LUNA INNOVATIONS INC
Form 10-Q
November 13, 2006
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2006

OR

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

For the transition period from to

COMMISSION FILE NUMBER 000-52008

LUNA INNOVATIONS INCORPORATED

(Exact name of registrant as specified in its charter)

Delaware	**54-1560050**
(State or Other Jurisdiction of Incorporation or Organization)	***(I.R.S. Employer Identification Number)***

1703 South Jefferson Street, SW, Suite 400

Roanoke, VA 24016

(Address of Principal Executive Offices)

(540) 769-8400

(Registrant s Telephone Number, Including Area Code)

10 South Jefferson Street, Suite 130

Roanoke, VA 24011

(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

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

x Yes ¨ No

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

Large Accelerated Filer ¨ Accelerated Filer ¨ Non-Accelerated Filer x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

¨ Yes x No

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date: As of November 9, 2006, there were 9,860,664 shares of the registrant s common stock outstanding.

Table of Contents

LUNA INNOVATIONS INCORPORATED

QUARTERLY REPORT ON FORM 10-Q

FOR THE QUARTER ENDED SEPTEMBER 30, 2006

TABLE OF CONTENTS

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. ***FINANCIAL STATEMENTS***

Luna Innovations Incorporated

Consolidated Balance Sheets

	September 30, 2006 (unaudited)	December 31, 2005
Assets		
Current assets		
Cash and cash equivalents	$ 22,442,016	$ 12,514,839
Accounts receivable, net	5,194,447	5,129,911
Refundable income taxes	396,062	514,797
Inventory	681,559	448,475
Other current assets	535,076	227,409
Total current assets	29,249,160	18,835,431
Property and equipment, net	3,831,631	2,972,287
Intangible assets, net	1,425,852	999,544
Deferred offering costs		710,018
Deferred tax asset	600,000	600,000
Other assets	13,447	16,550
Total assets	**$ 35,120,090**	**$ 24,133,830**
Liabilities and stockholders equity		
Current liabilities		
Current portion of capital lease obligation	$ 91,507	$ 98,820
Current portion of long-term debt obligation	214,955	
Accounts payable	1,639,717	3,647,505
Accrued liabilities	2,554,166	1,788,162
Deferred credits	1,076,549	1,458,393
Total current liabilities	5,576,894	6,992,880
Long-term capital lease obligation	50,216	117,134
Long-term debt obligation	5,000,000	5,214,955
Deferred credits	354,418	450,000
Total liabilities	10,981,528	12,774,969
Redeemable Class B common stock, 308,216 shares at December 31, 2005		504,984
Stockholders equity:		
Preferred Stock, par value $0.001, 5,000,000 shares authorized at September 30, 2006, no shares issued and outstanding at September 30, 2006		
Common stock		
Common stock, par value $0.001, 100,000,000 and 23,257,094 shares authorized at September 30, 2006 and December 31, 2005, respectively, 9,858,806 shares issued and outstanding at September 30, 2006	9,859	
Class A voting common stock, par value $0.001, 7,164,463 shares authorized at December 31, 2005, 2,834,814 shares issued and outstanding at December 31, 2005		2,835

Class B non-voting common stock, par value $0.001, 13,707,297 shares authorized at December 31, 2005, 734,427 shares issued and outstanding at December 31, 2005		734
Class C voting common stock, par value $0.001, 5,656,472 shares authorized at December 31, 2005, 2,131,474 shares issued and outstanding at December 31, 2005		2,131
Additional paid-in capital	30,970,277	10,935,049
Accumulated deficit	(6,841,574)	(86,872)
Total stockholders equity	24,138,562	10,853,877
Total liabilities and stockholders equity	**$ 35,120,090**	**$ 24,133,830**

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

Table of Contents

Luna Innovations Incorporated

Consolidated Statements of Operations

	Three Months Ended September 30, 2006	2005	Nine Months Ended September 30, 2006	2005
	(unaudited)		(unaudited)	
Revenues:				
Contract research revenues	$ 4,885,854	3,942,195	$ 12,977,066	$ 11,111,721
Product and license revenues	1,163,663		2,521,403	
Total revenues	6,049,517	3,942,195	15,498,469	11,111,721
Cost of revenues:				
Contract research costs	3,587,280	3,068,372	9,600,404	8,539,567
Product and license costs	520,699		1,194,969	
Total cost of revenues	4,107,979	3,068,372	10,795,373	8,539,567
Gross Profit	1,941,538	873,823	4,703,096	2,572,154
Operating expense	4,110,926	1,040,235	11,805,277	2,952,666
Operating loss	(2,169,388)	(166,412)	(7,102,181)	(380,512)
Other income (expense)				
Other income (expense)	934	(782)	10,331	(92)
Interest income / (expense), net	232,649	(9,893)	345,794	(75,206)
Total other income (expense)	233,583	(10,675)	356,125	(75,298)
Loss before income taxes	(1,935,805)	(177,087)	(6,746,056)	(455,810)
Income tax expense (benefit)	12,829	(126,396)	12,829	(187,273)
Net loss	$ (1,948,634)	(50,691)	(6,758,885)	(268,537)
Net loss per share:				
Basic	$ (0.20)	(0.01)	(0.87)	(0.08)
Diluted	$ (0.20)	(0.01)	(0.87)	(0.08)
Weighted average shares:				
Basic	9,842,265	3,839,512	7,743,885	3,229,683
Diluted	9,842,265	3,839,512	7,743,885	3,229,683

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

Table of Contents

Luna Innovations Incorporated

Consolidated Statements of Cash Flows

	Nine months ended September 30, 2006	2005
	(unaudited)	
Cash flows used in operating activities		
Net loss	$ (6,758,885)	$ (268,537)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	792,725	355,026
Deferred income taxes		(4,358)
Share-based compensation	1,164,709	137,829
Change in assets and liabilities:		
Accounts receivable	(64,536)	(509,743)
Refundable income taxes	118,735	570,162
Other assets	(524,201)	(406,035)
Accounts payable and accrued expenses	(545,211)	(175,595)
Deferred revenues	(477,426)	(154,341)
Net cash used in operating activities	(6,294,090)	(455,592)
Cash flows used in investing activities		
Acquisition of property and equipment	(1,377,466)	(452,762)
Intangible property costs	(282,840)	(159,749)
Net cash from acquisition of Luna Technologies		33,713
Capitalized software development costs		(14,468)
Net cash used in investing activities	(1,660,306)	(593,266)
Cash flows from financing activities		
Payments on capital lease obligations	(74,229)	(73,343)
Proceeds from the issuance of common stock, net	17,866,241	7,000,000
Proceeds from the exercise of options and warrants	89,561	76,575
Net cash from financing activities	17,881,573	7,003,232
Net change in cash	9,927,177	5,954,374
Cash beginning of period	12,514,839	609,636
Cash end of period	$ 22,442,016	$ 6,564,010
Supplemental disclosure of cash flow information		
Cash paid for interest	$ 30,690	$ 72,151
Cash paid for income taxes	$ 12,829	$ 25,927
Property and equipment financed by capital leases	$	$ 11,700

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

5

Table of Contents

Luna Innovations Incorporated

Notes to Consolidated Financial Statements

1. Basis of Presentation and Significant Accounting Policies

Nature of Operations

Luna Innovations Incorporated (Luna Innovations) was incorporated in the Commonwealth of Virginia in 1990 and subsequently reincorporated in the State of Delaware in April 2003. We are engaged in the research, development and commercialization of innovative technologies in the areas of molecular technology solutions and sensing solutions. We identify technology that can fulfill identified market needs, and we then take these solutions from the applied research stage through commercialization.

Unaudited Interim Financial Information

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (US GAAP) and with the instructions to Form 10-Q and Article 10 of Regulation S-X of the Securities Exchange Act of 1934. Accordingly, they do not include all of the information and footnotes required by US GAAP for audited financial statements. The unaudited consolidated financial statements have been prepared on the same basis as the annual financial statements and in the opinion of management reflect all adjustments, consisting of only normal recurring accruals, considered necessary to present fairly our financial position at September 30, 2006 and results of operations and cash flows for the three and nine months ended September 30, 2006 and 2005. The results of the operations for the three and nine months ended September 30, 2006, are not necessarily indicative of the results that may be expected for the year ending December 31, 2006.

The year-end consolidated balance sheet data was derived from the audited December 31, 2005, balance sheet.

The consolidated financial statements, including the Company s significant accounting policies, should be read in conjunction with the audited Consolidated Financial Statements and the notes thereto included in the Company s Registration Statement on Form S-1 (No. 333-131764) as amended and filed with the Securities and Exchange Commission on June 2, 2006. As used herein, the terms Luna , Company , we , our and us mean Luna Innovations Incorporated and its consolidated subsidiaries.

Certain reclassifications have been made to prior period amounts to conform with current year presentation.

Consolidation Policy

Our consolidated financial statements are prepared in accordance with US GAAP and include the accounts of the Company, its wholly owned subsidiaries and other entities in which the Company has a controlling financial interest. We eliminate from our financial results all significant intercompany transactions. The Company does not have any investments in entities it believes are variable interest entities for which the Company is the primary beneficiary.

Use of Estimates

The preparation of our consolidated financial statements in accordance with US GAAP requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and the disclosure of contingent assets and liabilities in our consolidated financial statements and accompanying notes. Although these estimates are based on our knowledge of current events and actions we may undertake in the future, actual results may differ from such estimates and assumptions.

Table of Contents

Net Loss Per Share

We compute net loss per share in accordance with Statement of Financial Accounting Standards (SFAS) No. 128, *Earnings Per Share*. Basic per share data is computed by dividing loss available to common shareholders by the weighted average number of shares outstanding during the period. Diluted per share data is computed by dividing loss available to common shareholders by the weighted average shares outstanding during the period increased to include, if dilutive, the number of additional common share equivalents that would have been outstanding if potential common shares had been issued using the treasury stock method. Diluted per share data would also include the potential common share equivalents relating to convertible securities by application of the if-converted method.

Per share amounts for all periods presented in this report have been adjusted to reflect the 1-for-1.7691911 reverse stock split of our common stock effected on May 23, 2006. All applicable share and per share amounts in the financial statements give pro forma effect to such split. The following information presents the pro forma effect of such split on basic and diluted net loss per share:

	Three Months Ended September 30,		Nine months ended September 30,	
	2006	2005	2006	2005
Net loss	$ (1,948,634)	$ (50,691)	$ (6,758,885)	$ (268,537)
Weighted average shares basic	9,842,265	3,839,512	7,743,885	3,229,683
Dilutive effect of common stock equivalents: Shares issued upon the exercise of stock options and warrants				
Weighted averages shares diluted	9,842,265	3,839,512	7,743,885	3,229,683
Net loss per share basic	$ (0.20)	$ (0.01)	$ (0.87)	$ (0.08)
Net loss per share diluted	$ (0.20)	$ (0.01)	$ (0.87)	$ (0.08)

The effect of 3,800,510 and 2,813,097 common stock equivalents are ignored for the three months ended September 30, 2006 and 2005, as they are antidilutive to earnings per share. The effect of 3,842,338 and 2,589,076 common stock equivalents are ignored for the nine months ended September 30, 2006 and 2005, as they are antidilutive to earnings per share. In addition, the conversion of the $5.0 million in senior convertible promissory notes would have been antidilutive for such periods.

Share Based Compensation

We have a stock-based compensation plan, which is described further in Note 9 to the Financial Statements in the Company s Registration Statement on Form S-1 (No. 333-131764) as amended and filed with the Securities and Exchange Commission on June 2, 2006. Effective January 1, 2006, we adopted SFAS No. 123R, *Share-Based Payment* (SFAS No. 123R) using the modified prospective transition method. Under this transition method, our financial statements for the periods prior to January 1, 2006 have not been restated. However, new awards and awards modified, repurchased or cancelled after January 1, 2006, result in compensation expense based on the fair value of the stock option as determined by the Black-Scholes option pricing model. We amortize share-based compensation for such awards on a straight-line basis over the related service period of the awards taking into account the effects of the employees expected exercise and post-vesting employment termination behavior.

The adoption of SFAS No. 123R has increased the net loss by approximately $440 thousand and $535 thousand for the three and nine months ended September 30, 2006, as compared to what our net loss would have been if we had continued to account for share-based compensation under Accounting Principles Board Opinion (APB) No. 25, *Accounting for Stock Issued to Employees* (APB No. 25).

Table of Contents

For the periods prior to 2006, we accounted for share-based employee compensation arrangements using the intrinsic value method in accordance with the provisions of APB No. 25, and related amendments and interpretations. We complied with the disclosure provisions of Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-based Compensation,* as amended by SFAS No. 148, *Accounting for Stock Based Compensation Transition and Disclosure*, which requires fair value recognition for employee stock-based compensation. We account for equity instruments issued to non-employees in accordance with the provisions of SFAS No. 123 and Emerging Issues Task Force (EITF) Issue No. 96-18.

Generally, we award options to employees and directors with exercise prices equal to or greater than the estimated fair value of our common stock on the date of grant. In September 2003, we entered into an option exchange with our employees that resulted in the new option grant being considered a re-pricing in accordance with FASB Interpretation No. (FIN) 44, *Accounting for Certain Transactions Involving Stock Compensation* (FIN 44). We apply variable plan accounting to outstanding options related to this award and measure compensation expense at each reporting period equal to an amount that reflects the change in the fair value of the underlying security.

Had compensation expense been measured under the fair value method prescribed by SFAS No. 123, our pro forma net loss, and pro forma net loss per share would have been as follows:

	Three Months ended September 30, 2005	Nine months ended September 30, 2005
Net loss:		
As reported	$ (50,691)	$ (268,537)
Add share-based employee compensation expense in reported net loss, net of related tax effects	62,785	134,131
Deduct total share-based employee compensation expense determined under Black-Scholes method for all awards, net of related tax effects	(100,227)	(328,981)
Pro forma net loss	$ (88,133)	$ (463,387)
Basic net loss per common share:		
As reported	$ (0.01)	$ (0.08)
Pro forma	$ (0.02)	$ (0.14)
Diluted net loss per common share:		
As reported	$ (0.01)	$ (0.08)
Pro forma	$ (0.02)	$ (0.14)

The fair value of each option granted is estimated as of the grant date using the Black-Scholes option pricing model with the following assumptions:

	Three Months ended September 30, 2006	Nine months ended September 30, 2006
Risk-free interest rate range	4.77%	4.55% 5.20%
Expected life of option range of years	7.5	7.0 7.5
Expected stock price volatility	64%	64%
Expected dividend yield		

The risk-free interest rate is based on US Treasury interest rates, the terms of which are consistent with the expected life of the stock options. Expected volatility is based upon an average volatility of comparable public companies due to the limited time our shares have been publicly traded. The expected life and estimated post employment termination behavior is based upon historical experience of homogeneous groups within our company.

Table of Contents

A summary of the status of our 2003 Stock Plan and 2006 Equity Incentive Plan is presented below for the periods indicated:

	Options Outstanding				Options Exercisable		
	Number of Shares	Price per Share Range	Weighted Average	Aggregate Intrinsic Value (1)	Number of Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value (1)
Balance, December 31, 2005	3,975,555	$0.35 - $1.77	$ 0.65	3,962,864	1,519,397	$ 0.35	1,975,216
Granted	981,946	$1.77	$ 1.77				
Exercised	(128,633)	$0.35	$ 0.35				
Canceled	(16,501)	$0.35	$ 0.35				
Balance, March 31, 2006	4,812,367	$0.35 - $1.77	$ 0.89	39,028,605	1,505,850	$ 0.35	13,025,603
Granted	186,685	$6.00 - $7.08	$ 6.31				
Exercised	(94,712)	$0.35	$ 0.35				
Canceled	(17,211)	$0.35 - $1.77	$ 0.61				
Balance, June 30, 2006	4,887,129	$0.35 - $7.08	$ 1.11	23,899,988	1,754,088	$ 0.35	9,910,597
Granted	189,750	$5.47	$ 5.47				
Exercised	(29,768)	$0.35	$ 0.35				
Canceled	(48,436)	$0.35 - $1.77	$ 0.81				
Balance, September 30, 2006	4,998,675	$0.35 - $7.08	$ 1.28	12,771,610	2,045,215	$ 0.49	6,503,784

(1) The intrinsic value of an option represents the amount by which the market value of the stock exceeds the exercise price of the option of in-money options only. The aggregate intrinsic value is based on the price of $9.00, $6.00, and $3.67 for the Company s stock on March 31, 2006, June 30, 2006, and September 30, 2006, respectively. The price on June 30, 2006 and September 30, 2006 represent the closing price of the Company s Common Stock on the NASD Global Market on the respective dates.

At September 30, 2006, our 5.0 million outstanding stock options (including fully vested options and options that are expected to vest) had a weighted average remaining contractual term of 8.4 years, and our 2.0 million outstanding and exercisable stock options had a weighted average remaining contractual term of 7.7 years.

For the three and nine months ended September 30, 2006, we recognized $403,427 and $1,164,709 in share-based payment expense. We will recognize approximately $5,616,000 over the remaining requisite service period.

Income Taxes

Our effective quarterly tax rate is estimated based upon the effective tax to be applicable to the full fiscal year. A deferred tax asset of $600,000 was recorded at December 31, 2005, and September 30, 2006, based upon management s assessment that more likely than not the benefit will be realized in future periods.

Recent Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. SFAS No. 157 clarifies the principle that fair value should be based on the assumptions market participants would use when pricing an asset or liability and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. SFAS No. 157 is effective for the fiscal year beginning January 1, 2007. The Company is currently evaluating the potential impact of the adoption of SFAS No. 157 on its future consolidated financial statements.

In September 2006, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB 108). SAB 108 provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The SEC staff believes that registrants should quantify errors using both a balance sheet and an income statement approach and evaluate whether either approach results in quantifying a misstatement that, when all relevant quantitative and qualitative factors are considered, is material. SAB 108 is effective for the fiscal year ending December 31, 2006.

9

Table of Contents

In June 2006, the FASB issued FIN 48, *Accounting for Uncertainty in Income Taxes*, which is an interpretation of SFAS No. 109, *Accounting for Income Taxes* . FIN 48 clarifies the accounting for uncertainty in income taxes recognized in accordance with SFAS No. 109 by prescribing a recognition threshold and measurement process for recording in the financial statements uncertain tax positions taken or expected to be taken on a tax return. Additionally, FIN 48 provides guidance on the derecognition, classification, accounting in interim periods and disclosure requirements for uncertain tax positions. FIN 48 will be effective for the Company beginning January 1, 2007. The Company is in the process of determining the effect, if any, the adoption of FIN 48 will have on its financial statements.

2. Line of Credit

There were no outstanding balances on our $2.5 million line of credit with First National Bank (FNB) at September 30, 2006 and at December 31, 2005, and no borrowings during the nine month period ended September 30, 2006. In May 2006, we obtained a modification to allow a $1.0 million sub-limit under the line of credit for the issuance of letters of credit, and FNB issued a $719,500 letter of credit on our behalf to the Industrial Development Authority of Montgomery County, Virginia, in conjunction with the execution of an office lease.

The covenants under this line of credit agreement are reviewed annually at December 31. At December 31, 2005, we were not in compliance with the minimum interest coverage covenant. We requested and received a waiver from FNB for fiscal 2005.

3. Initial Public Offering and Capital Structure

On May 23, 2006, we effected a 1-for-1.7691911 reverse stock split of our common stock in anticipation of our initial public offering. In connection with our June 2, 2006 initial public offering, we sold 3,500,000 shares of common stock at $6.00 per share resulting in gross proceeds of $21.0 million. In connection with this offering, we paid $1.47 million in underwriting discounts and commissions and incurred estimated other offering expenses of approximately $1.66 million. The net proceeds from the offering were approximately $17.87 million.

Concurrent with the initial public offering, all outstanding shares of our Class A voting Common Stock, Class B non-voting Common Stock, and Class C voting Common Stock were converted to shares of common stock on a one-for-one basis. All outstanding shares of our Redeemable Class B Common Stock converted to common stock on a one-for-one basis as the successful initial public offering eliminated the redeemable feature of such shares. We also issued 96,724 shares of common stock to Carilion Health System in accordance with the anti-dilution provisions of our previous amended and restated certificate of incorporation, which was adopted in connection with our Class C Common Stock financing in December 2005. Upon the closing of our initial public offering the total authorized shares of our capital stock increased to 100,000,000 shares of common stock and 5,000,000 shares of preferred stock.

Table of Contents

For the nine months ended September 30, 2006, our capital structure changed as follows:

	Class A Common Stock Shares	Class A Common Stock $	Class B Common Stock Shares	Class B Common Stock $	Class C Common Stock Shares	Class C Common Stock $	Common Stock Shares	Common Stock $	Additional Paid-in Capital
Balances, December 31, 2005	2,834,814	$ 2,835	734,429	$ 734	2,131,474	$ 2,131		$	$ 10,935,049
Exercise of stock options			139,049	139			114,071	114	89,310
Issuance of warrants and options in connection with Luna Technologies acquisition									418,073
Share-based payment expense									1,164,709
Initial Public Offering, net of costs							3,500,000	3,500	17,862,741
Carilion anti-dilution shares							96,724	97	(97)
Conversion of Class A, Class B, and Class C Common Stock to Common Stock	(2,834,814)	(2,835)	(873,478)	(873)	(2,131,474)	(2,131)	5,839,766	5,839	
Conversion of Redeemable Class B Common Stock to Common Stock							308,216	308	504,676
Rounding of Fractional Shares and par value effect of Stock Split							29	1	(4,184)
Balances, September 30, 2006		$		$		$	9,858,806	$ 9,859	$ 30,970,277

4. Operating Segments

Our operations are divided into two operating segments Contract Research and Product and Licensing.

The Contract Research segment 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. We then compete to win fee-for-service contracts from government agencies and industrial customers who seek innovative solutions to practical problems that require new technology. The Contract Research segment derives its revenue primarily from services.

The Product and Licensing segment develops and sells products or licenses technologies based on commercially viable concepts developed by the Contract Research segment. The Product and Licensing segment derives its revenue from product sales, funded product development and technology licenses.

The Chief Executive Officer and his direct reports collectively represent our chief operating decision makers, and they evaluate segment performance based primarily on revenue and operating income or loss. The accounting policies of our segments are the same as those described in the summary of significant accounting policies (see Note 1 to our Financial Statements presented in the Registration Statement on Form S-1 filed with the Securities and Exchange Commission on June 2, 2006).

Table of Contents

The table below presents revenues and operating loss for reportable segments:

	Three Months Ended September 30,		Nine months ended September 30,	
	2006	2005	2006	2005
Contract Research Revenue from External Customers	$ 4,885,854	$ 3,942,195	$ 12,977,066	$ 11,111,721
Product and License Revenue from External Customers	1,163,663		2,521,403	
Total Revenue from External Customers	$ 6,049,517	$ 3,942,195	$ 15,498,469	$ 11,111,721
Contract Research Operating Loss	$ (715,563)	$ (166,412)	$ (2,629,963)	$ (380,512)
Product and License Operating Loss	(1,453,825)		(4,472,218)	
Total Operating Loss	$ (2,169,388)	$ (166,412)	$ (7,102,181)	$ (380,512)

Additional segment information is as follows:

	September 30, 2006	December 31, 2005
Total segment assets:		
Contract Research	$ 31,545,230	$ 21,583,007
Product and License Revenue	3,574,860	2,550,823
Total	$ 35,120,090	$ 24,133,830

There are no material inter-segment revenues for any period presented.

The United States Government accounted for approximately 72% and 81% of revenues for the three months ended September 30, 2006 and 2005, and 74% and 64% of revenues for the nine months ended September 30, 2006 and 2005.

International revenues (customers outside of the United States) accounted for 4.0% and 2.8% of total revenues for the three months ended September 30, 2006 and 2005, and 3.5% and 1.3% for the nine months ended September 30, 2006 and 2005.

5. Contingencies and Guarantees

The Company is from time to time involved in certain legal proceedings in the ordinary course of conducting its business. While the ultimate liability pursuant to these actions cannot currently be determined, the Company believes these legal proceedings will not have a material adverse effect on its financial position or results of operations.

The Company has an outstanding letter of credit at September 30, 2006, of $719,500 to the Industrial Development Authority of Montgomery County, Virginia, to support a lease of office space. This letter of credit expires in 2011.

The Company has an agreement with a supplier to purchase inventory and estimates its noncancellable obligation to approximate $959,400 through October 2007.

The Company leases its facilities in Blacksburg, Charlottesville, Danville, Hampton and Roanoke, Virginia, under non-cancellable operating leases that expire between 2006 and 2013. Certain of the leases are subject to fixed escalations. Future minimum lease payments for the remainder of 2006 and for each of the subsequent four years from 2007 through 2010 approximate $286,000, $1,483,000, $1,350,000, $1,199,000, and $1,178,000, respectively.

The Company has entered into indemnification agreements with its officers and directors, to the extent permitted by law, pursuant to which the Company has agreed to reimburse the officers and directors for legal expenses in the event of litigation and regulatory matters. The terms of these indemnification agreements provide for no limitation to the maximum potential future payments. The Company has a directors and officers insurance policy that may, in certain instances, mitigate the potential liability and payments.

Table of Contents

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

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and the related notes to those statements included elsewhere in this Quarterly Report on Form 10-Q. In addition to historical financial information, this report contains forward-looking statements that involve risks, uncertainties and assumptions. These statements may relate to, but are not limited to, expectations of future operating results or financial performance, capital expenditures, introduction of new products, regulatory compliance, plans for growth and future operations, as well as assumptions relating to the foregoing. Forward-looking statements are inherently subject to risks and uncertainties, some of which cannot be predicted or quantified. These risks and other factors include, but are not limited to, those listed under the section entitled Risk Factors in Item 1A of Part II of this report. In some cases, you can identify forward-looking statements by terminology such as may, will, should, could, expect, plan, anticipate, believe, estimate, predict, intend, potential, continue, seek or the negative of these terms or other comparable terminology. These statements are only predictions. Actual events and/or results may differ materially.

The forward-looking statements contained in this report are made pursuant to the safe harbor protection provided by the Private Securities Litigation Reform Act of 1995 and Section 27A of the Securities Act of 1933, as amended. Except as required by applicable law, including the rules and regulations of the SEC, we do not plan to publicly update or revise any forward-looking statements, whether as a result of any new information, future events or otherwise, other than through the filing of periodic reports in accordance with the Securities Exchange Act of 1934, as amended.

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 large and unmet 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 product candidates 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 products serving various industries including energy, telecommunications, life sciences and defense.

Our annual revenues were $16.5 million in 2005 and $15.5 million during the nine months ended September 30, 2006. We generate revenues through contract research, product sales and license fees. We had net losses of $2.0 million and $6.8 million for the year ended December 31, 2005 and the nine months ended

Table of Contents

September 30, 2006, respectively, and we expect to incur significant additional expenses as we expand our business. We also expect losses to continue for the foreseeable future primarily due to increased expenditures related to our nanomaterial and medical device product development efforts.

Historically, our contract research revenues have accounted for a large proportion of our total revenues, and we expect that they will continue to grow and will represent a significant portion of our total revenues for the foreseeable future. Our contract research revenue was $15.4 million in 2005. We generated contract research revenues of $4.9 million and $13.0 million for the three and nine months ended September 30, 2006, respectively. As of September 30, 2006, our Contract Research Group was working on 94 contracts. In addition to these contracts, we regularly have a backlog of contracts for which work has been scheduled, but for which a specified portion of work has not yet been completed. We define backlog as the dollar amount of obligations payable to us under negotiated contracts upon completion of a specified portion of work that has not yet been completed, exclusive of revenues previously recognized for work already performed under these contracts, if any. The approximate value of our backlog was $24.1 million as of September 30, 2006.

Revenues from product sales currently represent a small proportion of our total revenues, and, historically, we have derived most of these revenues from the sales of our sensing systems and products that make use of light-transmitting optical fibers, or fiber optics. License revenues were significant in 2004 primarily due to the Luna Energy transactions described in our Registration Statement on Form S-1. Although we have been successful in licensing certain technology, we do not expect license revenues to represent a significant portion of future revenues. However, over time we do intend to gradually increase such revenues. For the full year, we expect revenues from product sales to increase because of our acquisition of Luna Technologies, Inc. (Luna Technologies) on September 30, 2005. We also expect to increase our investments in product development and commercialization, which we anticipate will lead to increased product sales growth. In the future, we expect that revenues from product sales will represent a larger proportion of our total revenues and that as we develop and commercialize new products, these revenues will reflect a broader and more diversified mix of products.

In June 2005, prior to its acquisition by Luna Innovations, Luna Technologies entered into a Joint Cooperation Agreement with Luna Energy, an independent company which is no longer affiliated with us. Under this agreement, both parties have agreed to cooperate to develop a fiber optic sensing system product and have agreed to contribute materials, intellectual property, personnel and other resources to the development effort. Upon successful completion of product development, Luna Energy will receive a license to certain of Luna Technologies intellectual property and will be required beginning in 2007 and continuing through December 31, 2017 to make payments to Luna Technologies with respect to revenues derived from products sold that utilize this intellectual property. As of September 30, 2006, Luna Energy had not yet sold products that would entitle Luna Technologies to royalty payments under this joint cooperation agreement. Luna Technol