds of \$2,250,000. The remaining unexercised 5,300,000 Series B Warrants expired by their terms on May 2, 2012. These warrants were issued as part of our December 2011 financing. For the exercise of these warrants, we issued 1,800,000 shares of our common stock and 1,800,000 Series A Warrants. The Series A Warrants have an initial exercise price of \$1.40 per share and will expire on the fifth anniversary of the closing date of the initial financing transaction in December 2011.

### **Note 10. Subsequent Events**

Subsequent to the end of the second quarter, 691,000 Series A Warrants were exercised at an exercise price of \$1.40 per share. We received gross proceeds of \$967,400 and we issued 691,000 shares of our common stock. These warrants were issued as part of our December 2011 financing.

In July 2012, we sold a total of 4,207,361 shares of our common stock under a sales agreement entered into in June 2009 at an average price per share of \$2.06 for gross proceeds of approximately \$8,657,000. The sales agent is paid compensation equal to 3% of gross proceeds pursuant to the terms of the agreement. The shares were offered under our shelf registration statement previously filed with, and declared effective by, the SEC.

In July 2012, the California Institute for Regenerative Medicine (CIRM) approved an award to us and our collaborators for up to \$20 million under CIRM's Disease Team Therapy Development Award program (RFA 10-05). The award is to fund preclinical development of our HuCNS-SC product candidate as a potential treatment for cervical spinal cord injury. The award will provide funding over a maximum four-year period, with the goal of filing an investigational new drug (IND) application in that time. Funding to for-profit companies under RFA 10-05 will be structured as loans, in accordance with mutually agreed upon terms and conditions and CIRM regulations.

## **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), Swissmedic, 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 products; 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; uncertainties regarding our obligations with respect to our former facilities in Rhode Island; 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, 2011.



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### **Overview**

#### ***The Company***

We are engaged in researching, developing, and commercializing stem cell therapeutics and enabling tools and technologies for stem cell-based research and drug discovery and development. 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 corporate headquarters 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). In our CNS Program, our HuCNS-SC<sup>®</sup> product candidate (purified human neural stem cells) is currently in clinical development for several indications Pelizeaus-Merzbacher Disease (PMD), which is a myelination disorder in the brain, chronic spinal cord injury and dry age-related macular degeneration (AMD). In February 2012, we completed our four-patient Phase I clinical trial in PMD. Results from this trial were reported in March 2012 and showed preliminary evidence of durable and progressive donor-derived myelination in all four patients. In addition, there were measurable gains in neurological and/or motor function in three of the four patients, with the fourth patient clinically stable. We are conducting a Phase I/II clinical trial in Switzerland for the treatment of chronic spinal cord injury. This trial was authorized by Swissmedic and we completed the enrollment and dosing of the first patient cohort of this trial in December 2011. In January 2012, we received authorization from the FDA to conduct a Phase I/II clinical trial in dry AMD, and we initiated this trial in June 2012. We previously completed a Phase I clinical trial in infantile and late infantile neuronal ceroid lipofuscinosis (NCL), and the data from that trial 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 2011, we formed a wholly-owned subsidiary to focus on both the therapeutic and research tool applications of our human liver engrafting cells (hLEC) technologies and to serve as an investment vehicle for those interested in a pure play liver cell company. In July 2012, the California Institute for Regenerative Medicine (CIRM) approved an award to us and our collaborators for up to a \$20 million over a maximum four-year period. The award is to fund preclinical development of our proprietary HuCNS-SC cells as a potential treatment for cervical spinal cord injury, with the goal of filing an investigational new drug (IND) application in that time. For a brief description of our significant therapeutic research and development programs see Overview Research and Development Programs in the Business Section of Part I, Item 1 of our Form 10-K for the year ended December 31, 2011.

We are also engaged in developing and commercializing applications of our technologies to enable research, which we believe represent current and nearer-term commercial opportunities. Our portfolio of technologies includes cell technologies relating to embryonic stem cells, induced pluripotent stem (iPS) cells, and tissue-derived (adult) stem cells; expertise and infrastructure for providing cell-based assays for drug discovery; a cell culture products and antibody reagents business; and an intellectual property portfolio with claims relevant to cell processing, reprogramming and manipulation, as well as to gene targeting and insertion. Many of these enabling technologies were acquired in April 2009 as part of our acquisition of the operations of Stem Cell Sciences Plc (SCS).

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 cell culture products for use in 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 from equity and debt offerings and revenue from collaborative research arrangements with corporate sponsors to finance our operations. We have no such collaborative research arrangements at this time and there can be no assurance that such financing or partnering revenue will be available when needed or on terms acceptable to us.

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

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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 and hLEC 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, Swissmedic 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.

The research markets served by our tools and technologies products are highly competitive, complex and dynamic. Technological advances and scientific discoveries have accelerated the pace of change in biological research, and stem cell technologies have been evolving particularly fast. We compete mainly by focusing on specialty media and antibody reagent products and cell-based assays, which are custom designed for use in stem cell-based research, where we believe our expertise, intellectual property and reputation give us competitive advantage. We believe that, in this particular market niche, our products and technologies offer customers specific advantages over those offered by our competitors. We compete by offering innovative, quality-controlled products, consistently made and designed to produce reproducible results. We continue to make investments in research and development, quality management, quality improvement, and product innovation. We cannot assure you that we will have sufficient resources to continue to make such investments. For the three month period ended June 30, 2012, we generated revenues from the sale of specialty cell culture products of approximately \$211,000. We can give no assurances that we will be able to continue to generate such revenues in the future.

### ***Significant Events***

In April 2012, we presented preliminary evidence of progressive and durable donor-cell derived myelination in all four patients who underwent transplantation with our proprietary HuCNS-SC cells in our Phase I clinical trial for Pelizaeus-Merzbacher disease (PMD), a rare hypo-myelination disorder in children. In addition, clinical assessment revealed small but measureable gains in motor and/or cognitive function in three of the four patients; the fourth patient remained clinically stable. The study was conducted by researchers at the University of California, San Francisco (UCSF). A summary of the trial results were presented at the 2012 European Leukodystrophy Association (ELA) Families/Scientists Meeting in Paris. The findings have been submitted for publication in a peer-reviewed scientific journal.

In May 2012, we presented data from the first interim safety review of our Phase I/II spinal cord injury clinical trial, which indicated that the surgery, immunosuppression and the HuCNS-SC cell transplants have been well-tolerated. The trial, which was designed to evaluate the safety and preliminary efficacy of our proprietary HuCNS-SC cells, represents the first time that neural stem cells have been transplanted as a potential therapeutic agent for spinal cord injury. A summary of the data was presented at the *Interdependence 2012 Global SCI Conference*, which was held in Vancouver, Canada in May 2012.

In June 2012, we initiated our Phase I/II clinical trial of our proprietary HuCNS-SC cells in dry age-related macular degeneration (AMD). The trial is being conducted at the Retina Foundation of the Southwest's (RFSW) Anderson Vision Research Center in Dallas, Texas.

In July 2012, we presented preclinical data demonstrating that our proprietary human neural stem cells restored memory and enhanced synaptic function in two animal models relevant to Alzheimer's disease. The data was presented at the Alzheimer's Association International Conference 2012 in Vancouver, Canada.

In July 2012, CIRM approved an award to us and our collaborators for up to a \$20 million under their Disease Team Therapy Development Award program (RFA 10-05). The award is to fund preclinical development of our proprietary HuCNS-SC product candidate (purified human neural stem cells) as a potential treatment for cervical spinal cord injury. The award will provide funding over a maximum four-year period, with the goal of filing an IND application to begin clinical testing in that time. CIRM deferred a decision on our separate Alzheimer's disease application and referred the application back to its Grants Working Group for further consideration. CIRM is expected to review the application again at the next meeting of its governing board currently scheduled in September 2012.

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In July 2012, the Japan Patent Office granted us Patent Number 5007003, titled "Enriched Central Nervous System Stem Cell and Progenitor Cell Populations, and Methods for Identifying, Isolating and Enriching for Such Populations." The patent broadly covers the prospective isolation and enrichment of neural stem and progenitor cells using antibody selection, as well as the use of these cells to treat disorders of the central nervous system. Some of the more noteworthy claims in this patent include methods for isolating human neural stem cells, as well as compositions of matter comprising enriched neural stem cells, such as our proprietary HuCNS-SC cells, and the use of enriched neural stem cells as a medicament for the treatment of neurodegenerative diseases, acute brain injury and dysfunction of the central nervous system. The term of this patent extends into 2020.

## **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 June 30, 2012, we expect to recognize approximately \$3,394,000 of compensation expense related to unvested stock-based awards over a weighted-average period of 2.0 years. See also Note 5, "Stock-Based Compensation," in the notes to condensed consolidated financial statements of Part I, Item 1 of this Form 10-Q for further information.

## ***Wind-down expenses Rhode Island***

In connection with exiting our research and manufacturing operations in Lincoln, Rhode Island, and the relocation of our corporate headquarters and remaining research laboratories to California in October 1999, we provided a reserve for our estimate of the exit cost obligation. The reserve reflects estimates of the ongoing costs of our former scientific and administrative facility in Lincoln, which we hold on a lease that terminates on June 30, 2013. We are seeking to sublease, assign, sell, or otherwise divest ourselves of our interest in the facility at the earliest possible time, but we cannot determine with certainty a fixed date by which such events will occur, if at all.

In determining the facility exit cost reserve amount, we are required to consider our lease payments through to the end of the lease term and estimate other relevant factors such as facility operating expenses, real estate market conditions in Rhode Island for similar facilities, occupancy rates, and sublease rental rates projected over the course of the leasehold. We re-evaluate the estimate each quarter, taking account of changes, if any, in each underlying factor. The process is inherently subjective because it involves projections over time from the date of the estimate through the end of the lease and it is not possible to determine any of the factors, except the lease payments, with certainty over that period.

Management forms its best estimate on a quarterly basis, after considering actual sublease activity, reports from our broker/realtor about current and predicted real estate market conditions in Rhode Island, the likelihood of new subleases in the foreseeable future for the specific facility and significant changes in the actual or projected operating expenses of the property. We discount the projected net outflow over the term of the leasehold to arrive at the present value, and adjust the reserve to that figure. The estimated vacancy rate for the facility is an important assumption in determining the reserve because changes in this assumption have the greatest effect on estimated sublease income. In addition, the vacancy rate estimate is the variable most subject to change, while at the same time it involves the greatest judgment and uncertainty due to the absence of highly predictive information concerning the future of the local economy and future demand for specialized laboratory and office space in that area. The average vacancy rate of the facility over the last nine years (2003 through 2011) was approximately 73%, varying from

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62% to 89%. As of June 30, 2012, based on current information available to management, the vacancy rate is projected to be approximately 69% from 2012 through the end of the lease. These estimates are based on actual occupancy as of June 30, 2012, predicted lead time for

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acquiring new subtenants, historical vacancy rates for the area, and assessments by our broker/realtor of future real estate market conditions. Due to the short time remaining on the lease period, the reserve assumes no additional tenants from 2012 to the end of the lease. If the assumed operating expenses for the remainder of the lease had been 5% higher or lower at June 30, 2012, then the reserve would have increased or decreased by approximately \$33,000. Management does not wait for specific events to change its estimate, but instead uses its best efforts to anticipate them on a quarterly basis. See Note 6 Wind-Down Expenses, in the notes to condensed consolidated financial statements of Part I, Item 1 of this Form 10-Q for further information.

***Business Combinations***

The operating results of acquired companies or operations are included in our consolidated financial statements starting on the date of acquisition. Goodwill is recorded at the time of an acquisition and is calculated as the difference between the aggregate consideration paid for an acquisition and the fair value of the net tangible and intangible assets acquired. Accounting for acquisitions requires extensive use of accounting estimates and judgments to allocate the purchase price to the fair value of the net tangible and intangible assets acquired, including in-process research and development. Goodwill and intangible assets deemed to have indefinite lives are not amortized but are subject to annual impairment tests. If the assumptions and estimates used to allocate the purchase price are not correct, or if business conditions change, purchase price adjustments or future asset impairment charges could be required. We test goodwill for impairment on an annual basis or more frequently if we believe indicators of impairment exist. Impairment evaluations involve management estimates of asset useful lives and future cash flows. Significant management judgment is required in the forecasts of future operating results that are used in the evaluations. It is possible, however, that the plans and estimates used may be incorrect. If our actual results, or the plans and estimates used in future impairment analysis, are lower than the original estimates used to assess the recoverability of these assets, we could incur impairment charges in a future period.

***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 under contracts that cannot be net-cash settled, and are both indexed to and settled in the Company's common stock, can be classified as equity. As part of both our November 2008 and November 2009 financings, we issued warrants with five year terms to purchase 1,034,483 and 400,000 shares of our common stock at \$23.00 and \$15.00 per share, respectively. 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 with an exercise price of \$1.40 per share. The remaining unexercised 5,300,000 Series B Warrants expired by their terms on May 2, 2012. As terms of the warrants issued in 2008 and 2009, as well as the Series A and Series B 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) on change in fair value of warrant liability. The fair value of the warrants issued in the 2008 and 2009 financings is determined using the Black-Scholes-Merton (Black-Scholes) option pricing model and the fair value of the Series A and Series B Warrants is determined using the Monte Carlo simulation model (see Note 8, 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 the 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.

***Revenue Recognition***

We currently recognize revenue resulting from the licensing and use of our technology and intellectual property, from government grants, and from product sales. 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 are recognized net of a fixed percentage due to licensors as royalties. Grant revenue from government agencies are funds received to cover specific expenses and are recognized as earned upon either the incurring of reimbursable expenses directly related to the particular research plan or the completion of certain development milestones as defined within the terms of the relevant collaborative agreement or grant. Revenue from product sales are recognized when the product is shipped and the order fulfilled.

**Table of Contents****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, expenses arising out of the integration of the acquired SCS operations, developments in on-going patent prosecution and litigation, the on-going expenses to lease and maintain our Rhode Island facilities, and the costs associated with operating our California and Cambridge, U.K. facilities.

We acquired the operations of SCS on April 1, 2009, and have consolidated such operations since that date.

We effected a 1-for-10 reverse stock split on July 6, 2011. References to numbers of shares of common stock and per share data have been adjusted to reflect the reverse stock split on a retroactive basis. See Note 1 Summary of Significant Accounting Policies in the notes to condensed consolidated financial statements of Part I, Item 1 of this Form 10-Q for further information.

**Revenue and Cost of Product Sales**

Revenue for the three and six-month periods ended June 30, 2012, as compared with the same period in 2011, is summarized in the table below:

|                                 | Three months ended,<br>June 30 |            | Change in 2012 versus 2011 |       | Six months ended,<br>June 30 |            | Change in 2012 versus 2011 |      |
|---------------------------------|--------------------------------|------------|----------------------------|-------|------------------------------|------------|----------------------------|------|
|                                 | 2012                           | 2011       | \$                         | %     | 2012                         | 2011       | \$                         | %    |
| Revenue:                        |                                |            |                            |       |                              |            |                            |      |
| Licensing agreements and grants | \$ 38,085                      | \$ 49,257  | \$ (11,172)                | (23)% | \$ 410,762                   | \$ 121,349 | \$ 289,413                 | 238% |
| Product sales                   | 210,749                        | 184,840    | 25,909                     | 14%   | 482,108                      | 334,215    | 147,893                    | 44%  |
| Total revenue                   | 248,834                        | 234,097    | 14,737                     | 6%    | 892,870                      | 455,564    | 437,306                    | 96%  |
| Cost of product sales           | 64,277                         | 52,365     | 11,912                     | 22%   | 136,236                      | 106,889    | 29,347                     | 27%  |
| Gross profit                    | \$ 184,557                     | \$ 181,732 | \$ 2,825                   | 2%    | \$ 756,634                   | \$ 348,675 | \$ 407,959                 | 117% |

*Second quarter ended June 30, 2012 versus second quarter ended June 30, 2011.* Total revenue in the second quarter of 2012 was approximately \$249,000, which was 6% higher than total revenue of approximately \$234,000 in the second quarter of 2011. In the second quarter of 2012, revenue from product sales was approximately \$211,000, which was 14% higher, compared to the same period in 2011. This increase was primarily attributable to increased unit volumes in our SC Proven line of media and reagents. There were no significant changes to our licensing and grant revenue in the second quarter of 2012 compared to the same period in 2011.

*Six-month period ended June 30, 2012 versus six-month period ended June 30, 2011.* Total revenue in the six-month period ended June 30, 2012 was approximately \$893,000, which was 96% higher than total revenue of approximately \$456,000 in the same period of 2011. In the six-month period ended 2012, revenue from product sales was approximately \$482,000, which was 44% higher, compared to the same period in 2011. This increase was primarily attributable to increased unit volumes in our SC Proven line of media and reagents. Licensing and grant revenue in the six-month period ended 2012 totaled approximately \$411,000, which was 238% higher compared to the same period in 2011. This increase was primarily attributable to licensing fees from a license agreement with genOway, under which we granted genOway a worldwide exclusive license to our IRES technology for use in the development and commercialization of genetically engineered mice.

**Operating Expenses**

Operating expenses for the three and six-month periods ended June 30, 2012, as compared with the same period in 2011, is summarized in the table below:

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|                                   | Three months ended,<br>June 30 |              | Change in 2012 versus 2011 |       | Six months ended,<br>June 30 |               | Change in 2012 versus 2011 |       |
|-----------------------------------|--------------------------------|--------------|----------------------------|-------|------------------------------|---------------|----------------------------|-------|
|                                   | 2012                           | 2011         | \$                         | %     | 2012                         | 2011          | \$                         | %     |
| Operating expenses:               |                                |              |                            |       |                              |               |                            |       |
| Research & development            | \$ 3,749,066                   | \$ 5,053,834 | \$ (1,304,768)             | (26)% | \$ 7,687,457                 | \$ 10,579,511 | \$ (2,892,054)             | (27)% |
| Selling, general & administrative | 1,775,342                      | 2,103,262    | (327,920)                  | (16)% | 3,699,667                    | 4,178,991     | (479,324)                  | (11)% |
| Wind-down expenses                | 9,902                          | 114,918      | (105,016)                  | (91)% | 45,057                       | 190,055       | (144,998)                  | (76)% |
| Total operating expenses          | \$ 5,534,310                   | \$ 7,272,014 | \$ (1,737,704)             | (24)% | \$ 11,432,181                | \$ 14,948,557 | \$ (3,516,376)             | (24)% |

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### *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 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 six months ended June 30, 2012) were approximately \$160 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 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 each of our proprietary cell types, 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, to manufacture certain of our product candidates 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.

*Second quarter ended June 30, 2012 versus second quarter ended June 30, 2011.* R&D expenses totaled approximately \$3,749,000 in the second quarter of 2012 compared with \$5,054,000 in the second quarter of 2011. The decrease of 26%, or approximately \$1,305,000, in 2012 compared to 2011, was primarily attributable to (i) a decrease of approximately \$455,000 in personnel expenses due to the reduction in workforce effected in May 2011, (ii) a decrease of approximately \$138,000 in operating expenses at our U.K. operations as we consolidated our activities at the site, (iii) a decrease in facilities expense of approximately \$201,000 attributable to the relocation of our corporate headquarters and core research activities in July 2011; the second quarter of 2011 includes facilities expense from the previous lease which expired on August 31, 2011, (iv) a decrease of approximately \$446,000 in external services; the second quarter of 2011 includes higher external services expenses primarily related to continuing preclinical studies of our HuCNS-SC cells for retinal disorders and other potential indications, and (v) a decrease in other operating expenses of approximately \$65,000.

*Six-month period ended June 30, 2012 versus six-month period ended June 30, 2011.* R&D expenses totaled approximately \$7,687,000 in the six-month period ended June 30, 2012 compared with \$10,580,000 for the same period in 2011. The decrease of 27%, or approximately \$2,892,000, in 2012 compared to 2011, was primarily attributable to (i) a decrease of approximately \$924,000 in personnel expenses due to the reduction in workforce effected in May 2011, (ii) a decrease of approximately \$249,000 in operating expenses at our U.K. operations as we consolidated our activities at the site, (iii) a decrease in facilities expense of approximately \$626,000 attributable to the relocation of our corporate headquarters and core research activities in July 2011; the six-month period of 2011 includes facilities expense from the previous lease which expired on August 31, 2011, (iv) a decrease of approximately \$725,000 in external services; the six-month period of 2011 includes higher external services expenses primarily related to continuing preclinical studies of our HuCNS-SC cells for retinal disorders and other potential indications, and (v) a decrease in supplies and other operating expenses of approximately \$368,000.

### *Selling, General and Administrative Expenses*

Selling, general and administrative (SG&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, facilities and overhead costs, external legal and other external general and administrative services.

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*Second quarter ended June 30, 2012 versus second quarter ended June 30, 2011.* SG&A expenses totaled approximately \$1,775,000 in the second quarter of 2012 compared with approximately \$2,103,000 in the second quarter of 2011. The decrease of approximately \$328,000, or 16%, in 2012 compared to 2011, was primarily attributable to (i) a decrease of approximately \$106,000 in personnel expenses primarily due to the reduction in workforce effected in May 2011, (ii) a decrease of approximately \$204,000 in external services and (iii) a decrease of approximately \$21,000 in other operating expenses.

*Six-month period ended June 30, 2012 versus six-month period ended June 30, 2011.* SG&A expenses totaled approximately \$3,700,000 in the six-month period ended June 30 2012 compared with approximately \$4,179,000 in the same period of 2011. The decrease of approximately \$479,000, or 11%, in 2012 compared to 2011, was primarily attributable to (i) a decrease of approximately \$197,000 in personnel expenses primarily due to the reduction in workforce effected in May 2011, (ii) a decrease of approximately \$229,000 in external services and (iii) a decrease of approximately \$53,000 in other operating expenses.

**Wind-down Expenses**

In 1999, in connection with exiting our former research facility in Rhode Island, we created a reserve for the estimated lease payments and operating expenses related to it. The reserve has been re-evaluated and adjusted based on assumptions relevant to real estate market conditions and the estimated time until we could either fully sublease, assign or sell our remaining interests in the property. The reserve was approximately \$2,135,000 at December 31, 2011. Payments net of subtenant income of approximately \$300,000 and \$280,000 for the first and second quarter of 2012 respectively were recorded against this reserve. We re-evaluated the estimate at the end of each quarter in 2012 and adjusted the reserve to approximately \$1,498,000 by recording additional wind-down expenses of approximately \$45,000. For the similar period in 2011, payments recorded against the reserve were approximately \$317,000 and \$301,000 for the first and second quarter respectively, and to adjust the reserve, we recorded in aggregate additional wind-down expenses of approximately \$190,000. Expenses for this facility will fluctuate based on changes in tenant occupancy rates and other operating expenses related to the lease. Even though it is our intent to sublease, assign, sell, or otherwise divest ourselves of our interests in the facility at the earliest possible time, we cannot determine with certainty a fixed date by which such events will occur. In light of this uncertainty, based on estimates, we will periodically re-evaluate and adjust the reserve, as necessary. See Note 6

Wind-down expenses, in the notes to condensed consolidated financial statements of Part I, Item 1 of this Form 10-Q for further information.

**Other Income (Expense)**

Other income totaled approximately \$6,183,000 in the second quarter of 2012 compared with other income of \$3,055,000 in the same period of 2011, and other income of \$1,279,000 for the six-month period ended June 30, 2012 compared with other income of approximately \$4,817,000 for the six-month period ended June 30, 2011.

|                                                   | Three months ended,<br>June 30 |              | Change in 2012 versus<br>2011 |        | Six months ended,<br>June 30 |              | Change in 2012 versus<br>2011 |        |
|---------------------------------------------------|--------------------------------|--------------|-------------------------------|--------|------------------------------|--------------|-------------------------------|--------|
|                                                   | 2012                           | 2011         | \$                            | %      | 2012                         | 2011         | \$                            | %      |
| Other income (expense):                           |                                |              |                               |        |                              |              |                               |        |
| Change in fair value of<br>warrant liability      | \$ 6,205,957                   | \$ 3,020,228 | \$ 3,185,729                  | 105%   | \$ 1,264,780                 | \$ 4,803,183 | \$ (3,538,403)                | (74)%  |
| Realized gain on sale of<br>marketable securities |                                | 83,750       | (83,750)                      | (100)% |                              | 83,750       | (83,750)                      | (100)% |
| Interest income                                   | 2,811                          | 6,446        | (3,635)                       | (56)%  | 7,021                        | 7,818        | (797)                         | (10)%  |
| Interest expense                                  | (14,175)                       | (19,793)     | 5,618                         | (28)%  | (28,622)                     | (40,000)     | 11,378                        | (28)%  |
| Other income (expense), net                       | (11,318)                       | (35,542)     | 24,224                        | (68)%  | 36,451                       | (37,297)     | 73,748                        | (197)% |
| Total other income (expense)                      | \$ 6,183,275                   | \$ 3,055,089 | \$ 3,128,186                  | 102%   | \$ 1,279,630                 | \$ 4,817,454 | \$ (3,537,824)                | (73)%  |

**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 since 2008 and have classified all these warrants 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 the 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 the Monte Carlo simulation model requires input of

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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 8 Warrant Liability in the notes to condensed consolidated financial statements of Part I, Item 1 of this Form 10-Q for further information.

**Table of Contents***Interest Income*

Interest income in the three and six-month period ended June 30, 2012 and 2011 were not significant due to low average yields.

*Interest Expense*

Interest expense decreased by approximately \$6,000 or 28% in the second quarter of 2012, and \$11,000 or 28% for the six-month period ended June 30, 2012, when compared to the same periods in 2011. Interest expense is primarily for outstanding debt and capital lease balances. See Note 7 Commitment and Contingencies, 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 expense for the second quarter of 2012 is primarily for state franchise taxes and other income for the six-month period ended June 30, 2012 includes approximately \$63,000 of R&D tax credits due to our wholly-owned subsidiary Stem Cell Sciences (U.K.) Ltd. The above income was offset by other expenses primarily related to state franchise taxes. Other expense for the similar period in 2011 was primarily state franchise taxes.

**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, revenue from collaborative agreements, research grants, license fees, and interest income.

|                           | June 30,<br>2012 | December 31,<br>2011 | Change<br>\$   | %     |
|---------------------------|------------------|----------------------|----------------|-------|
| Cash and cash equivalents | \$ 7,203,428     | \$ 13,311,261        | \$ (6,107,833) | (46)% |

In summary, our cash flows were:

|                                                     | Six months ended June 30,<br>2012 | 2011            | Change in 2012 versus 2011<br>\$ | %      |
|-----------------------------------------------------|-----------------------------------|-----------------|----------------------------------|--------|
| Net cash used in operating activities               | \$ (10,715,052)                   | \$ (13,130,967) | \$ 2,415,915                     | (18)%  |
| Net cash provided by (used in) investing activities | \$ 1,565,919                      | \$ (9,041,281)  | \$ 10,607,200                    | (117)% |
| Net cash provided by financing activities           | \$ 3,053,858                      | \$ 9,014,970    | \$ (5,961,112)                   | (66)%  |

***Net Cash Used in Operating Activities***

Net cash used in operating activities in the six-month period ended June 30, 2012 decreased by approximately \$2,416,000, or 18%, when compared to the same period of 2011. 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 Provided by (Used in) Investing Activities***

Net cash provided by investing activities increased approximately \$10,607,000, or 117%, from 2011 to 2012. The increase was primarily attributable to the net maturities of short-term marketable debt securities of approximately \$1,583,000 in the six-month period ended June 30, 2012 as compared to net purchases of marketable debt securities of approximately \$8,967,000 for the same period in 2011. Capital expenditures decreased from 2011 to 2012 and were not significant for both years.

***Net Cash Provided by Financing Activities***

Net cash provided by financing activities in the six-month period ended June 30, 2012 decreased by approximately \$6,000,000, or 66%, compared to the same period in 2011. In 2012, an aggregate of 2,700,000 Series B warrants were exercised. These warrants



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were issued as part of our December 2011 financing. For the exercise of these warrants, we issued 2,700,000 shares of our common stock and 2,700,000 Series A Warrants with an exercise price of \$1.40 per share and received gross proceeds of \$3,375,000. For the similar period in 2011, we raised gross proceeds of \$10,000,000 through the sale of 1,000,000 shares of our common stock to selected institutional investors at a price of \$10.00 per share. We received net proceeds, after deducting offering expenses and fees, of approximately \$9,400,000.

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 therapeutic products, pursuit of regulatory approvals, acquisition of capital equipment, laboratory and office facilities, establishment of production capabilities, for selling, 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, 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 November 2010, 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. As of July 30, 2012, we had approximately \$38 million under this universal shelf registration statement available for issuing debt or 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.

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, the 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.

On May 16, 2012, we were notified by the Nasdaq Stock Market ( "Nasdaq" ) that we were no longer in compliance with the minimum stockholders equity requirement for continued listing on the Nasdaq Global Market. The Nasdaq Listing Rules requires registrants to maintain a minimum of \$10 million in stockholders equity in order to continue listing on the Nasdaq Global Market. Our stockholders equity at March 31, 2012 did not meet this requirement. In accordance with Nasdaq Listing Rules, we had 45 calendar days to submit to Nasdaq either a plan to regain compliance with this minimum stockholders equity requirement or to submit an application to voluntarily transfer listing of our common stock to the Nasdaq Capital Market, which requires a minimum of \$2.5 million in stockholders equity for continued listing. We requested Nasdaq to transfer the listing of our common stock to the Nasdaq Capital Market and the transfer went into effect on July 16, 2012. Our listing on the Nasdaq Capital Market is contingent upon meeting all the continued listing requirements of the Nasdaq Capital Market with the exception of the minimum bid price requirement.

Also on May 16, 2012, we were notified by Nasdaq that the closing bid price of our common stock had been below \$1.00 per share for the previous 30 consecutive business days, and therefore we were not in compliance with the minimum bid price requirement for continued listing on the Nasdaq Global Market. In accordance with Nasdaq Listing Rules we have 180 calendar days, or until November 12, 2012, to regain compliance with this minimum bid price requirement. The Nasdaq Capital Market also has a \$1.00 per share minimum bid requirement for continued listing. To regain compliance, the Nasdaq Listing Rules require our common stock to evidence a closing bid price of \$1.00 per share or more for ten consecutive days. On July 31, 2012, we were notified by Nasdaq that we had regained compliance with the minimum bid price requirement because our common stock had a closing bid price of more than \$1.00 per share for ten consecutive days since July 17, 2012.

### ***Commitments***

See Note 7, "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

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condition, changes in financial condition, revenue or expenses, results of operations, liquidity, capital expenditures or capital resources.

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### *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 September 2010, we entered into a two-year sublease agreement with Caliper Life Sciences, Inc., for approximately 13,200 square feet in a facility located in Mountain View, California. In June 2012, we extended the sublease term to September 30, 2013. We will pay approximately \$1,081,000 in aggregate as rent over the term of the lease. The lease contains escalating rent payments, which we recognize as operating lease expense on a straight-line basis. Deferred rent was approximately \$650 as of June 30, 2012, and approximately \$2,600 as of December 31, 2011.

In December 2010, we entered into a commercial lease agreement with BMR-Gateway Boulevard LLC ( "BMR" ), as landlord, for approximately 43,000 square feet of 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 we relocated our corporate headquarters and core research activities from a facility located at the Stanford Research Park in Palo Alto, California, to this facility in July 2011. The lease for the Palo Alto facility expired on August 31, 2011. We will pay approximately \$17,869,000 in aggregate as rent over the term of the lease, which we recognize as operating lease expense on a straight-line basis. Deferred rent was approximately \$1,350,000 as of June 30, 2012, and approximately \$1,301,000 as of December 31, 2011. We constructed laboratories, offices and related infrastructure within the leased space during the first several months of the lease. As part of the lease, BMR has agreed to provide various financial allowances so that we can build initial and future laboratories, offices and other improvements, subject to customary terms and conditions relating to landlord-funded tenant improvements. As part of the lease, we have, until January 2013, an option to lease up to an additional 30,000 square feet in the building.

#### *Operating Leases Rhode Island*

We entered into a fifteen-year lease agreement for a scientific and administrative facility (SAF) in Rhode Island in connection with a sale and leaseback arrangement in 1997. The lease term expires June 30, 2013 and includes escalating rent payments which we recognize on a straight-line basis. Deferred rent expense for this facility was approximately \$350,000 at June 30, 2012 and \$452,000 at December 31, 2011, and is included as part of the wind-down accrual on the accompanying condensed consolidated balance sheets. For the year 2012, we expect to pay approximately \$1,172,000 in operating lease payments and estimated operating expenses of approximately \$690,000, before receipt of sub-tenant income and we expect to receive, in aggregate, approximately \$439,000 in sub-tenant rent and operating expenses. As a result of the above transactions, our estimated cash outlay net of sub-tenant rent for the SAF will be approximately \$1,423,000 for 2012.

#### *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 space from approximately 5,000 square feet to approximately 1,900 square feet of office and lab space. The lease by its terms was extended to September 30, 2013. We expect to pay approximately 61,000 GBP as rental payments for 2012. StemCells, Inc. is the guarantor of Stem Cell Sciences (U.K.) Ltd's obligations under the existing lease.

With the exception of the leases discussed above, we have not entered into any 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.

**Table of Contents****Contractual Obligations**

In the table below, we set forth our legally binding and enforceable contractual cash obligations at June 30, 2012:

|                                           | <b>Total<br/>Obligations<br/>at June 30,<br/>2012</b> | <b>Payable in (July<br/>to<br/>December)<br/>2012</b> | <b>Payable in<br/>2013</b> | <b>Payable in<br/>2014</b> | <b>Payable in<br/>2015</b> | <b>Payable in<br/>2016</b> | <b>Payable in<br/>2017<br/>and<br/>Beyond</b> |
|-------------------------------------------|-------------------------------------------------------|-------------------------------------------------------|----------------------------|----------------------------|----------------------------|----------------------------|-----------------------------------------------|
| Operating lease payments(1)               | \$ 18,703,997                                         | \$ 1,526,538                                          | \$ 2,538,660               | \$ 1,529,890               | \$ 1,581,352               | \$ 1,627,668               | \$ 9,899,889                                  |
| Bonds Payable (principal & interest)(2)   | 494,260                                               | 119,815                                               | 237,593                    | 136,852                    |                            |                            |                                               |
| <b>Total contractual cash obligations</b> | <b>\$ 19,198,257</b>                                  | <b>\$ 1,646,353</b>                                   | <b>\$ 2,776,253</b>        | <b>\$ 1,666,742</b>        | <b>\$ 1,581,352</b>        | <b>\$ 1,627,668</b>        | <b>\$ 9,899,889</b>                           |

- (1) Operating lease payments exclude space-sharing and sub-lease income (see Off-Balance Sheet Arrangements Operating Leases above for further information), but include rent payments for our Rhode Island facility that are included as part of our Accrued wind-down expenses in our condensed consolidated financial statements. See Note 6, Wind-down expenses and Note 7, 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, Commitments and Contingencies in the notes to condensed consolidated financial statements of Part I, Item 1 of this Form 10-Q for further information.

Under license agreements with NeuroSpheres, Ltd., we obtained an exclusive patent license covering all uses of certain neural stem cell technology. We made up-front payments to NeuroSpheres of 6,500 shares of our common stock and \$50,000, and will make additional cash payments as stated milestones are achieved. Effective in 2004, we were obligated to pay annual payments of \$50,000, creditable against certain royalties. Effective in 2008, as part of the indemnification agreement with NeuroSpheres described above, we offset the annual \$50,000 obligation against litigation costs incurred under that agreement.

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 2012. Milestone payments beyond fiscal year 2012 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 June 30, 2012.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Our market risks at June 30, 2012 have not changed materially from those discussed in Item 7A of our Form 10-K for the year ended December 31, 2011 on file with the U.S. Securities and Exchange Commission.

See also Note 2, Financial Assets, 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

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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.

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### **PART II-OTHER INFORMATION**

#### **ITEM 1. LEGAL PROCEEDINGS**

In July 2006, we filed suit against Neuralstem, Inc. in the Federal District Court for the District of Maryland, alleging that Neuralstem's activities violate claims in four of the patents we exclusively licensed from NeuroSpheres, specifically U.S. Patent No. 6,294,346 (claiming the use of human neural stem cells for drug screening), U.S. Patent No. 7,101,709 (claiming the use of human neural stem cells for screening biological agents), U.S. Patent No. 5,851,832 (claiming methods for proliferating human neural stem cells), and U.S. Patent No. 6,497,872 (claiming methods for transplanting human neural stem cells). In May 2008, we filed a second patent infringement suit against Neuralstem and its two founders, Karl Johe and Richard Garr. In this suit, which we filed in the Federal District Court for the Northern District of California, we allege that Neuralstem's activities infringe claims in two patents we exclusively license from NeuroSpheres, specifically U.S. Patent No. 7,361,505 (claiming composition of matter of human neural stem cells derived from any source material) and U.S. Patent No. 7,115,418 (claiming methods for proliferating human neural stem cells). In addition, we allege various state law causes of action against Neuralstem arising out of its repeated derogatory statements to the public about our patent portfolio. Also in May 2008, Neuralstem filed suit against us and NeuroSpheres in the Federal District Court for the District of Maryland seeking a declaratory judgment that the 505 and 418 patents are either invalid or are not infringed by Neuralstem and that Neuralstem has not violated California state law. In August 2008, the California court transferred our lawsuit against Neuralstem to Maryland for resolution on the merits. In July 2009, the Maryland District Court granted our motion to consolidate these two cases with the litigation we initiated against Neuralstem in 2006. Discovery is ongoing in these cases and we anticipate a trial date in 2013.

In addition to the actions described above, in April 2008, we filed an opposition to Neuralstem's European Patent No. 0 915 968 (methods of isolating, propagating and differentiating CNS stem cells), because the claimed invention is believed by us to be unpatentable over prior art, including the patents exclusively licensed by us from NeuroSpheres. In December 2010, the European Patent Office ruled that all composition claims in Neuralstem's 968 European patent were invalid and unpatentable over prior art including several of the NeuroSpheres patents licensed to us. Neuralstem has appealed this decision.

#### **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, 2011.

#### **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.

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ITEM 6. EXHIBITS

|                      |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                              |
|----------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Exhibit 31.1</b>  | Certification of Martin McGlynn under Section 302 of the Sarbanes-Oxley Act of 2002                                                                                                                                                                                                                                                                                                                                                                                                          |
| <b>Exhibit 31.2</b>  | Certification of Rodney K. B. Young under Section 302 of the Sarbanes-Oxley Act of 2002                                                                                                                                                                                                                                                                                                                                                                                                      |
| <b>Exhibit 32.1</b>  | 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                                                                                                                                                                                                                                                                                                                                                     |
| <b>Exhibit 32.2</b>  | Certification of Rodney K. B. Young Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002                                                                                                                                                                                                                                                                                                                                                 |
| <b>Exhibit 101.1</b> | The following materials from the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2012 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. (****) |

\*\*\*\* Pursuant to Rule 406T of Regulation S-T, the XBRL files on Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

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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)

August 8, 2012

/s/ Rodney K. B. Young  
Rodney K. B. Young  
Chief Financial Officer

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