LUNA INNOVATIONS INC
Form S-1/A
May 19, 2006

As filed with the Securities and Exchange Commission on May 19, 2006

Registration No. 333-131764

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Amendment No. 5

to

FORM S-1

REGISTRATION STATEMENT

Under

The Securities Act of 1933

LUNA INNOVATIONS INCORPORATED

(Exact name of Registrant as specified in its charter)

Delaware	**8731**	**54-1560050**
(State or other jurisdiction of incorporation or organization)	**(Primary Standard Industrial Classification Code Number)**	**(I.R.S. Employer Identification Number)**

10 South Jefferson Street, Suite 130

Roanoke, Virginia 24011

(540) 552-5128

(Address, including zip code, and telephone number, including area code, of Registrant s principal executive offices)

Kent A. Murphy, Ph.D.

President, Chief Executive Officer and Chairman

Luna Innovations Incorporated

10 South Jefferson Street, Suite 130

Roanoke, Virginia 24011

(540) 552-5128

(Name, address, including zip code, and telephone number, including area code, of agent for service)

Copies to:

Trevor J. Chaplick, Esq.	**Aaron S. Hullman, Esq.**	**Marjorie Sybul Adams, Esq.**
Mark R. Fitzgerald, Esq.	**Vice President and General Counsel**	**Daniel I. Goldberg, Esq.**
Wilson Sonsini Goodrich & Rosati,	**Luna Innovations Incorporated**	**DLA Piper Rudnick Gray Cary US LLP**
Professional Corporation	**10 South Jefferson Street, Suite 130**	**1251 Avenue of the Americas**
Two Fountain Square,	**Roanoke, Virginia 24011**	**New York, New York 10020**
Reston Town Center	**(540) 552-5128**	**(212) 835-6000**
11921 Freedom Drive, Suite 600		
Reston, Virginia 20190		
(703) 734-3100		

Approximate date of commencement of proposed sale to the public: As soon as practicable after the effective date of this Registration Statement.

If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, check the following box. ¨

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

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

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

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

The information contained in this preliminary prospectus is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This preliminary prospectus is not an offer to sell these securities and it is not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.

PRELIMINARY PROSPECTUS **SUBJECT TO COMPLETION, DATED MAY 19, 2006**

4,000,000 Shares

Common Stock

$ per Share

This is the initial public offering of shares of common stock by Luna Innovations Incorporated.

We are offering 4,000,000 shares of our common stock. We expect the initial public offering price to be between $11.00 and $13.00 per share. Prior to this offering, there has been no public market for our common stock.

We have applied to have the common stock included for quotation on the Nasdaq National Market under the symbol LUNA.

Investing in our common stock involves risks. See Risk factors beginning on page 8 to read about factors you should consider before buying shares of our common stock.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

	Per Share	Total
Initial public offering price	$	$
Underwriting discount	$	$
Proceeds, before expenses, to Luna Innovations Incorporated	$	$

We have granted the underwriters the right to purchase up to an additional 600,000 shares of common stock from us at the initial public offering price less the underwriting discount to cover any over-allotments. The underwriters can exercise this right at any time within 30 days after the offering. We expect that delivery of the shares will be made to investors on or about , 2006.

ThinkEquity Partners LLC

WR Hambrecht + Co

Merriman Curhan Ford & Co.

, 2006

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You should rely only on the information contained in this prospectus. We have not, and the underwriters have not, authorized anyone to provide you with different information. We are not making an offer of these securities in any state where the offer or sale is not permitted. You should not assume that the information contained in this prospectus is complete and accurate as of any date other than the date on the front cover, regardless of the time of delivery, of this prospectus.

We obtained statistical data and certain other industry forecasts used throughout this prospectus from publicly available information, including market research and industry publications. We have not independently verified such data or

sought the consent of the sources to refer to their reports in this prospectus.

Until , all dealers that effect transactions in these securities, whether or not participating in this offering, may be required to deliver a prospectus. This is in addition to the dealers obligation to deliver a prospectus when acting as underwriters and with respect to their unsold allotments or subscriptions.

Prospectus summary

This summary highlights information contained elsewhere in this prospectus. This summary does not contain all of the information you should consider before buying shares in this offering. Therefore, you should read this entire prospectus carefully, including the Risk factors section beginning on page 8 and the financial statements and the related notes. Unless the context requires otherwise, the words we, us and our refer to Luna Innovations Incorporated and its consolidated subsidiaries.

Overview

We research, develop and commercialize innovative technologies in two primary areas: molecular technology solutions and sensing solutions. We have a disciplined and integrated business model that is designed to accelerate the process of bringing new and innovative products to market. We identify technologies that can fulfill identified market needs and then take these technologies from the applied research stage through commercialization in our two areas of focus:

- **Molecular Technology Solutions.** We develop molecular technology solutions, which are substances and materials with enhanced performance characteristics obtained by harnessing chemical, physical and biological properties of novel combinations of matter. We focus on substances and materials at the molecular level, including nanomaterials, which are materials whose size can be measured in nanometers, or one billionth of a meter. Examples of our solutions in this area include flame retardants, protective coatings, and materials that can help physicians identify diseased tissues using magnetic resonance imaging, or MRI.

- **Sensing Solutions.** We develop integrated sensing solutions, which are products that combine sensors, software and hardware to measure, monitor and control chemical, physical and biological properties. We have particular expertise in optical, acoustic and wireless technologies. Examples of our solutions in this area include medical monitoring products and industrial instrumentation for aerospace, energy generation and distribution, and defense applications.

We have a successful track record in executing our market-driven business model. Since our inception, we have developed more than a dozen products serving various industries including energy, telecommunications, life sciences and defense. We have created five companies in our areas of focus, sold two of them to industry leaders in their fields, raised private capital for two of our companies, formed one joint venture and entered into four licensing agreements.

Our aggregate revenues from January 1, 2003 through March 31, 2006 were $61.1 million, and our aggregate cost of revenues during that same period were $40.5 million. For the year ended December 31, 2005 and the three months ended March 31, 2006, we had net losses of $2.0 million and $2.1 million, respectively, and we expect to incur significant additional expenses as we expand our business. We also expect significantly greater losses for the foreseeable future primarily due to increased expenditures related to our nanomaterial and medical device product development efforts and due to certain non-cash charges for compensation expense from the grant of stock options.

Our company is organized into three main groups: our Contract Research Group, our Commercialization Strategy Group and our Products Group. These groups work closely together to turn ideas into products.

Contract Research Group. Our Contract Research Group provides applied research to customers in our areas of focus. Our engineers and scientists collaborate with our network of government, academic and industry experts to identify technologies and ideas with promising market potential. After these promising technologies are identified, our Contract Research Group competes to win fee-for-service contracts from government agencies and industrial clients who seek innovative solutions to practical problems that require new technology. We focus primarily on contract research opportunities where we can retain partial or full rights to the intellectual property developed, and generally obtain full funding of the costs of contracts we undertake from our customers. This approach allows us to cover the costs of early-stage technology development with

contract research revenues. Our contract research revenues grew from $10.4 million in 2003 to $13.8 million in 2004 and to $15.4 million in 2005. During this same period, our contract research costs increased from $8.9 million in 2003 to $11.0 million in 2004 and to $12.6 million in 2005. In the first quarter of 2006, we generated contract research revenues of $3.9 million while incurring contract research costs of $2.9 million. Our Contract Research Group seeks to continually supply our product pipeline with new opportunities.

Commercialization Strategy Group. Our Commercialization Strategy Group works closely with our network of federal and industrial customers to identify new market opportunities for our technologies. After ideas are driven to proof of concept in the Contract Research Group, our Commercialization Strategy Group develops detailed business plans for commercially viable products. It is at this stage that we first consider investing our own funds to finance the continued development of a product, which is then managed in our Products Group.

Products Group. Our Products Group currently consists of the following three divisions:

- **Luna Advanced Systems Division.** Most new product opportunities that are approved for further development by our management team are initially allocated to our Luna Advanced Systems Division. Products currently managed in this division include medical diagnostic instruments using our innovative ultrasound technologies, non-destructive industrial testing and homeland security devices, remote and secure wireless asset monitoring systems, flame retardants, multi-functional protective coating systems and blast and ballistic resistant materials. We transfer products to existing or new divisions within our Products Group with the resources needed for the successful commercialization of the technology if we determine that a product line is broad enough or that the market opportunity is sufficiently large.

- **Luna nanoWorks Division.** Our Luna nanoWorks Division develops and commercializes innovative products based on nanomaterials made from carbon, or carbon nanomaterials, that have broad potential applications. This division is developing MRI contrast agents, which are materials that can help physicians identify diseased tissues using MRI and that are designed to be potentially safer than, and technically superior to, contrast agents currently on the market. We currently supply nanomaterials to research laboratories and plan to supply proprietary high value-added carbon nanomaterials to customers who manufacture products such as solar cells, strong and light-weight composites and coatings to shield devices from electromagnetic interference.

- **Luna Technologies Division.** Our Luna Technologies Division manufactures and markets test and measurement equipment and integrated sensing solutions. This division s products are used for process and control monitoring in telecommunications, manufacturing, power generation and distribution, down-hole oil and gas production, aerospace and defense applications. Our products have won numerous awards and are sold and distributed throughout North America, Europe, the Middle East and Asia.

We expect that the capital raised in this offering will provide us greater flexibility in funding the commercialization of new technologies and will provide us the opportunity to increase the speed, quality and volume of products that we can develop.

Our Growth Strategy

We have the following key strategies to achieve our goal of accelerating the development and commercialization of innovative technologies and to create successful products in our areas of focus:

- **Focus on developing and commercializing a growing portfolio of innovative products.** We intend to build and commercialize a growing portfolio of high value-added products using innovative technologies and utilize our existing relationships to identify, prioritize and allocate resources to respond rapidly to market needs, and shorten the time to market for new products.

- **Transition our mix of revenues to a higher percentage of product sales and license revenues.** We plan to commercialize a growing number of products in order to increase the amount of revenues that we generate

from product sales and license payments. To this end, we will seek to expand our distribution network and our ability to service our customers. We will also seek to allocate resources to improve our ability to manufacture and shorten the cycle time from idea to market and to monetize our intellectual property portfolio by licensing our technologies. As a result, we believe that product sales and license revenues will comprise a greater portion of our total revenues in the future.

- **Continue to strengthen our Contract Research Group.** We will seek to strengthen our Contract Research Group through increased resource allocation and hiring and by expanding our network of relationships with federal laboratories, major research universities and industry leaders. These steps will provide us the opportunity to grow our applied research business, remain informed of the latest technological advances and increase the quality and volume of high potential technologies that will support our product pipeline.

- **Expand our intellectual property portfolio in our areas of focus.** We will seek to expand our intellectual property portfolio by applying our disciplined processes to generate know-how and intellectual property through our network of relationships and our own research and development efforts. By continuing to expand our intellectual property, we will seek to enhance our competitive position and develop additional products in these areas.

Challenges in Executing our Growth Strategy

We face several challenges to the successful implementation of our growth strategy. In addition, our business is subject to numerous risks, which we highlight in the section entitled Risk factors immediately following this prospectus summary. For example, our ability to grow by developing and commercializing multiple products simultaneously requires that we manage a diverse range of projects, expand our personnel resources and broaden our geographic presence. Our inability to do any of these could prevent us from successfully implementing our growth strategy. In addition, the success of our business model depends on our ability to correctly identify market needs for new technologies. If we are not successful in identifying market needs or in developing new products to meet those needs, we may not be successful in growing our product revenues or transitioning our revenues mix from contract research revenues to product sales and license revenues.

We believe that sustained growth at a higher rate will place a strain on our management, as well as on our other human resources. If we are unable to attract and retain qualified personnel as we grow our operations, we may be unable to staff and manage projects adequately, which may slow the development process, result in the commercialization of fewer products or compromise the quality of our work. Moreover, the products that we have developed or are currently developing will compete with other technologically innovative products as well as products incorporating conventional materials and technologies. Our competitors may be able to adapt more quickly to new or emerging technologies and changes in customer requirements. If we are unable to compete successfully against current or new competitors, our product revenues may not increase or may decline.

In addition, our commercial success will depend in part on our obtaining and maintaining intellectual property protection for our technologies as well as successfully enforcing and defending our intellectual property rights against third-party challenges. Moreover, if the commercial versions of our products that are currently under development do not incorporate our proprietary technologies, our intellectual property portfolio may not afford us a competitive advantage.

Company Information

We were incorporated as a Virginia corporation in July 1990. In December 1998 we changed our name from FEORC, Inc. to F&S Technologies, Inc., and in July 1999, we changed our name to Luna Innovations Incorporated. In April 2003, we reincorporated through a merger as a Delaware corporation and retained the name Luna Innovations Incorporated. Our principal offices are located at 10 South Jefferson Street, Suite 130, Roanoke, Virginia 24011. Our telephone number is (540) 552-5128. You can access our web site at www.lunainnovations.com. Information contained on our website does not constitute part of this prospectus.

The Offering

Proposed Nasdaq National Market symbol	LUNA
Common stock offered by us	4,000,000 shares
Common stock outstanding after this offering	10,234,325 shares
Use of proceeds	We intend to use the net proceeds from this offering principally to fund further development and expansion of our products and product candidates, in particular our nanomaterial and ultrasound-related product candidates, and for general working capital purposes. We may also use such proceeds for potential acquisitions of complementary products, technologies or businesses. See Use of proceeds.

The number of shares of common stock that will be outstanding after this offering is based on 6,234,325 shares outstanding as of March 31, 2006, which includes 6,137,601 shares outstanding as of March 31, 2006 and up to 96,724 shares of common stock that will be issued to Carilion Health System in connection with certain anti-dilution provisions afforded to that stockholder upon the effectiveness of this offering, and excludes:

- 4,812,367 shares of common stock issuable upon exercise of options outstanding at a weighted-average exercise price of $0.90 per share, which includes 2,834,129 shares of common stock issuable upon exercise of options outstanding at an exercise price of $0.35 per share, 113,047 shares of common stock issuable upon exercise of options outstanding at an exercise price of $0.39 per share and 1,865,191 shares of common stock issuable upon exercise of options outstanding at an exercise price of $1.77 per share;

- 235,777 shares of common stock reserved for future issuance upon the exercise of options available for grant under our 2003 Stock Plan;

- 61,214 shares of common stock issuable upon exercise of warrants (not subject to escrow) outstanding at a weighted-average exercise price of $3.04 per share, which includes 2,182 shares of common stock issuable upon exercise of outstanding warrants at an exercise price of $37.26 per share and 59,032 shares of common stock issuable upon exercise of outstanding warrants at an exercise price of $1.77 per share;

- 1,065,740 shares of common stock issuable upon the conversion of the principal amount outstanding under senior convertible promissory notes issued to Carilion Health System on December 30, 2005 and, assuming we elect to convert all of the accrued interest on these notes into shares of common stock after these notes remain outstanding for a maximum period of up to eight years, up to an additional 511,553 shares of common stock; and

- 69,390 shares of common stock issued or reserved for issuance in connection with the acquisition of Luna Technologies, Inc. that were held in escrow on that date, and 146 shares of common stock issuable upon the exercise of warrants at an exercise price of $37.26 per share held in escrow as of that date, and which shares and warrants to purchase shares are expected to be cancelled upon the closing of this offering.

We adopted our 2006 Equity Incentive Plan in February 2006, subject to stockholder approval, which will be effective upon the completion of this offering.

Unless otherwise indicated, all information in this prospectus assumes:

- a 1-for-1.7691911 reverse split of our common stock, to be effected immediately prior to the effectiveness of this offering;
- the conversion, in accordance with our certificate of incorporation, of all our shares of outstanding Class A Common Stock, Class B Common Stock and Class C Common Stock into shares of our common stock;
- that the underwriters do not exercise their over-allotment option; and
- the adoption of our amended and restated certificate of incorporation and bylaws.

Summary historical and pro forma financial data

The following table presents summary historical and unaudited pro forma consolidated financial data. We derived the summary consolidated statements of operations data for the years ended December 31, 2003, 2004 and 2005 from our audited consolidated financial statements. The summary consolidated balance sheet data as of March 31, 2006 and the summary consolidated statements of operations data for the three months ended March 31, 2005 and 2006 were derived from our unaudited consolidated financial statements included elsewhere in this prospectus. We have prepared this unaudited information on the same basis as the audited consolidated financial statements and have included all adjustments, consisting only of normal recurring adjustments, that we consider necessary for a fair presentation of our financial position at such date and operating results for such periods. Historical results are not necessarily indicative of the results of operations to be expected for the future periods, and interim results may not be indicative of results for the remainder of the year.

The unaudited pro forma consolidated statement of operations data give effect to our September 30, 2005 purchase of Luna Technologies, Inc. and the issuance of shares of our common stock to former Luna Technologies stockholders in connection with that transaction as if it had occurred on January 1, 2005.

You should read the following information together with the more detailed information contained in Selected consolidated financial data, Management s discussion and analysis of financial condition and results of operations, and the financial statements and the accompanying notes included elsewhere in this prospectus. These sections include, among other things, more detailed information regarding the $169 thousand and $409 thousand stock-based compensation charges reflected in the following table under Operating expense for the periods ended December 31, 2005 and March 31, 2006, respectively.

(in thousands, except share and per share data)	Years Ended December 31,			Three Months Ended March 31,	
	2003	2004	2005	2005	2006
				(unaudited)	(unaudited)
Consolidated Statements of Operations Data:					
Revenues:					
Contract research revenues	$10,358	$13,835	$15,380	$3,256	$3,921
Product sales and license revenues	7,234	8,752	1,074		595
Total revenues	17,592	22,587	16,454	3,256	4,516
Cost of revenues:					
Contract research costs	8,949	10,985	12,552	2,671	2,908
Product sales and license costs	1,543	2,881	410		266
Total cost of revenues	10,492	13,866	12,962	2,671	3,174
Gross profit	7,100	8,721	3,492	585	1,342
Operating expense	4,856	4,190	6,004	882	3,442
Operating income (loss)	2,244	4,531	(2,512)	(297)	(2,100)
Other income (expense)(1)	(138)	(257)	2	1	6
Interest income (expense), net	(87)	(90)	(41)	(40)	5

Income (loss) before income taxes	2,019	4,184	(2,551)	(336)	(2,089)
Income tax expense (benefit)	886	128	(557)	(73)	
Net income (loss)	$1,133	$4,056	$(1,994)	$(263)	$(2,089)
Net income (loss) per common share:					
Basic	$0.40	$1.40	$(0.53)	$(0.09)	$(0.34)
Diluted	$0.39	$1.14	$(0.53)	$(0.09)	$(0.34)
Weighted-average shares:					
Basic	2,843,349	2,903,022	3,735,811	2,911,255	6,069,780
Diluted	2,905,849	3,561,788	3,735,811	2,911,255	6,069,780

(1) Includes minority interests and excludes interest expense.

Summary historical and pro forma financial data

(in thousands, except share and per share data)	Pro Forma Year Ended December 31, 2005 (unaudited)
Pro Forma Consolidated Statement of Operations Data:	
Revenues	$18,560
Cost of revenues	13,997
Gross profit	4,563
Operating expense	7,490
Operating (loss)	(2,927)
Interest (expense), net	(53)
Miscellaneous income	2
(Loss) before income taxes	(2,978)
Income tax expense (benefit)	(557)
Net (loss)	$(2,421)
Net (loss) per common share:	
Basic	$(0.65)
Diluted	$(0.65)
Weighted-average number of shares used in per share calculations:	
Basic	3,735,811
Diluted	3,735,811

The following table presents selected balance sheet data as of March 31, 2006 on an actual basis and on an as adjusted basis to give effect to the sale by us of 4,000,000 shares of our common stock in this initial public offering at an assumed price of $12.00 per share, the mid-point of the range on the front cover of this prospectus, after deducting the underwriting discount and estimated offering expenses.

(in thousands)	As of March 31, 2006	
	Actual	As Adjusted
	(unaudited)	
Consolidated Balance Sheet Data:		
Cash and cash equivalents	$10,099	$53,239
Working capital	9,627	52,767
Total assets	21,369	64,509
Total current liabilities	5,684	5,684

Total debt(1)	5,406	5,406
Stockholders equity	9,637	52,777

(1) Includes capital lease obligations.

Risk factors

An investment in our common stock offered by this prospectus involves a substantial risk of loss. You should carefully consider these risk factors, together with all of the other information included in this prospectus, before you decide to purchase shares of our common stock. The occurrence of any of the following risks could harm our business. In that case, the trading price of our common stock could decline, and you may lose part or all of your investment.

Risks Related to Our Business and Technologies

If we are unable to manage our growth effectively, our revenues and profits could be adversely affected.

While historically we have developed and commercialized only a few products at a time, we plan to grow by developing and commercializing multiple products concurrently across many industries, technologies and markets. Our ability to grow by developing and commercializing multiple products simultaneously requires that we manage a diverse range of projects, expand our personnel resources and broaden our geographic presence. Our inability to do any of these could prevent us from successfully implementing our growth strategy, and our revenues and profits could be adversely affected.

As of March 31, 2006, we had 68 research contracts covering a broad range of technologies, industries and markets. To advance the development of multiple promising potential products concurrently, we need to manage effectively the logistics of maintaining the requisite corporate, operational, administrative and financing functions for each of these products. Expanding our operations into new geographic areas and relying on multiple facilities to develop and manufacture different products concurrently pose additional challenges. We have little experience in managing these functions simultaneously for multiple projects in development or in building new infrastructure and integrating the operations of various facilities. If we cannot manage this process successfully, we may be subject to operating difficulties, additional expenditures and reduced revenues.

We need to expand our personnel resources to grow our business effectively. We believe that sustained growth at a higher rate will place a strain on our management, as well as on our other human resources. To manage this growth, we must continue to attract and retain qualified management, professional, scientific and technical and operating personnel. If we are unable to do so, we may be unable to staff and manage projects adequately, which may slow the development process, result in the commercialization of fewer products or compromise the quality of our work.

We have incurred recent losses, and because our strategy for expansion may be costly to implement, we may experience continuing losses which may be significant.

We incurred consolidated net losses of approximately $2.0 million and $2.1 million for the year ended December 31, 2005 and the three months ended March 31, 2006, respectively. We expect to continue to incur significant additional expenses as we expand our business, including increased expenses for research and development, sales and marketing, manufacturing, finance and accounting personnel and expenses associated with being a public company. We may also grow our business in part through acquisitions of additional companies and complementary technologies which could cause us to incur greater than anticipated

transaction expenses, amortization or write-offs of intangible assets and other acquisition-related expenses. As a result, we expect that we may likely continue to incur losses for the foreseeable future, and these losses could be substantial.

Because of the numerous risks and uncertainties associated with our business and our expansion strategy, we are unable to predict when or if we will be able to achieve profitability again. If our revenues do not increase, or if our expenses increase at a greater rate than our revenues, we will continue to experience losses. Even if we do achieve profitability, we may not be able to sustain or increase our profitability on a quarterly or annual basis.

We may not be successful in identifying market needs for new technologies and developing new products to meet those needs.

The success of our business model depends on our ability to identify correctly market needs for new technologies. We intend to identify new market needs, but we may not always have success in doing so, in part, because our contract research largely

centers on technologies characterized by constant change and unpredictable markets. Furthermore, we must identify the most promising technologies from a sizable pool of projects. For example, we had 68 contract research projects as of March 31, 2006. If our Commercialization Strategy Group fails to identify the projects with the highest commercial potential or if management does not ensure that only the highest potential projects advance to the commercialization stage, we may not successfully commercialize new products and grow our revenues.

Our growth strategy requires that we not only identify new technologies that meet market needs, but that we also develop successful commercial products that address those needs. We face several challenges in developing successful new products. Many of our existing products and those currently under development including our Trimetasphere carbon nanomaterials, which are nanomaterials in the form of a carbon sphere with three metal atoms enclosed inside are technologically innovative and require significant and lengthy product development efforts. These efforts include planning, designing, developing and testing at the technological, product and manufacturing-process levels. These activities require us to make significant investments. Although there are many potential applications for our technologies, our resource constraints require us to focus on specific products and to forgo other opportunities. We expect that one or more of the potential products we choose to develop will not be technologically feasible or will not achieve commercial acceptance, and we cannot predict which, if any, of our products we will successfully develop or commercialize. The technologies we research and develop are new and steadily changing and advancing. The products that are derived from these technologies may not be applicable or compatible with the state of technology or demands in existing markets. Our existing products and technologies may become uncompetitive or obsolete if our competitors adapt more quickly than we do to new technologies and changes in customers requirements. Furthermore, we may not be able to identify if and when new markets will open for our products given that future applications of any given product may not be readily determinable, and we cannot reasonably estimate the size of any markets that may develop. If we are not able to successfully develop new products, we may be unable to increase our product revenues.

We rely and will continue to rely on contract research for a significant portion of our revenues. Any decrease in these revenues, including Small Business Innovation Research, or SBIR, revenues, could adversely affect our business.

We derive a significant portion of our revenues from contract research that we perform for third parties. Contract research accounted for approximately 61.3%, 93.5% and 86.8% of our consolidated total revenues for the years ended December 31, 2004 and 2005 and the three months ended March 31, 2006, respectively. SBIR revenues accounted for approximately 43.3%, 59.8% and 67.3% of our consolidated total revenues for the years ended December 31, 2004 and 2005 and the three months ended March 31, 2006, respectively, and 40.2% and 52.8% of our pro forma consolidated total revenues, which include the operations of Luna Technologies for the years ended December 31, 2004 and 2005, respectively. Contract research will remain a significant portion of our consolidated total revenues for the foreseeable future. Our strategy for developing innovative technologies and products depends in large part on our ability to continue to enter into and generate revenues from contract research, including SBIR contracts, for which we must comply with certain eligibility criteria. Our contract research customer base includes government agencies, academic institutions and corporations. Our customers are not obligated to extend their agreements with us. In addition, our contracts with government agencies, which accounted for approximately 86.1%, 93.3% and 87.9% of our contract research revenues for the years ended December 31, 2004 and 2005 and the three months ended March 31, 2006, respectively, provide that the U.S. government may terminate funding prior to the expiration of these contracts, regardless of whether we have demonstrated technological feasibility or have met specified milestones. In addition, we may not be successful in securing future contracts. Our customers priorities regarding funding for certain projects may change and funding resources may no longer be available at previous levels.

We rely and will continue to rely on contracts and grants awarded under the SBIR program for a significant portion of our revenues. A finding by the Small Business Administration, or SBA, that we no longer qualify to receive SBIR funding could adversely affect our business.

We may not qualify to participate in the Small Business Administration s, or SBA s, SBIR program or receive an SBIR award from any federal agency in the future. In order to qualify for SBIR contracts and grants, at least 51% of our equity must be

owned and controlled by U.S. citizens or permanent resident aliens, or by another entity that is at least 51% owned or controlled by U.S. citizens or permanent resident aliens, and we must have 500 or fewer employees. These eligibility criteria are applied as of the time of the award of a contract or grant. In determining whether we satisfy the 51% equity ownership requirement, agreements to merge, stock options, convertible debt and other similar instruments are given present effect by the SBA, as though the underlying securities were actually issued unless the exercisability or conversion of such securities is speculative, remote or beyond the control of the security holder. We therefore believe our outstanding options and warrants held by eligible individuals may be counted as, and our convertible debt may be excluded from, outstanding equity for purposes of meeting the 51% equity ownership requirement. As of March 31, 2006, giving present effect to our outstanding options, approximately 76% of our equity was owned by U.S. citizens or permanent resident aliens. Upon the completion of this offering, at least approximately 57% of our equity will be owned by U.S. citizens or permanent resident aliens (and at least approximately 55% assuming exercise of the underwriters over-allotment option).

We believe that we are currently in compliance with the SBIR eligibility criteria but we cannot provide assurance that the SBA will interpret its regulations in our favor. We must be able to certify that we meet the SBIR ownership and size requirements as of the time we enter into each SBIR contract or grant, and SBA may review our size status in connection with each SBIR contract or grant. As we grow our business, it is foreseeable that we will eventually exceed the SBIR eligibility limitations and we may need to find other sources to fund our research and development efforts. If we are unsuccessful in obtaining additional contracts or funding grants because we cannot meet the eligibility requirements or if our customers decide to reduce or discontinue support of our products, we may be required to seek alternative sources of revenues or capital.

The SBA could determine that, as a result of Carilion Health System s equity ownership, the number of our employees exceeds the size limitation placed on SBA contract and SBIR grant recipients, and therefore we will not be eligible to receive future SBA contracts and SBIR grants.

In addition to the U.S. ownership eligibility criteria discussed above, to be eligible for SBA contracts and SBIR grants, the number of our employees including those of any entities that are considered to be affiliated with us, cannot exceed 500. As of March 31, 2006, we, including all of our divisions, had 148 full-time and 13 part-time employees. However, in determining whether we are affiliated with any other entity, the SBA analyzes whether another entity controls or has the power to control us. If the SBA determines that another entity controls or has the power to control us, it will aggregate that entity s employees (and the employees of its subsidiaries and affiliates) with our own for purposes of applying the 500 employee test.

The SBA may make an affiliation determination based on stock ownership. For example, the SBA may presume that two or more entities have the power to control a company if the entities each own, control or has the power to control, less than 50 percent of the company s stock, such minority holdings are equal or approximately equal in size, and the aggregate of the minority holdings is large as compared to any other stock holding. However, this presumption may be rebutted by showing that such control or power to control does not in fact exist. Prior to this offering, giving effect to the conversion of our Class A common stock, Class B common stock and Class C common stock into shares of our common stock such that an additional 96,724 shares are issued to Carilion Health System, Carilion Health System held 34.2% of our common stock, and Dr. Kent Murphy owned 42.3% of the voting power of our common stock, and after the offering, these ownership percentages will be approximately equal to 20.8% and 25.8%, respectively. Thus, applying the criteria stated above, the SBA could find that both Carilion Health System and Dr. Murphy own less than 50% of the stock, their percentages are roughly equal, and their respective percentages are large compared to any other stock holding. We believe that the relative beneficial ownership of our individual stockholders rebuts the presumption of control by Carilion Health System because the shares held by our executive officers and directors constitute the controlling interest in us. However, if the SBA were to make a determination that we are affiliated with Carilion Health System, we would exceed the size limitations as Carilion Health System has over 500 employees, and we therefore would lose eligibility for SBA contracts, public contracts, grants and other awards that are set aside for small businesses, including SBIR grants.

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Risk factors

We depend on government-funded research contracts for most of our contract research revenues, and a decline in government funding of existing or future government research contracts could adversely affect our revenues and cash flows and our ability to fund our growth.

Government-funded research accounted for approximately 86.1%, 93.3% and 87.9% of our contract research revenues and 52.8%, 87.2% and 76.3% of our consolidated total revenues for the years ended December 31, 2004 and 2005 and the three months ended March 31, 2006, respectively. On a pro forma consolidated basis, which includes the results of operations of Luna Technologies as if acquired on January 1, 2004, government-funded research accounted for 49.0% and 76.9% of our pro forma consolidated total revenues for the years ended December 31, 2004 and 2005, respectively. As a result, we are vulnerable to adverse changes in our revenues and cash flows if a significant number of our government research contracts and subcontracts are simultaneously delayed or canceled for budgetary, performance or other reasons. The U.S. government may cancel these contracts at any time without cause and without penalty or may change its requirements, programs or contract budget, any of which could reduce our revenues and cash flows from U.S. government research contracts. Our revenues and cash flows from U.S. government research contracts could also be reduced by declines or other changes in U.S. defense, homeland security and other federal agency budgets. In addition, we compete as a small business for some of these contracts, and in order to maintain our eligibility to compete as a small business, we (together with any affiliates) must continue to meet size and revenue limitations established by the U.S. government.

In addition to contract cancellations and changes in agency budgets, our future financial results may be adversely affected by curtailment of the U.S. government s use of contract research providers, including curtailment due to government budget reductions and related fiscal matters. These or other factors could cause U.S. defense and other federal agencies to conduct research internally rather than through commercial research organizations, to reduce their overall contract research requirements or to exercise their rights to terminate contracts. Any of these actions could limit our ability to obtain new contract awards and adversely affect our revenues and cash flows and our ability to fund our growth.

If we cannot successfully transition our revenues mix from contract research revenues to product sales and license revenues, we may not be able to fully execute our business model or grow our business.

Our business model and future growth depend on our ability to transition to a revenues mix that contains significantly larger product sales and license revenues components. Product sales and license revenues potentially offer greater scalability than services-based contract research revenues. Our current plan is to increase our portfolio of commercial products and, accordingly, we expect that our future product sales and license revenues will represent a larger percentage of total revenues. However, if we are unable to develop and grow our product sales and license revenues to augment our contract research revenues, our ability to execute our business model or grow our business could suffer.

We face and will face substantial competition in several different markets that may adversely affect our results of operations.

We face or will face substantial competition from a variety of companies in several different markets. Our competitors in contract research include, but are not limited to, companies such as General Dynamics Corporation, Lockheed Martin Corporation, SAIC, Inc. and SRA International, Inc. In the molecular technology solutions products market, our competitors include, but are not limited to, large public manufacturers such as The Dow Chemical Company, E.I. du Pont de Nemours and Company, Rohm and Haas Company and 3M Company, as well as emerging companies. In addition, in the MRI contrast agent market our competitors include Amersham Plc, Berlex Laboratories, Inc., Bracco Diagnostics, Inc., and Mallinckrodt Inc. In the sensor solutions products market,

our competitors include, but are not limited to, large companies such as Agilent Technologies, Inc., Analog Devices, Inc., Freescale Semiconductor, Inc., JDS Uniphase Corp., Robert Bosch GmbH and Silicon Sensing, as well as emerging companies.

The products that we have developed or are currently developing will compete with other technologically innovative products as well as products incorporating conventional materials and technologies. We expect that our products will compete with

companies in a wide range of industries, including semiconductors, electronics, biotechnology, textiles, alternative energy, military, defense, healthcare, telecommunications, industrial measurement, security applications and consumer electronics.

Many of our competitors have longer operating histories, greater name recognition, larger customer bases and significantly greater financial, sales and marketing, manufacturing, distribution, technical and other resources than we do. These competitors may be able to adapt more quickly to new or emerging technologies and changes in customer requirements. In addition, current and potential competitors have established or may establish financial or strategic relationships among themselves or with existing or potential customers or other third parties. Accordingly, new competitors or alliances among competitors could emerge and rapidly acquire significant market share. We cannot assure you that we will be able to compete successfully against current or new competitors, in which case our net revenues may fail to increase or may decline.

A substantial portion of our technology is subject to retained rights of our licensors, and we may not be able to prevent the loss of those rights or the grant of similar rights to third parties.

A substantial portion of our technology is licensed from academic institutions, corporations and government agencies. Under these licensing arrangements, a licensor may obtain rights over the technology, including the right to require us to grant a license to one or more third parties selected by the licensor or that we provide licensed technology or material to third parties for non-commercial research. For example, under the Trimetasphere nanomaterials license, we have been required to supply Trimetasphere nanomaterials to three foreign and five domestic university research institutions and one corporate industrial research laboratory and may be required to supply such materials to other organizations for non-commercial research. The grant of a license for any of our core technologies to a third party could have a material and adverse effect on our business. In addition, our licensors retained certain rights under the licenses including the right to grant additional licenses to a substantial portion of our core technology to third parties for noncommercial academic and research use. It is difficult to monitor and enforce such noncommercial academic and research uses, and we cannot predict whether the third party licensees would comply with the use restrictions of such licenses. We could incur substantial expenses to enforce our rights against them. We also may not fully control the ability to assert or defend those patents or other intellectual property which we have licensed from other entities, or which we have licensed to other entities.

In addition, some of our licenses with academic institutions give us the right to use certain technology previously developed by researchers at these institutions. In certain cases we also have the right to practice improvements on the licensed technology to the extent they are encompassed by the licensed patents and within our field of use. Our licensors may currently own and may in the future obtain additional patents and patent applications that are necessary for the development, manufacture and commercial sale of our anticipated products. We may be unable to agree with one or more academic institutions from which we have obtained licenses that certain intellectual property developed by researchers at these academic institutions is covered by our existing licenses. In the event that the new intellectual property is not covered by our existing licenses, we would be required to negotiate a new license agreement. We may not be able to reach agreement with current or future licensors on commercially reasonable terms, if at all, or the terms may not permit us to sell our products at a profit after payment of royalties, which could harm our business.

Some of our patents may cover inventions that were conceived or first reduced to practice under, or in connection with, U.S. government contracts or other federal funding agreements. With respect to inventions conceived or first reduced to practice under a federal funding agreement, the U.S. government may retain a nonexclusive, non-transferable, irrevocable, paid-up license to practice or have practiced for or on behalf of the United States the invention throughout the world. We may not have succeeded in our efforts to retain title in patents, maintain ownership of intellectual property or in limiting the U.S. government s rights in our proprietary technologies and intellectual property whether such intellectual property was developed in the performance of a federal

funding agreement or developed at private expense.

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Risk factors

Our proprietary rights may not adequately protect our technologies.

Our commercial success will depend in part on our obtaining and maintaining patent, trade secret, copyright and trademark protection of our technologies in the United States and other jurisdictions as well as successfully enforcing this intellectual property and defending this intellectual property against third-party challenges. We will only be able to protect our technologies from unauthorized use by third parties to the extent that valid and enforceable intellectual property protections, such as patents or trade secrets, cover them. In particular, we place considerable emphasis on obtaining patent and trade secret protection for significant new technologies, products and processes. Furthermore, the degree of future protection of our proprietary rights is uncertain because legal means afford only limited protection and may not adequately protect our rights or permit us to gain or keep our competitive advantage. Moreover, the degree of future protection of our proprietary rights is uncertain for products that are currently in the early stages of development such as the Trimetasphere carbon nanomaterials products because we cannot predict which of these products will ultimately reach the commercial market or whether the commercial versions of these products will incorporate proprietary technologies.

Our patent position is highly uncertain and involves complex legal and factual questions. Accordingly, we cannot predict the breadth of claims that may be allowed or enforced in our patents or in third-party patents. For example:

- we or our licensors might not have been the first to make the inventions covered by each of our pending patent applications and issued patents;
- we or our licensors might not have been the first to file patent applications for these inventions;
- others may independently develop similar or alternative technologies or duplicate any of our technologies;
- it is possible that none of our pending patent applications or the pending patent applications of our licensors will result in issued patents;
- our issued patents and issued patents of our licensors may not provide a basis for commercially viable technologies, or may not provide us with any competitive advantages, or may be challenged and invalidated by third parties; and
- we may not develop additional proprietary technologies that are patentable.

Patents may not be issued for any pending or future pending patent applications owned by or licensed to us, and claims allowed under any issued patent or future issued patent owned or licensed by us may not be valid or sufficiently broad to protect our technologies. Moreover, protection of certain of our intellectual property may be unavailable or limited in the United States or in foreign countries, and certain of our products including our Trimetasphere carbon nanomaterials products do not have foreign patent protection. Any issued patents owned by or licensed to us now or in the future may be challenged, invalidated, or circumvented, and the rights under such patents may not provide us with competitive advantages. In addition, competitors may design around our technology or develop competing technologies. Intellectual property rights may also be unavailable or limited in some foreign countries, and in the case of certain products no foreign patents were filed or can be filed. This could make it easier for competitors to capture or increase their market share with respect to related technologies. Although we are not currently involved in any legal proceedings related to intellectual property, we could incur substantial costs to bring suits in which we may assert our patent rights

against others or defend ourselves in suits brought against us. An unfavorable outcome of any such litigation could have a material adverse effect on our business and results of operations.

We also rely on trade secrets to protect our technology, especially where we believe patent protection is not appropriate or obtainable. However, trade secrets are difficult to protect. We vigorously pursue confidentiality agreements and contractual provisions with our collaborators, employees, and consultants to protect our trade secrets and proprietary know-how. These agreements may be breached and or may not have adequate remedies for such breach. While we use reasonable efforts to protect our trade secrets, our employees, consultants, contractors or scientific and other advisors, or those of our strategic partners, may unintentionally or willfully disclose our information to competitors. If we were to enforce a claim that a third party

had illegally obtained and was using our trade secrets, our enforcement efforts would be expensive and time consuming, and the outcome would be unpredictable. In addition, courts outside the United States are sometimes unwilling to protect trade secrets. Moreover, if our competitors independently develop equivalent knowledge, methods and know-how, it will be more difficult for us to enforce our rights and our business could be harmed.

If we are not able to defend the patent or trade secret protection position of our technologies, then we will not be able to exclude competitors from developing or marketing competing technologies, and we may not generate enough revenues from product sales to justify the cost of development of our technologies and to achieve or maintain profitability.

We also rely on trademarks to establish a market identity for Luna and Luna products. We currently have one registered trademark in the United States and three pending trademark applications filed with the U.S. Patent and Trademark Office. To maintain the value of our trademarks, we might have to file lawsuits against third parties to prevent them from using trademarks confusingly similar to or dilutive of our registered or unregistered trademarks. Also, we might not obtain registrations for our pending trademark applications, and might have to defend our registered trademark and pending trademark applications from challenge by third parties. Enforcing or defending our registered and unregistered trademarks might result in significant litigation costs and damages, including the inability to continue using certain trademarks.

Third parties may claim that we infringe their intellectual property, and we could suffer significant litigation or licensing expense as a result.

Various U.S. and foreign issued patents and pending patent applications, which are owned by third parties, exist in our technology areas. Such third parties may claim that we infringe their patents. Because patent applications can take several years to result in a patent issuance, there may be currently pending applications, unknown to us, which may later result in issued patents that our technologies may infringe. For example, we are aware of competitors with patents in technology areas applicable to our optical test equipment products. Such competitors may allege that we infringe these patents. There could also be existing patents of which we are not aware that our technologies may inadvertently infringe. If third parties assert claims against us alleging that we infringe their patents or other intellectual property rights including third parties that have asserted claims against businesses that we have acquired prior to our acquisition of these businesses we could incur substantial costs and diversion of management resources in defending these claims, and the defense of these claims could have a material adverse effect on our business, financial condition, and results of operations. In addition, if third parties assert claims against us and we are unsuccessful in defending against these claims, these third parties may be awarded substantial damages, as well as injunctive or other equitable relief against us, which could effectively block our ability to make, use, sell, distribute, or market our products and services in the United States or abroad. For example, we acquired a business that had received a letter in 2002 from a competitor alleging infringement of certain patents. The competitor sent an additional letter on January 14, 2004 to the business that we acquired, again alleging infringement of the competitor s patents. Neither we nor the business that we acquired have received any further communications from this third party. We cannot currently predict whether this third party, or any other third party, will assert a claim against us, or whether any third parties that have asserted such claims against businesses that we have acquired will assert claims or pursue infringement litigation against us; nor can we predict the ultimate outcome of any such potential claims or litigation.

Commercial application of nanotechnologies, or technologies involving nanomaterials, is new and the scope and breadth of patent protection is uncertain. Consequently, the patent positions of companies involved in nanotechnologies have not been tested and complex legal and factual questions for which important legal principles will be developed or may remain unresolved. In addition, it is not clear whether such patents will be subject to interpretations or legal doctrines that differ from conventional patent law principles. Changes in either the patent laws or in interpretations of patent laws in the United States and other countries may diminish the value of our nanotechnology-related intellectual property. Accordingly, we cannot predict the breadth of claims that

may be allowed or enforced in our nanotechnology-related patents or in third party patents.

In the event that a claim relating to intellectual property is asserted against us, or third parties not affiliated with us hold pending or issued patents that relate to our products or technology, we may seek licenses to such intellectual property or

challenge those patents. However, we may be unable to obtain these licenses on commercially reasonable terms, if at all, and our challenge of the patents may be unsuccessful. Our failure to obtain the necessary licenses or other rights could prevent the sale, manufacture, or distribution of our products and, therefore, could have a material adverse effect on our business, financial condition, and results of operations.

For example, we are a party to an exclusive license agreement with NASA for certain patented ultrasound technology. The field of this license is limited to measurement of intracranial pressure and compartment syndrome. We currently engage in ultrasound product development activities in bone strength measurement, embolus detection and detection of concealed weapons. To the extent that these activities are covered by the licensed NASA patents, we may be required to acquire an additional license from NASA. We cannot currently predict whether NASA would grant an additional license to us for these fields of use, if such a license were required.

As a provider of contract research to the U.S. government, we are subject to federal rules, regulations, audits and investigations, the violation or failure of which could adversely affect our business.

We must comply with and are affected by laws and regulations relating to the award, administration and performance of U.S. government contracts. Government contract laws and regulations affect how we do business with our government customers and, in some instances, impose added costs on our business. A violation of specific laws and regulations could result in the imposition of fines and penalties or the termination of our contracts or debarment from bidding on contracts. In some instances, these laws and regulations impose terms or rights that are more favorable to the government than those typically available to commercial parties in negotiated transactions. For example, the U.S. government may terminate any of our government contracts and, in general, subcontracts, at their convenience, as well as for default based on performance.

In addition, U.S. government agencies, including the Defense Contract Audit Agency and the Department of Labor, routinely audit and investigate government contractors. These agencies review a contractor s performance under its contracts, cost structure and compliance with applicable laws, regulations and standards. The U.S. government also may review the adequacy of, and a contractor s compliance with, its internal control systems and policies, including the contractor s purchasing, property, estimating, compensation and management information systems. Any costs found to be improperly allocated to a specific contract will not be reimbursed, while such costs already reimbursed must be refunded. If an audit uncovers improper or illegal activities, we may be subject to civil and criminal penalties and administrative sanctions, including termination of contracts, forfeiture of profits, suspension of payments, fines and suspension or prohibition from doing business with the U.S. government. In addition, we could suffer serious reputational harm if allegations of impropriety were made against us.

In March 2003, the Office of Inspector General of the Department of Commerce advised us that the government was investigating anonymous allegations of contract improprieties. We have cooperated fully and extensively with that investigation through interviews and document production. In April 2003, the government advised our regulatory counsel that to date no wrongdoing had been identified, although the government indicated that we may not have fully complied with contractual reporting requirements in one or two instances, which the government did not specify. We believe that the investigation has been resolved favorably, based on statements by the government investigator to our employees in June 2003, and that this matter effectively is at an end absent any advice or communication from the government to the contrary. However, there can be no assurance as to how or whether our relationships, business, financial condition or results of operations will ultimately be affected, if at all, by the investigation.

On November 9, 2004, we received a subpoena from the Department of Defense Office of the Inspector General covering certain government research contracts awarded to us between January 1, 1998 and November 9, 2004 to determine if we had duplicated work in our submission of project reports to the government. In connection with the investigation, the government alleged that duplication occurred in three research reports that we prepared under the contracts. We submitted a response to the Inspector General in September 2005 challenging the government s findings. On November 15, 2005, we entered into a

settlement agreement with the government and received a general release with respect to the civil and administrative claims in this matter in return for a payment of $165,333.

In March 2006, our senior management became aware that seven foreign national citizens who were working for us had access to International Traffic in Arms Regulations, or ITAR, controlled technical data. Such data may be deemed to have been exported/disclosed to certain of these individuals without the required export licenses. We do not believe that exports of ITAR-controlled technical data occurred to any other unauthorized parties. In addition, we do not believe that any disclosures to foreign nationals involved technology related to classified contracts. Following this discovery, in an effort to ensure full compliance with ITAR we submitted voluntary disclosure of these circumstances to the U.S. Department of State in April 2006. While the Department of State encourages such voluntary disclosure, we nevertheless could be subject to potential investigation and may be exposed to potential regulatory consequences ranging from a no-action letter, government oversight of facilities and export transactions, monetary penalties, and in extreme cases, debarment from government contracting, denial of export privileges and criminal sanctions.

In addition to the risk of government audits and investigations, U.S. government contracts and grants impose requirements on contractors and grantees relating to ethics and business practices, which carry civil and criminal penalties ranging from monetary fines, assessments, loss of the ability to do business with the U.S. government and certain other criminal penalties.

We may also be prohibited from commercially selling certain products that we develop under our Contract Research Group or related products based on the same core technologies if the U.S. government determines that the commercial availability of those products could pose a risk to national security. For example, certain of our wireless technologies have been classified as secret by the U.S. government and as a result we cannot sell them commercially. Any of these determinations would limit our ability to generate product sales and license revenues.

We are subject to significant foreign and domestic government regulations, including environmental and health and safety regulations, and failure to comply with these regulations could harm our business.

Our facilities and current and proposed activities involve the use of a broad range of materials that are considered hazardous under applicable laws and regulations. Accordingly, we are subject to a number of foreign, federal, state, and local laws and regulations relating to health and safety, protection of the environment, and the storage, use, disposal of, and exposure to, hazardous materials and wastes. We could incur costs, fines and civil and criminal penalties, personal injury and third party property damage claims, or could be required to incur substantial investigation or remediation costs if we were to violate or become liable under environmental, health and safety laws. Moreover, a failure to comply with environmental laws could result in fines and the revocation of environmental permits, which could prevent us from conducting our business. Liability under environmental laws can be joint and several and without regard to fault. There can be no assurance that violations of environmental health and safety laws will not occur in the future as a result of the inability to obtain permits, human error, equipment failure or other causes. Environmental laws could become more stringent over time, imposing greater compliance costs and increasing risks and penalties associated with violations, which could harm our business. Accordingly, violations of present and future environmental laws could restrict our ability to expand facilities, pursue certain technologies, and could require us to acquire costly equipment, or to incur potentially significant costs to comply with environmental regulations.

The European Union Directive 2002/96/EC on Waste Electrical and Electronic Equipment, known as the WEEE Directive, requires producers of certain electrical and electronic equipment, including monitoring instruments, to be financially responsible for specified collection, recycling, treatment and disposal of past and present covered products placed on the market in the European Union. As a manufacturer of covered products, we may be required to register as a producer in some European Union countries, and we may incur some financial responsibility for the collection, recycling, treatment and disposal of both new product sold, and product already sold prior to the WEEE Directive s enforcement date, including the products of other manufacturers where these are replaced by our own products. European Union Directive 2002/95/EC on the Restriction of the use of Hazardous Substances in electrical and electronic equipment, known as the RoHS Directive, restricts the use of certain hazardous substances, including mercury, lead and cadmium in specified covered products; however, the RoHS

Risk factors

Directive currently exempts monitoring instruments from its requirements. If the European Commission were to remove this exemption in the future, we would be required to change our manufacturing processes and redesign products regulated under the RoHS Directive in order to be able to continue to offer them for sale within the European Union. For some products, substituting certain components containing regulated hazardous substances may be difficult, costly or result in production delays. We will continue to review the applicability and impact of both directives on the sale of our products within the European Union, and although we cannot currently estimate the extent of such impact, they are likely to result in additional costs and could require us to redesign or change how we manufacture our products, any of which could adversely affect our operating results. Failure to comply with the directives could result in the imposition of fines and penalties, inability to sell covered products in the European Union and loss of revenues.

Compliance with foreign, federal, state and local environmental laws and regulations represents a small part of our present budget. If we fail to comply with any such laws or regulations, however, a government entity may levy a fine on us or require us to take costly measures to ensure compliance. Any such fine or expenditure may adversely affect our development. We are committed to complying with and, to our knowledge, are in compliance with, all governmental regulations. We cannot predict the extent to which future legislation and regulation could cause us to incur additional operating expenses, capital expenditures, or restrictions and delays in the development of our products and properties.

Our ability to develop and market certain of our current and potential products may be hindered as a result of FDA regulatory requirements and a lengthy and expensive approval process.

Certain of our current and potential products will require regulatory clearances or approvals prior to commercialization. In particular, our Trimetasphere nanomaterial-based MRI contrast agent and our ultrasound diagnostic devices for measuring certain medical conditions will be considered a drug and medical devices, respectively, under the Federal Food, Drug & Cosmetic Act, or FDC Act. Drugs and medical devices are subject to rigorous preclinical testing and other approval requirements by the Food and Drug Administration, or FDA, pursuant to the FDC Act, and regulations under the FDC Act, as well as by similar health authorities in foreign countries. Various federal statutes and regulations also govern or influence the testing, manufacturing, safety, labeling, packaging, advertising, storage, registration, listing and recordkeeping related to marketing of these products. The process of obtaining these clearances or approvals and the subsequent compliance with appropriate federal statutes and regulations require the expenditure of substantial resources. We cannot be certain that any required FDA or other regulatory approval will be granted or, if granted, will not be withdrawn. Our failure to obtain the necessary regulatory approvals, or our failure to obtain them in a timely manner, will prevent or delay our commercialization of new products and our business could suffer.

Our failure to attract, train and retain skilled employees would adversely affect our business and operating results.

The availability of highly trained and skilled technical and professional personnel is critical to our future growth and profitability. Competition for scientists, engineers, technicians and professional personnel is intense and competitors aggressively recruit key employees. Although we have not previously experienced material difficulties in hiring or retaining these personnel, our growth strategy and future needs for additional experienced personnel, particularly in highly specialized areas such as nanomaterial manufacturing and innovative ultrasound technologies, may make it more difficult to meet all of our needs for these employees in a timely manner. Although we intend to continue to devote significant resources to recruit, train and retain qualified employees, we may not be able to attract and retain these employees, especially in technical fields where the supply of experienced qualified candidates is limited. Any failure to do so would have an adverse effect on our business.

In addition, our future success depends in a large part upon the continued service of key members of our senior management team. In particular, our Chairman, CEO and founder, Kent A. Murphy, Ph.D., is essential to our overall management as well as the development of our technologies, our culture and our strategic direction. All of our executive officers and key employees are at-will employees, and, except with respect to Kent A. Murphy, Ph.D., we do not maintain any key-person life insurance policies. The loss of any of our management or key personnel could seriously harm our business.

Risk factors

We might require additional capital to support business growth, and this capital might not be available.

We intend to continue to make investments to support our business growth and may require additional funds to respond to business challenges, including the need to develop new products or enhance our existing products, enhance our operating infrastructure, complete our development activities, build our commercial scale manufacturing facilities and acquire complementary businesses and technologies. Accordingly, we may need to engage in equity or debt financings to secure additional funds for these investments. If we raise additional funds through issuances of equity or convertible debt securities, our existing stockholders could suffer significant dilution, and any new equity securities we issue could have rights, preferences and privileges superior to those of holders of our common stock, including shares of common stock sold in this offering. Furthermore, such financings may jeopardize our ability to apply for SBIR grants or qualify for SBIR contracts or grants, and our dependence on SBIR grants may restrict our ability to raise additional outside capital. Our ability to obtain additional capital could be restricted by the covenants in our existing senior secured credit facility with First National Bank. Among other things, these covenants restrict us, without the prior approval of First National Bank, from guaranteeing the debt of an affiliate or subsidiary or incurring in excess of $200 thousand non-First National Bank debt annually. Any debt financing obtained by us in the future could involve restrictive covenants relating to our capital raising activities and other financial and operational matters, which may make it more difficult for us to obtain additional capital and to pursue business opportunities, including potential acquisitions. In addition, we may not be able to obtain continued SBIR funding, or other additional financing on terms favorable to us, if at all. In order to retain SBIR eligibility, we may be restricted in our ability to raise certain forms of equity capital from institutional investors. For example, in connection with the closing of our financing with Carilion Health System on December 30, 2005, we were not able to raise all proceeds through the issuance of equity without potentially jeopardizing our SBIR eligibility. We therefore elected to issue debt in the amount of $5.0 million of the total $8.0 million raised in such financing to maintain SBIR eligibility. Under the terms of these notes, we agreed that we will not draw down any amount under our existing senior secured credit facility with First National Bank or incur additional indebtedness other than under certain limited conditions. If we are unable to obtain adequate financing or financing on terms satisfactory to us, when we require it, our ability to continue to support our business growth and to respond to business challenges could be significantly limited.

We expect to incur significant expenditures in connection with a grant from the City of Danville, Virginia. If we fail to make certain agreed upon expenditures, we may be obligated to repay part or all of the proceeds from such grant.

In March 2004, we received a grant of $900 thousand from the City of Danville, Virginia under a Grant Agreement to support the expansion of economic and commercial growth within the City. Under the Grant Agreement, we agreed to locate a nanomaterials manufacturing and research facility and maintain its operations in Danville until March 25, 2009. Our obligations under this Grant Agreement require us to incur significant expenditures in order to retain such proceeds from the grant. Specifically, we agreed under the Grant Agreement to invest at least $5.2 million in capital equipment expenditures and $1.2 million in certain facilities by September 25, 2006 and to maintain such investments in our Danville facility until March 25, 2009. We also agreed to create by September 25, 2006 at least 54 new full-time jobs at the Danville facility at an average annual wage of at least $39 thousand plus benefits, and to maintain these jobs at such facility until March 25, 2009. These contractual requirements will restrict the use of significant assets and could obligate us to an annual payroll obligation exceeding $2.0 million until March 25, 2009. To the extent such hiring results in salaries in excess of the required minimum wages, our annual payroll obligation could be substantially greater than $2.0 million. If we fail to make these capital expenditures and create these jobs by September 25, 2006, we will be obligated to repay the City of Danville all or a portion of the $900 thousand in funds based on a formula of the pro rata shortfall of such expenditures and jobs falling below such required levels. At this time, we do not anticipate that we will satisfy the investment and hiring targets of the grant prior to September 25, 2006, and we expect that we may have to return some or all of the grant proceeds. We currently have classified the full amount of the grant as a liability on our balance sheet in anticipation of returning the funds.

Risk factors

We have limited experience manufacturing our products in commercial quantities in a cost-effective manner, which could adversely impact our business.

We have produced most of our products on a custom order basis rather than pursuant to large contracts that require production on a large volume basis. Accordingly, other than the commercial manufacture of products by our Luna Technologies Division, we have no experience manufacturing products in large volume. Because our experience in large scale manufacturing is limited, we may encounter unforeseen difficulties in our efforts to manufacture other products or materials in commercial quantities. For example, we may need to develop or in-license Trimetasphere nanomaterial purification and isolation technology, which would result in manufacturing delays or shortfalls. We may also encounter difficulties and delays in manufacturing our products for the following reasons:

- Ø we plan to expand our manufacturing operations, and our production processes may have to change to accommodate this growth;
- Ø to increase our manufacturing output significantly, we will have to attract and retain qualified employees, who are in short supply, for the assembly and testing operations;
- Ø we might have to sub-contract to outside manufacturers which might limit our control of costs and processes; and
- Ø our manufacturing operations may have to comply with government specifications including FDA regulations.

If we are unable to keep up with demand for our products, our revenues could be impaired, market acceptance for our products could be adversely affected and our customers might instead purchase our competitors products. Moreover, failure to develop and maintain a U.S. market for goods developed with U.S. government-licensed technology may result in the cancellation of the relevant U.S. government licenses. Our inability to manufacture our products successfully would have a material adverse effect on our revenues.

Even if we are able to manufacture our products on a commercial scale, the cost of manufacturing our products may be higher than we expect. If the costs associated with manufacturing are not significantly less than the prices at which we can sell our products, we may not be able to operate at a profit.

We depend on third-party vendors for specialized components in our manufacturing operations, making us vulnerable to supply shortages and price fluctuations that could harm our business.

We primarily rely on third-party vendors for the manufacture of the specialized components used in our products. Although we do not have any sole source suppliers of materials, the highly specialized nature of our supply requirements poses risks that we may not be able to locate additional sources of the specialized components required in our business. For example, we are aware of only two manufacturers that produce the special lasers used in our optical test equipment. Moreover, none of these third-party vendors is obligated to continue to supply us with components. Our reliance on these vendors subjects us to a number of risks that could impact our ability to manufacture our products and harm our business, including interruption of supply.

Any significant delay or interruption in the supply of components, or our inability to obtain substitute components or materials from alternate sources at acceptable prices in a timely manner, could impair our ability to meet the demand of our customers and harm our business.

Our nanotechnology-enabled products are new and may be, or may be perceived as being, harmful to human health or the environment.

While we believe that none of our current products contain chemicals known by us to be hazardous or subject to environmental regulation, it is possible our current or future products, particularly carbon-based nanomaterials, may become

subject to environmental regulation. We intend to develop and sell carbon-based nanomaterials as well as nanotechnology-enabled products, which are products that include nanomaterials as a component to enhance those products performance. Nanomaterials and nanotechnology-enabled products have a limited historical safety record. Because of their size or shape or because they may contain harmful elements, such as gadolinium and other rare-earth metals, our products could pose a safety risk to human health or the environment. These characteristics may also cause countries to adopt regulations in the future prohibiting or limiting the manufacture, distribution or use of nanomaterials or nanotechnology-enabled products. Such regulations may inhibit our ability to sell some end user products containing those materials and thereby harm our business or impair our ability to develop commercially viable products.

The subject of nanotechnology has received negative publicity and has aroused public debate. Government authorities could, for social or other purposes, prohibit or regulate the use of nanotechnology. Ethical and other concerns about nanotechnology could adversely affect acceptance of our potential products or lead to government regulation of nanotechnology-enabled products.

We face risks associated with our international business.

Our Luna Technologies Division and our Luna nanoWorks Division currently conduct business internationally and we might considerably expand our international activities in the future. Our international business operations are subject to a variety of risks associated with conducting business internationally, including:

- changes in or interpretations of foreign regulations that may adversely affect our ability to sell our products, perform services or repatriate profits to the United States;
- the imposition of tariffs;
- hyperinflation or economic or political instability in foreign countries;
- imposition of limitations on or increase of withholding and other taxes on remittances and other payments by foreign subsidiaries or joint ventures;
- conducting business in places where business practices and customs are unfamiliar and unknown;
- the imposition of restrictive trade policies;
- the imposition of inconsistent laws or regulations;
- the imposition or increase of investment and other restrictions or requirements by foreign governments;

- Ø uncertainties relating to foreign laws and legal proceedings;
- Ø having to comply with a variety of U.S. laws, including the Foreign Corrupt Practices Act;
- Ø having to comply with U.S. export control regulations and policies that restrict our ability to communicate with non-U.S. employees and supply foreign affiliates and customers; and
- Ø having to comply with licensing requirements.

We do not know the impact that these regulatory, geopolitical and other factors may have on our international business in the future.

Risks Related to This Offering

Our common stock has never been publicly traded, and we expect that the price of our common stock will fluctuate substantially.

Before this initial public offering, there has been no public market for our common stock. An active public trading market may not develop after completion of this offering or, if developed, may not be sustained. The initial public offering price may not be

indicative of prices that will prevail in the trading market. The public trading price for our common stock after this offering will be affected by a number of factors, including:

- Ø changes in earnings estimates, investors perceptions, recommendations by securities analysts or our failure to achieve analysts earning estimates;
- Ø changes in our status as an entity eligible to receive SBIR contracts and grants;
- Ø quarterly variations in our or our competitors results of operations;
- Ø general market conditions and other factors unrelated to our operating performance or the operating performance of our competitors;
- Ø announcements by us, or our competitors, of acquisitions, new products, significant contracts, commercial relationships or capital commitments;
- Ø commencement of, or involvement in, litigation;
- Ø any major change in our board of directors or management;
- Ø changes in governmental regulations or in the status of our regulatory approvals;
- Ø announcements related to patents issued to us or our competitors and to litigation;
- Ø a lack of, limited or negative industry or security analyst coverage; and
- Ø developments in our industry.

In addition, the stock prices of many technology companies have experienced wide fluctuations that have often been unrelated to the operating performance of those companies. These factors may materially and adversely affect the market price of our common stock.

New investors in our common stock will experience immediate and substantial dilution.

Our initial public offering price is substantially higher than the book value per share of our common stock. If you purchase common stock in this offering, you will incur immediate dilution of $6.93 in net tangible book value per share of common stock. This amount represents the difference between the assumed initial public offering price of $12.00 per share, which is based on the mid-point of the range on the front cover of this prospectus, and the net tangible book value per share of common stock after the offering of $5.07. In addition, the number of shares available for issuance under our stock plans may increase annually without further stockholder approval. Investors will incur additional dilution upon the exercise of stock options and warrants. See Dilution.

If there are substantial sales of our common stock, our stock price could decline.

If our existing stockholders sell a large number of shares of our common stock or the public market perceives that these sales may occur, the market price of our common stock could decline. Upon the closing of this offering, assuming no outstanding options are exercised prior to the closing of this offering, we will have approximately 10,234,325 shares of common stock outstanding. The 4,000,000 shares to be sold under this prospectus will be freely tradable without restriction or further registration under the federal securities laws, unless purchased by our affiliates. Taking into consideration the effect of the 180-day lock-up agreements that have been entered into by certain of our stockholders, we estimate that the remaining 6,234,325 shares of our common stock outstanding upon the closing of this offering will be available for sale pursuant to Rule 144, Rule 144(k) and Rule 701, as follows:

- Ø 566 shares will be immediately eligible for sale in the public market without restriction pursuant to Rule 144(k);
- Ø no additional shares will be eligible for sale in the public market under Rule 144 or Rule 701 beginning 90 days after the date of this prospectus, subject to volume, manner of sale, and other limitations under those rules;

- Ø 3,998,777 additional shares will become eligible for sale, subject to the provisions of Rule 144, Rule 144(k) or Rule 701, beginning 180 days after the date of this prospectus, upon the expiration of agreements not to sell such shares entered into between the underwriters and such stockholders; and

- Ø 2,234,982 additional shares will be eligible for sale from time to time thereafter upon expiration of their respective one-year holding periods, but could be sold earlier if the holders exercise any available registration rights. Of such shares subject to the provisions of Rule 144, 1,492,032 and 639,442 shares may be sold by Carilion Health System beginning August 4, 2006 and December 30, 2006, respectively, and 103,508 shares may be sold by three individuals beginning November 22, 2006.

Existing stockholders holding an aggregate of 5,489,872 shares of common stock (including shares of our common stock purchasable pursuant to warrants to purchase our common stock), based on shares outstanding as of March 31, 2006, have rights with respect to the registration of these shares of common stock with the SEC. See Description of capital stock Registration Rights. If we register these shares of common stock, these holders will be able to sell immediately those shares in the public market.

Within three months following the completion of this offering, we intend to file a registration statement to register 12,715,000 shares of common stock reserved for issuance under our 2003 Stock Plan and 2006 Equity Incentive Plan, thus permitting the resale of such shares. As of March 31, 2006, 4,812,367 shares were subject to outstanding options, 1,505,850 of which options were vested.

Once we register these shares, they can be freely sold in the public market upon issuance, subject to the underwriter lock-up agreements, our stock purchase restriction agreements and restrictions on our affiliates.

In addition, holders of warrants exercisable for up to 61,214 shares of common stock may exercise those rights and subsequently sell the underlying shares in the public market.

ThinkEquity Partners LLC, on behalf of the underwriters, may in its sole discretion, at any time without notice, release all or any portion of the shares subject to the lock-up agreements, which would result in more shares being available for sale in the public market at earlier dates. Sales of common stock by existing stockholders in the public market, the availability of these shares for sale, our issuance of securities or the perception that any of these events might occur could materially and adversely affect the market price of our common stock.

In addition, employees holding options exercisable for 1,830,028 shares of our common stock have entered into an agreement not to sell more than 20.0% of such shares in any year during the five years following the effective date of this offering, provided, any share subject to such annual limit not sold in a year may be sold in subsequent years notwithstanding such limitation. Certain members of our management holding options exercisable for 2,220,054 shares of our common stock have entered into an agreement not to sell more than 15.0% of such shares in any year during the five years following the effective date of this offering, provided, any share subject to such annual limit not sold in a year may be sold in subsequent years notwithstanding such limitation. We have the right to waive any of these resale restrictions for employees and management at our discretion, and in such instance, the shares would become freely tradable.

Our management will have broad discretion over the use of the proceeds to us from this offering and might not apply the proceeds of this offering in ways that increase the value of your investment.

Our management will have broad discretion to use the net proceeds from this offering, and you will be relying on the judgment of our management regarding the application of these proceeds. They might not apply the net proceeds of this offering in ways that increase the value of your investment. We expect to use the net proceeds from this offering for general corporate purposes, which may include working capital, capital expenditures, other corporate expenses and potential acquisitions of complementary products, technologies or businesses. We have not allocated these net proceeds for any specific purposes. Our management might not be able to yield a significant return, if any, on any investment of these net proceeds.

Risk factors

Our directors and management will collectively control over 52% of our outstanding common stock.

Immediately after this offering, our directors and executive officers and their affiliates will collectively control approximately 51.7% of our outstanding common stock or approximately 48.8% if the underwriters exercise their over-allotment option in full. As a result, these stockholders, if they act together, will be able to influence our management and affairs and all matters requiring stockholder approval, including the election of directors and approval of significant corporate transactions. You and other stockholders will have minimal influence over these actions. This concentration of ownership may have the effect of delaying or preventing a change in control of our company and might adversely affect the market price of our common stock.

Our financial results may vary significantly from period to period which may reduce our stock price.

Our financial results may fluctuate as a result of a number of factors, many of which are outside of our control, which may cause the market price of our common stock to fall. For these reasons, comparing our operating results on a period-to-period basis may not be meaningful, and you should not rely on our past results as an indication of our future performance. Our financial results may be negatively affected by any of the risk factors listed in this Risk factors section and, in particular, the following risks:

- Ø a reduction of contract research funding;
- Ø decisions by government agencies, academic institutions or corporations not to exercise contract options or to modify, curtail or terminate our major contracts;
- Ø failure to estimate or control contract costs;
- Ø adverse judgments or settlements in legal disputes;
- Ø expenses related to acquisitions, mergers or joint ventures; and
- Ø other one-time financial charges.

We will incur increased costs as a result of being a public company.

As a public company, we will incur significant legal, accounting and other expenses that we did not incur as a private company. We will incur costs associated with our public company reporting requirements. We also anticipate that we will incur costs associated with corporate governance requirements, including requirements under the Sarbanes-Oxley Act of 2002, as well as new rules implemented by the SEC and the National Association of Securities Dealers, Inc., or NASD. We expect these rules and regulations to increase our legal and financial compliance costs and to make some activities more time-consuming and costly. We also expect these rules and regulations may make it more difficult and more expensive for us to obtain director and officer liability insurance

and we may be required to accept reduced policy limits and coverage or incur substantially higher costs to obtain the same or similar coverage. As a result, it may be more difficult for us to attract and retain qualified individuals to serve on our board of directors or as executive officers. We cannot predict or estimate the amount of additional costs we may incur or the timing of such costs.

Investors could lose confidence in our financial reports, and our stock price may be adversely affected, if our internal control over financial reporting are found not to be effective by management or by an independent registered public accounting firm or if we make disclosure of existing or potential significant deficiencies or material weaknesses in those controls.

Beginning with our Annual Report for the year ending December 31, 2007, Section 404 of the Sarbanes-Oxley Act of 2002 requires us to include an internal control report with our Annual Report on Form 10-K. That report must include management s assessment of the effectiveness of our internal control over financial reporting as of the end of the fiscal year. Additionally, our independent registered public accounting firm will be required to issue a report on management s assessment of our internal control over financial reporting and a report on their evaluation of the operating effectiveness of our internal control over financial reporting.

Risk factors

We continue to evaluate our existing internal control over financial reporting against the standards adopted by the Public Company Accounting Oversight Board, or PCAOB. During the course of our ongoing evaluation of the internal controls, we may identify areas requiring improvement, and may have to design enhanced processes and controls to address issues identified through this review. Remedying any deficiencies, significant deficiencies or material weaknesses that we or our independent registered public accounting firm may identify, may require us to incur significant costs and expend significant time and management resources. We cannot assure you that any of the measures we implement to remedy any such deficiencies will effectively mitigate or remedy such deficiencies. Investors could lose confidence in our financial reports, and our stock price may be adversely affected, if our internal controls over financial reporting are found not to be effective by management or by an independent registered public accounting firm or if we make disclosure of existing or potential significant deficiencies or material weaknesses in those controls.

Our independent auditors have identified material weaknesses and significant deficiencies in our internal controls, and if we are unable to develop, implement and maintain appropriate controls we will not be able to comply with applicable regulatory requirements imposed on reporting companies.

In connection with the audit of our financial statements for each of the three years in the period ended December 31, 2005, our independent registered public accounting firm identified certain weaknesses in our internal control over financial reporting, which they considered to be material weaknesses and significant deficiencie