

SUPERCONDUCTOR TECHNOLOGIES INC
Form 10-Q
November 13, 2018
[Table of Contents](#)

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 29, 2018

**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 0-21074

SUPERCONDUCTOR TECHNOLOGIES INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

77-0158076
(IRS Employer
Identification No.)

9101 Wall Street, Suite 1300, Austin, Texas 78754

(Address of principal executive offices & zip code)

(512) 334-8900

(Registrant's telephone number including area code)

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See the definitions of large accelerated filer, accelerated filer, smaller reporting company, and emerging growth company in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

We had 3,270,609 shares of our common stock outstanding as of the close of business on November 8, 2018.

Table of Contents

SUPERCONDUCTOR TECHNOLOGIES INC.

INDEX TO FORM 10-Q

For the Three and Nine Months Ended September 29, 2018

| | |
|--|----|
| <u>SPECIAL NOTE REGARDING FORWARD LOOKING STATEMENTS</u> | 1 |
| <u>PART I - FINANCIAL INFORMATION</u> | |
| <u>ITEM 1. Financial Statements</u> | |
| <u>Condensed Consolidated Statements of Operations</u> | 2 |
| <u>Condensed Consolidated Balance Sheets</u> | 3 |
| <u>Condensed Consolidated Statements of Cash Flows</u> | 4 |
| <u>Notes to Unaudited Condensed Consolidated Financial Statements.</u> | 5 |
| <u>ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 15 |
| <u>ITEM 3. Quantitative and Qualitative Disclosures About Market Risk</u> | 20 |
| <u>ITEM 4. Controls and Procedures</u> | 20 |
| <u>PART II - OTHER INFORMATION</u> | |
| <u>ITEM 1. Legal Proceedings</u> | 21 |
| <u>ITEM 1A. Risk Factors</u> | 21 |
| <u>ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds</u> | 21 |
| <u>ITEM 3. Defaults Upon Senior Securities</u> | 21 |
| <u>ITEM 4. Mine Safety Disclosures</u> | 21 |
| <u>ITEM 5. Other Information</u> | 21 |
| <u>ITEM 6. Exhibits</u> | 21 |
| <u>SIGNATURES</u> | 22 |

Table of Contents

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. We claim the protection of the safe harbor contained in the Private Securities Litigation Reform Act of 1995 for these forward-looking statements. Our forward-looking statements relate to future events or our future performance and include, but are not limited to, statements concerning our business strategy, future commercial revenues, market growth, capital requirements, new product introductions, expansion plans and the adequacy of our funding. Other statements contained in this Report that are not historical facts are also forward-looking statements. We have tried, wherever possible, to identify forward-looking statements by terminology such as may, will, could, should, expects, anticipates, intends, plans, believes, seeks, estimates and other comparable terminology.

We caution investors that any forward-looking statements presented in this Report, or that we may make orally or in writing from time to time, are based on our beliefs and assumptions made by, and information currently available to, us. Such statements are based on assumptions and the actual outcome will be affected by known and unknown risks, trends, uncertainties and factors that are beyond our control or ability to predict. Although we believe that our assumptions are reasonable, they are not guarantees of future performance and some will inevitably prove to be incorrect. As a result, our actual future results can be expected to differ from our expectations, and those differences may be material. Accordingly, investors should use caution in relying on past forward-looking statements, which are based on known results and trends at the time they are made, to anticipate future results or trends.

Some of the risks and uncertainties that may cause our actual results, performance or achievements to differ materially from those expressed or implied by forward-looking statements include the following:

our limited cash and a history of losses;

our need to materially grow our revenues from commercial operations and/or to raise additional capital (which financing may not be available on acceptable terms or at all) to continue to implement our current business plan and maintain our viability, with our existing cash reserves only expected to be sufficient into the third quarter of 2019;

the performance and use of our equipment to produce wire in accordance with our timetable;

overcoming technical challenges in attaining milestones to develop and manufacture commercial lengths of our high temperature superconducting (HTS) wire;

the possibility of delays in customer evaluation and acceptance of our HTS wire;

the limited number of potential customers and customer pressures on the selling prices of our products;

the limited number of suppliers for some of our components and our HTS wire;

there being no significant backlog from quarter to quarter;

our market being characterized by rapidly advancing technology;

the impact of competitive products, technologies and pricing;

manufacturing capacity constraints and difficulties;

the impact of any financing activity on the level of our stock price;

the dilutive impact of any issuances of securities to raise capital;

if we fail to maintain the listing of our common stock with a U.S. national securities exchange, the liquidity of our common stock could be adversely affected.

cost and uncertainty from compliance with environmental regulations; and

local, regional, and national and international economic conditions and events, and the impact they may have on us and our customers.

For further discussion of these and other factors see, Management's Discussion and Analysis of Financial Condition and Results of Operations and Risk Factors in our Annual Report on Form 10-K for the fiscal year ended December 31, 2017.

This Report and all subsequent written and oral forward-looking statements attributable to us or any person acting on our behalf are expressly qualified in their entirety by the cautionary statements contained or referred to in this section. We do not undertake any obligation to release publicly any revisions to our forward-looking statements to reflect events or circumstances after the date of this Report.

Table of Contents**PART I****FINANCIAL INFORMATION****Item 1. Financial Statements****SUPERCONDUCTOR TECHNOLOGIES INC.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(Unaudited)**

| | Three Months Ended | | Nine Months Ended | |
|--|-----------------------|-----------------------|-----------------------|-----------------------|
| | September 29, 2018 | September 30, 2017 | September 29, 2018 | September 30, 2017 |
| Commercial product revenues | \$ | \$ | \$ | \$ 9,000 |
| Government contract revenues | 517,000 | 130,000 | 1,556,000 | 130,000 |
| Total revenues | 517,000 | 130,000 | 1,556,000 | 139,000 |
| Costs and expenses: | | | | |
| Cost of commercial product revenues | 604,000 | 790,000 | 1,611,000 | 2,421,000 |
| Cost of government contract revenues | 395,000 | 85,000 | 1,129,000 | 96,000 |
| Research and development | 665,000 | 766,000 | 1,655,000 | 2,094,000 |
| Selling, general and administrative | 1,041,000 | 1,063,000 | 3,088,000 | 3,296,000 |
| Total costs and expenses | 2,705,000 | 2,704,000 | 7,483,000 | 7,907,000 |
| Loss from operations | (2,188,000) | (2,574,000) | (5,927,000) | (7,768,000) |
| Other Income and Expense: | | | | |
| Adjustments to fair value of warrant derivatives | 3,000 | 59,000 | 52,000 | 67,000 |
| Adjustment to warrant exercise price | | | (24,000) | |
| Other income | 16,000 | 11,000 | 30,000 | 27,000 |
| Net loss | \$ (2,169,000) | \$ (2,504,000) | \$ (5,869,000) | \$ (7,674,000) |
| Basic and diluted net loss per common share | \$ (0.88) | \$ (2.34) | \$ (3.66) | \$ (7.34) |
| Basic and diluted weighted average number of common shares outstanding | 2,469,371 | 1,071,492 | 1,601,752 | 1,046,063 |

See accompanying notes to the unaudited condensed consolidated financial statements.

Table of Contents

SUPERCONDUCTOR TECHNOLOGIES INC.
CONDENSED CONSOLIDATED BALANCE SHEETS

| | September 29, 2018 (Unaudited) | December 31, 2017 (See Note) |
|--|--------------------------------------|------------------------------------|
| <u>ASSETS</u> | | |
| Current Assets: | | |
| Cash and cash equivalents | \$ 7,586,000 | \$ 3,056,000 |
| Accounts receivable, net | 108,000 | 151,000 |
| Inventories, net | 149,000 | 102,000 |
| Prepaid expenses and other current assets | 128,000 | 83,000 |
| Total Current Assets | 7,971,000 | 3,392,000 |
| Property and equipment, net of accumulated depreciation of \$11,949,000 and \$11,200,000, respectively | 1,233,000 | 1,793,000 |
| Patents, licenses and purchased technology, net of accumulated amortization of \$1,016,000 and \$948,000, respectively | 711,000 | 742,000 |
| Other assets | 69,000 | 69,000 |
| Total Assets | \$ 9,984,000 | \$ 5,996,000 |
| <u>LIABILITIES AND STOCKHOLDERS EQUITY</u> | | |
| Current Liabilities: | | |
| Accounts payable | \$ 405,000 | \$ 349,000 |
| Accrued expenses | 586,000 | 481,000 |
| Total Current Liabilities | 991,000 | 830,000 |
| Other long-term liabilities | 26,000 | 54,000 |
| Total Liabilities | 1,017,000 | 884,000 |
| Commitments and contingencies-Notes 5 and 6 | | |
| Stockholders Equity: | | |
| Preferred stock, \$.001 par value, 2,000,000 shares authorized, 331,487 and 328,925 shares issued and outstanding, respectively | | |
| Common stock, \$.001 par value, 250,000,000 shares authorized, 3,070,609 and 1,074,659 shares issued and outstanding, respectively | 3,000 | 1,000 |
| Capital in excess of par value | 326,446,000 | 316,724,000 |
| Accumulated deficit | (317,482,000) | (311,613,000) |
| Total Stockholders Equity | 8,967,000 | 5,112,000 |
| Total Liabilities and Stockholders Equity | \$ 9,984,000 | \$ 5,996,000 |

See accompanying notes to the unaudited condensed consolidated financial statements.

Note December 31, 2017 balances were derived from audited financial statements.

Table of Contents

SUPERCONDUCTOR TECHNOLOGIES INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

| | Nine Months Ended | |
|---|--------------------|--------------------|
| | September 29, 2018 | September 30, 2017 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net loss | \$ (5,869,000) | \$ (7,674,000) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Depreciation and amortization | 781,000 | 1,474,000 |
| Stock-based compensation expense | 44,000 | 300,000 |
| Adjustments to fair value of warrant derivatives | (52,000) | (67,000) |
| Adjustment to warrant exercise price | 24,000 | |
| Changes in assets and liabilities: | | |
| Accounts receivable | 43,000 | (78,000) |
| Inventories | (47,000) | 22,000 |
| Prepaid expenses and other current assets | (44,000) | (55,000) |
| Patents, licenses and purchased technology | (1,000) | 189,000 |
| Other assets | | 27,000 |
| Accounts payable, accrued expenses and other current liabilities | 160,000 | 13,000 |
| Net cash used in operating activities | (4,961,000) | (5,849,000) |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchases of property and equipment | (189,000) | (121,000) |
| Net cash used in investing activities | (189,000) | (121,000) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Net proceeds from the sale of common stock, preferred stock and warrants | 9,680,000 | |
| Net proceeds from the exercise of outstanding warrants | | 200,000 |
| Net cash provided by financing activities | 9,680,000 | 200,000 |
| Net increase (decrease) in cash and cash equivalents | 4,530,000 | (5,770,000) |
| Cash and cash equivalents at beginning of period | 3,056,000 | 10,452,000 |
| Cash and cash equivalents at end of period | \$ 7,586,000 | \$ 4,682,000 |

See accompanying notes to the unaudited condensed consolidated financial statements.

Table of Contents

SUPERCONDUCTOR TECHNOLOGIES INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. General

Superconductor Technologies Inc. (together with our subsidiaries, we or us) was incorporated in Delaware on May 11, 1987. We develop and produce high temperature superconducting (HTS) materials and associated technologies. We have generated more than 100 patents as well as proprietary trade secrets and manufacturing expertise. We are now leveraging our key enabling technologies in HTS materials and cryogenics, to pursue emerging opportunities in the electrical grid and in equipment platforms that utilize electrical circuits.

Our initial superconducting products were completed in 1998, and we began delivery to a number of wireless network providers. In the following 14 years, our cost reducing efforts led to the invention of our proprietary, high-yield and high throughput HTS material deposition manufacturing process.

Since 2010, we have focused our research and development efforts on adapting our successful HTS materials deposition techniques to the production of our HTS Conductus[®] wire for next generation power applications, including Next Generation Electrical Machines (NGEMs). While most of our historical commercial product revenues came from the sale of high performance wireless communications infrastructure products, production of our Conductus wire is our principal opportunity to grow our future revenue.

Historically, we used research and development contracts as a source of funds for our commercial technology development. In November 2016, we were selected as the prime recipient of a \$4.5 million program award provided by the U.S. Department of Energy (DOE) and, in June 2017, the related contract was finalized and we have now commenced work under that contract.

The unaudited condensed consolidated financial information furnished herein has been prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP) and reflects all adjustments, consisting only of normal recurring adjustments, which in the opinion of management, are necessary for a fair statement of the results of operations for the periods presented.

The preparation of the condensed consolidated financial statements in conformity with U.S. GAAP requires us to make estimates and assumptions that affect the amounts reported in the condensed consolidated financial statements and the accompanying notes. Actual results could differ from those estimates and such differences may be material to the condensed consolidated financial statements. This quarterly report on Form 10-Q should be read in conjunction with our Form 10-K for 2017. The results of operations for the nine months ended September 29, 2018 are not necessarily indicative of the results for all of 2018.

2. Summary of Significant Accounting Policies

Basis of Presentation

We have incurred significant net losses since our inception and have an accumulated deficit of \$317.5 million. In 2017, we incurred a net loss of \$9.5 million and had negative cash flows from operations of \$7.4 million. At September 29, 2018, we had \$7.6 million in cash and cash equivalents. In July 2018, we raised approximately \$7.98 million, net of expenses, from the sale of common stock, preferred stock and warrants. Unless we can materially grow our revenues from commercial opportunities in the remainder of 2018 and 2019, we may need to raise additional

capital to continue to implement our current business plan and maintain our viability. We currently forecast that our existing cash resources will be sufficient to fund our planned operations into the third quarter of 2019. Additional financing may not be available on acceptable terms or at all. If we issue additional equity securities to raise funds, the ownership percentage of our existing stockholders would be reduced. New investors may demand rights, preferences or privileges senior to those of existing holders of common stock. If we cannot raise any needed funds, we might be forced to make further substantial reductions in our operating expenses, which could adversely affect our ability to implement our current business plan and ultimately our viability as a company. These factors raise substantial doubt about our ability to continue as a going concern.

Table of Contents

Our plans regarding improving our future liquidity will require us to successfully use our expertise and our technology to generate revenues in various ways, including commercial operations, joint ventures and licenses. We have invested and will continue to invest in our Austin, Texas manufacturing facility to enable us to produce our Conductus wire products. However, delays in the timing of our ability to, including but not limited to, raise additional capital, unexpected production delays, and our ability to sell our Conductus wire products in large scale could substantially impact our estimates used in the determination of expected future cash flows and/or expected future profitability.

The accompanying condensed consolidated financial statements do not include any adjustments that may result from the outcome of the uncertainties set forth above.

On July 24, 2018, we effected a 1-for-10 reverse stock split of our common stock, or the Reverse Stock Split. As a result of the Reverse Stock Split, every ten shares of our pre-Reverse Stock Split common stock were combined and reclassified into one share of our common stock. The Reverse Stock Split did not change the authorized number of shares or the par value of our common stock. Share and per share data included herein has been retroactively restated for the effect of the Reverse Stock Split as applicable. In addition, we identified certain critical accounting policies which affect certain of our more significant estimates and assumptions used in preparing our condensed consolidated financial statements in our Annual Report on Form 10-K for the fiscal year ended December 31, 2017. We have not made any material changes to these policies.

We have updated our revenue recognition policy since issuance of our 2017 Annual Report as a result of the adoption of ASU No. 2014-09, Revenue from Contracts with Customers (ASC 606) in the first quarter 2018. ASC 606 has not had a material impact on our condensed consolidated financial statements. We have reviewed other recently issued Financial Accounting Standards Board pronouncements and do not believe they will have a material impact on our condensed consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842), which supersedes all existing guidance on accounting for leases in ASC Topic 840. ASU 2016-02 is intended to provide enhanced transparency and comparability by requiring lessees to record right-of-use assets and corresponding lease liabilities on the balance sheet. ASU 2016-02 will continue to classify leases as either finance or operating, with classification affecting the pattern of expense recognition in the statement of income. ASU 2016-02 is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption is permitted. ASU 2016-02 is required to be applied with a modified retrospective approach to each prior reporting period presented with various optional practical expedients. We are currently assessing the potential impact of adopting ASU 2016-02 on our condensed consolidated financial statements and related disclosures.

Principles of Consolidation

The interim condensed consolidated financial statements include the accounts of Superconductor Technologies Inc. and its wholly owned subsidiaries. All significant intercompany transactions have been eliminated from the condensed consolidated financial statements.

Cash and Cash Equivalents

Cash and cash equivalents consist of highly liquid investments with original maturities of three months or less. Cash and cash equivalents are maintained with what we believe to be quality financial institutions and exceed FDIC limits. Historically, we have not experienced any losses due to such concentration of credit risk.

Accounts Receivable

We grant uncollateralized credit to our customers. We perform usual and customary credit evaluations of our customers before granting credit. Trade accounts receivable are recorded at the invoiced amount and do not bear interest. The allowance for doubtful accounts is our best estimate of the amount of probable credit losses in our existing accounts receivable. We determine the allowance based on historical write-off experience. Past due balances are reviewed for collectibility. Accounts balances are charged off against the allowance when we deem it is probable the receivable will not be recovered. We do not have any off -balance sheet credit exposure related to our customers. As of September 29, 2018, all of accounts receivable was with the DOE.

Revenue Recognition

In May 2014, the Financial Accounting Standards Board issued an accounting standard update ASC 606 on revenue recognition. The new guidance creates a single, principle-based model for revenue recognition that expands and improves disclosures about revenue. On January 1, 2018, we adopted the accounting standard update for revenue from contracts with customers. To determine revenue recognition for the arrangements that we determine are within the scope of ASC 606, we perform the following five steps: (1) identify the contract(s) with a customer, (2) identify the performance obligations in the contract, (3) determine the transaction price, (4) allocate the transaction price to the performance obligations in the contract, and (5) recognize revenue as we satisfy our performance obligation. The adoption of this standard has not had a material impact on our condensed consolidated financial statements.

Table of Contents

Government contract revenues are principally generated under research and development contracts. Revenues from research-related activities are derived from contracts with agencies of the U.S. Government. Credit risk related to accounts receivable arising from such contracts is considered minimal. All payments to us for work performed on contracts with agencies of the U.S. Government are subject to adjustment upon audit by the Defense Contract Audit Agency. Based on historical experience and review of our current project in process, we believe that adjustments from open audits will not have an effect on our financial position, results of operations or cash flows. We are using the expected cost-plus-margin approach as the suitable method for allocating transaction price to the performance obligations in the contract under ASC 606.

Shipping and Handling Fees and Costs

Shipping and handling fees billed to customers are included in revenues. Shipping and handling fees associated with freight are generally included in cost of revenues.

Warranties

We offer warranties generally ranging from one to five years, depending on the product and negotiated terms of purchase agreements with our customers. Such warranties require us to repair or replace defective product returned to us during such warranty period at no cost to the customer. An estimate by us for warranty related costs is recorded by us at the time of sale based on our actual historical product return rates and expected repair costs. Such costs have been within our expectations.

Indemnities

In connection with the sales and manufacturing of our commercial products, we indemnify, without limit or term, our customers and contract manufacturers against all claims, suits, demands, damages, liabilities, expenses, judgments, settlements and penalties arising from actual or alleged infringement or misappropriation of any intellectual property relating to our products or other claims arising from our products. We cannot reasonably develop an estimate of the maximum potential amount of payments that might be made under our indemnities because of the uncertainty as to whether a claim might arise and how much it might total. Historically, we have not incurred any expenses related to these indemnities.

Research and Development Costs

Research and development costs are charged to expense as incurred and include salary, facility, depreciation and material expenses. Research and development costs are charged to research and development expense.

Inventories

Inventories were stated at the lower of cost or net realizable value, with costs primarily determined using standard costs, which approximate actual costs utilizing the first-in, first-out method. We review inventory quantities on hand and on order and record, on a quarterly basis, a provision for excess and obsolete inventory and/or vendor cancellation charges related to purchase commitments. If the results of the review determine that a write-down is necessary, we recognize a loss in the period in which the loss is identified, whether or not the inventory is retained. Our September 29, 2018 net inventory value was \$149,000 compared to a December 31, 2017 net inventory value of \$102,000. Our inventory reserves establish a new cost basis for inventory and are not reversed until we sell or dispose of the related inventory. Such provisions are established based on historical usage, adjusted for known changes in demands for such products, or the estimated forecast of product demand and production requirements. Costs

associated with idle capacity are charged to expense immediately.

Property and Equipment

Property and equipment are recorded at cost. Equipment is depreciated using the straight-line method over their estimated useful lives ranging from three to five years. Leasehold improvements and assets financed under capital leases are amortized over the shorter of their useful lives or the lease term. Furniture and fixtures are depreciated over seven years. Expenditures for additions and major improvements are capitalized. Expenditures for minor tooling, repairs and maintenance and minor improvements are charged to expense as incurred. When property or equipment is retired or otherwise disposed of, the related cost and accumulated depreciation are removed from the accounts. Gains or losses from retirements and disposals are recorded in selling, general and administration expenses.

Patents, Licenses and Purchased Technology

Patents and licenses are recorded at cost and are amortized using the straight-line method over the shorter of their estimated useful lives or seventeen years.

Table of Contents

Other Assets and Investments

The realizability of long-lived assets is evaluated periodically as events or circumstances indicate a possible inability to recover the carrying amount. Long-lived assets that will no longer be used in the business are written off in the period identified since they will no longer be used in operations and generate any positive cash flows for us. Periodically, long-lived assets that will continue to be used by us will need to be evaluated for recoverability. Such evaluation is based on various analyses, including cash flow and profitability projections, as well as alternative uses, such as government contracts or awards. The analyses necessarily involve significant management judgment. Market acceptance and significant revenues from our new Conductus wire is a key assumption in realization of our investment in long-lived assets. In the event the projected undiscounted cash flows are less than net book value of the assets, the carrying value of the assets will be written down to their estimated fair value. We tested our long-lived assets for recoverability at September 29, 2018 and did not believe there was any impairment.

Loss Contingencies

In the normal course of our business we are subject to claims and litigation, including allegations of patent infringement. Liabilities relating to these claims are recorded when it is determined that a loss is probable and the amount of the loss can be reasonably estimated. The costs of our defense in such matters are expensed as incurred. Insurance proceeds recoverable are recorded when deemed probable.

Income Taxes

We recognize deferred tax liabilities and assets based on the differences between the financial statement carrying amounts and the tax bases of assets and liabilities, using enacted tax rates in effect in the years the differences are expected to reverse. Deferred income tax benefit (expense) results from the change in net deferred tax assets or deferred tax liabilities. A valuation allowance is recorded when it is more likely than not that some or all deferred tax assets will not be realized. The guidance further clarifies the accounting for uncertainty in income taxes and sets a consistent framework to determine the appropriate level of tax reserve to maintain for uncertain tax positions. This interpretation uses a two-step approach wherein a tax benefit is recognized if a position is more-likely-than-not to be sustained. The amount of the benefit is then measured to be the highest tax benefit that is greater than 50% likely to be realized and sets out disclosure requirements to enhance transparency of our tax reserves. Unrecognized tax positions, if ever recognized in the condensed consolidated financial statements, are recorded in the statement of operations as part of the income tax provision. Our policy is to recognize interest and penalties accrued on uncertain tax positions, if any, as part of the income tax provision.

No liabilities for uncertain tax positions were recorded in the current year. No interest or penalties on uncertain tax positions have been expensed to date. We are not under examination by any taxing authorities. Our state and federal statute of limitations for examination of us is open for 2013 and 2014, respectively, and subsequent filings.

Due to our operating losses, the Tax Cuts and Jobs Act (the 2017 Tax Act) has not impacted our operating results or income tax expense. The primary impact of the 2017 Tax Act was the re-measurement of our deferred tax assets, based upon the new U.S. statutory corporate tax rate of 21% and the required change to the related valuation allowance.

As of December 31, 2017, we had net operating loss carryforwards for federal and state income tax purposes. We concluded that under the Internal Revenue Code change of control limitations, a maximum of \$12.3 million of our \$353.6 net operating loss carryforwards, which expire in the years 2018 through 2037, would be available for reduction of taxable income and reduced both the deferred tax asset and valuation allowance accordingly. Due to the

uncertainty surrounding their realization, we recorded a full valuation allowance against our net deferred tax assets. Our effective rate is 0% and 0%, respectively, in the three months and nine months ended September 29, 2018 compared to 0% and 0%, respectively, in the three and nine months ended September 30, 2017. Our effective rate is a result of the full valuation allowance maintained against net deferred tax assets.

Marketing Costs

All costs related to marketing and advertising our products are charged to expense as incurred or at the time the advertising takes place. Advertising costs were not material in each of the nine months ended September 29, 2018 and September 30, 2017.

Net Loss Per Share

Basic and diluted net loss per share is computed by dividing net loss available to common stockholders by the weighted average number of common shares outstanding in each year. Net loss available to common stockholders is computed after deducting accumulated dividends on cumulative preferred stock, deemed dividends and accretion of redemption value on redeemable preferred stock for the period and beneficial conversion features on issuance of convertible preferred stock. Potential common shares are not included in the calculation of diluted loss per share because their effect is anti-dilutive.

Table of Contents*Stock-based Compensation Expense*

We grant both restricted stock awards and stock options to our key employees, directors and consultants. For the three and nine months ended September 29, 2018 and September 30, 2017 no options or awards were granted. The following table presents details of total stock-based compensation expense that is included in each functional line item on our condensed consolidated statements of operations:

| | Three months ended | | Nine months ended | |
|--|---------------------------|----------------------|--------------------------|----------------------|
| | September 29, | September 30, | September 29, | September 30, |
| | 2018 | 2017 | 2018 | 2017 |
| Cost of revenue | \$ | \$ | \$ | \$ |
| Research and development | 1,000 | 13,000 | 4,000 | 41,000 |
| Selling, general and administrative | 13,000 | 85,000 | 39,000 | 258,000 |
| Total stock-based compensation expense | \$ 14,000 | \$ 99,000 | \$ 44,000 | \$ 300,000 |

Use of Estimates

The preparation of the condensed consolidated financial statements in conformity with U.S. GAAP requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. The significant estimates in the preparation of the financial statements relate to the assessment of the carrying amount of accounts receivable, fixed assets, intangibles, estimated provisions for warranty costs, fair value of warrant derivatives, income taxes and disclosures related to litigation. Actual results could differ from those estimates and such differences may be material to the condensed consolidated financial statements.

Fair Value of Financial Instruments

We have estimated the fair value amounts of our financial instruments using the available market information and valuation methodologies considered appropriate. We determined the book value of our cash and cash equivalents, accounts receivable, and other current liabilities as of September 29, 2018 approximate fair value.

The fair value of our warrant derivative liability, which expired in August 2018, was estimated using the Binomial Lattice option valuation model.

Fair value for financial reporting purposes is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date, ASC 820, Fair Value Measurement and Disclosures, also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. ASC 820 describes three levels of inputs that may be used to measure fair value:

Level 1 quoted prices in active markets for identical assets or liabilities

Level 2 quoted prices for similar assets and liabilities in active markets or inputs that are observable

Level 3 inputs that are unobservable (for example cash flow modeling inputs based on assumptions)

The fair value of our warrant liabilities was determined based on level 3 inputs. These derivative liabilities are adjusted to reflect fair value at each period end, with any increase or decrease in the fair value being recorded in results of operations as Adjustments to fair value of warrant derivatives . See Note 3 Stockholders Equity: *Warrants*.

Comprehensive Income

We have no items of other comprehensive income in any period and consequently have not included a Statement of Comprehensive Income.

Segment Information

We have historically operated in a single business segment: the research, development, manufacture and marketing of high performance products used in cellular base stations. We derived net commercial product revenues primarily from the sales of our AmpLink and SuperPlex products which we sold directly to wireless network operators in the United States. Net revenues derived principally from government contracts are presented separately on the consolidated statements of operations for all periods presented. As discussed in this Report, we are adapting our unique HTS material deposition techniques to produce our energy efficient, cost-effective and high performance Conductus wire.

Table of Contents*Certain Risks and Uncertainties*

Our long-term prospects are dependent upon the successful commercialization and market acceptance of our Conductus wire products. We do not currently have a customer buying significant amounts of our wire products. With respect to our Conductus wire business, we expect to also have some customer concentration in that business as we continue to commercialize our wire product. The loss of or reduction in sales, or the inability to collect outstanding accounts receivable, from any significant customer could have a material adverse effect on our business, financial condition, results of operations and cash flows.

We currently rely on a limited number of suppliers for key components of our products. The loss of any of these suppliers could have material adverse effects on our business, financial condition, results of operations and cash flows.

In connection with the sales of our commercial products, we indemnify, without limit or term, our customers against all claims, suits, demands, damages, liabilities, expenses, judgments, settlements and penalties arising from actual or alleged infringement or misappropriation of any intellectual property relating to our products or other claims arising from our products. We cannot reasonably develop an estimate of the maximum potential amount of payments that might be made under our indemnity obligations because of the uncertainty as to whether a claim might arise and how much it might total at September 29, 2018.

3. Stockholders Equity

The following is a summary of stockholders equity transactions for the nine months ended September 29, 2018:

| | Convertible Preferred Stock | | Common Stock | | Capital in Excess of Par Value | Accumulated Deficit | Total |
|--|-----------------------------|--------|--------------|----------|--------------------------------|---------------------|--------------|
| | Shares | Amount | Shares | Amount | | | |
| Balance at December 31, 2017 | 328,925 | \$ | 1,074,659 | \$ 1,000 | \$ 316,724,000 | \$(311,613,000) | \$ 5,112,000 |
| Issuance of Series E preferred | 4,135 | | | | | | |
| Conversion of Series E preferred stock to common stock | (1,573) | | 449,429 | | | | |
| Issuance of common stock (net of costs) | | | 1,509,000 | 2,000 | 9,678,000 | | 9,680,000 |
| Stock-based compensation | | | | | 44,000 | | 44,000 |
| Warrant exercises | | | 38,720 | | | | |
| Cancellation of shares from reverse stock split | | | (1,199) | | | | |
| Net loss | | | | | | (5,869,000) | (5,869,000) |
| Balance at September 29, 2018 | 331,487 | \$ | 3,070,609 | \$ 3,000 | \$ 326,446,000 | \$(317,482,000) | \$ 8,967,000 |

Stock Options

At September 29, 2018, we had two active equity award option plans, the 2003 Equity Incentive Plan and the 2013 Equity Incentive Plan (collectively, the Stock Option Plan), although we can only grant new options under the 2013 Equity Incentive Plan. Under our Stock Option Plan, stock awards were made to our directors, key employees, consultants, and non-employee directors and consisted of stock options, restricted stock awards, performance awards, and performance share awards. Stock options were granted at prices no less than the market value on the date of grant. There were no stock option exercises during the three or nine months ended September 29, 2018 or during the three and nine months ended September 30, 2017.

The impact to the condensed consolidated statements of operations for the three and nine months ended September 29, 2018 on net loss was \$7,000 and \$24,000 and \$0.00 and \$0.01 on basic and diluted net loss per common share, respectively, compared to \$96,000 and \$290,000 and \$0.09 and \$0.28 on basic and diluted net loss per common share for the three and nine months ended September 30, 2017. No stock compensation cost was capitalized during either period.

Table of Contents

The following is a summary of stock option transactions under our Stock Option Plan at September 29, 2018:

| | Number of Shares | Price Per Share | Weighted Average Exercise Price | Number of Options Exercisable | Weighted Average Exercise Price |
|-------------------------------|-----------------------------|------------------------|--|--|--|
| Balance at December 31, 2017 | 12,613 | \$ 33.00 - \$9,216.00 | \$ 370.30 | 12,613 | \$ 370.30 |
| Granted | | | | | |
| Exercised | | | | | |
| Canceled | (290) | 33.00 - 9,216.00 | 4723.90 | | |
| Balance at September 29, 2018 | 12,323 | \$ 33.00 - \$4,716.00 | \$ 268.00 | 12,323 | \$ 268.00 |

The outstanding options expire on various dates through the end of November 2025. The weighted-average contractual term of options outstanding is 5.9 years and the weighted-average contractual term of stock options currently exercisable is 5.9 years. The exercise prices for these options range from \$33 to \$4,716 per share, for an aggregate exercise price of \$3.3 million. At September 29, 2018, no options had an exercise price less than the current market value.

Restricted Stock Awards

The grant date fair value of each share of our restricted stock awards is equal to the fair value of our common stock at the grant date. Shares of restricted stock under awards all have service conditions and vest over one to three years. The following is a summary of our restricted stock award transactions at September 29, 2018:

| | Number of Shares | Weighted Average Grant Date Fair Value |
|---|-----------------------------|---|
| Balance nonvested at December 31, 2017 | 3,166 | \$ 10.70 |
| Granted | | |
| Vested | (1,166) | 10.81 |
| Forfeited | | |
| Balance nonvested at September 29, 2018 | 2,000 | \$ 10.68 |

Restricted stock award expense to the condensed consolidated statements of operations was \$7,000 and \$20,000 and \$0.00 and \$0.02, respectively, on basic and diluted net loss per common share for the three and nine months ended September 29, 2018, respectively, and \$2,000 and \$7,000 and \$0.00 and \$0.01 on basic and diluted net loss per common share for the three and nine months ended September 30, 2017, respectively. No stock compensation cost was capitalized during the period. The total compensation cost related to nonvested awards not yet recognized was \$15,000 and the weighted-average period over which the cost is expected to be recognized was 10 months.

Warrants

The following is a summary of outstanding warrants at September 29, 2018:

| | | | Common Shares Price per Share | Expiration Date |
|------|---|----------------------------------|--|------------------------|
| | Total | Currently Exercisable | | |
| (1) | Warrants related to April 2013 financing | 1,713 | 1,713 \$ 817.50 | April 26, 2019 |
| (2) | Warrants related to February 2015 agreement | 306 | 306 \$ 450.45 | February 13, 2020 |
| (3) | Warrants related to March 2015 financing | 10,209 | 10,209 \$ 244.88 | September 24, 2020 |
| (4) | Warrants related to March 2015 financing | 1,021 | 1,021 \$ 306.09 | March 20, 2020 |
| (5) | Warrants related to October 2015 financing | 135,517 | 135,517 \$ 60.00 | October 14, 2020 |
| (6) | Warrants related to October 2015 financing | 9,035 | 9,035 \$ 65.63 | October 14, 2020 |
| (7) | Warrants related to August 2016 financing | 53,506 | 53,506 \$ 30.00 | February 2, 2022 |
| (8) | Warrants related to August 2016 financing | 4,994 | 4,994 \$ 38.55 | August 2, 2021 |
| (9) | Warrants related to December 2016 financing | 685,667 | 685,667 \$ 20.00 | December 14, 2021 |
| (10) | Warrants related to March 2018 financing | 158,100 | 158,100 \$ 11.40 | September 9, 2023 |
| (11) | Warrants related to March 2018 financing | 11,067 | 11,067 \$ 15.80 | March 6, 2023 |
| (12) | Warrants related to July 2018 financing | 2,571,429 | 2,571,429 \$ 3.50 | July 25, 2023 |
| (13) | Warrants related to July 2018 financing | 154,286 | \$ 4.38 | July 25, 2023 |

Table of Contents

On July 30, 2018 we completed a public offering of an aggregate of 2,571,429 shares of our common stock (or common stock equivalents initially in the form of Series E Preferred Stock) and warrants to purchase an aggregate of 2,571,429 shares of common stock with gross proceeds to us of \$9.0 million. The net proceeds to us from the offering, after deducting the placement agent fees and our estimated offering expenses, was \$7.98 million. The offering was priced at \$3.50 per share of common stock (or common stock equivalent), with each share of common stock (or common stock equivalent) sold with one five-year warrant to purchase one share of common stock, at an exercise price of \$3.50 per share. The placement agent also received warrants to purchase 154,286 shares of common stock, at an exercise price of \$4.375, that are subject to a six month lock-up and will expire July 25, 2023.

On March 9, 2018, we completed a registered offering of 158,100 shares of common stock (and common stock equivalents in the form of pre-funded warrants) and warrants with gross proceeds to us of \$2.0 million, with net proceeds to us, after deducting the placement agent fees and our estimated offering expenses, was \$1.7 million. In a concurrent private placement, we issued to the investor an unregistered warrant to purchase 158,100 shares of common stock. The warrants have an exercise price of \$11.40 per share, and are exercisable immediately and will expire five years and nine months from the date of issuance. The placement agent also received warrants to purchase 11,067 shares of common stock, at an exercise price of \$15.80, that are immediately exercisable and will expire March 6, 2023.

Warrants are exercisable by paying cash or, solely in the absence of an effective registration statement or prospectus, by cashless exercise for unregistered shares of common stock. The exercise price of the warrants is subject to standard antidilutive provision adjustment in the case of stock dividends or other distributions on shares of common stock or any other equity or equity equivalent securities payable in shares of common stock, stock splits, stock combinations, reclassifications or similar events affecting our common stock, and also, subject to limitations, upon any distribution of assets, including cash, stock or other property to our stockholders. The exercise price of the warrants is not subject to price-based anti-dilution adjustment. We have determined that these warrants related to issuance of common stock are subject to equity treatment because the warrant holder has no right to demand cash settlement and there are no unusual anti-dilution rights.

Certain warrants that expired on August 9, 2018 were not considered indexed to our common shares under ASC 815-40, and required separate accounting as derivative instruments with changes in fair value recognized in earnings each period. The warrants contain a provision whereby the warrant exercise price would be decreased in the event that future common stock issuances were made at a price less than the then exercise price. Due to the potential variability of their exercise price, these warrants do not qualify for equity treatment, and therefore were recognized as a liability. The warrant liability was adjusted to fair value each reporting period, and any change in value was recognized in the statement of operations. Using the binomial lattice valuation model, including an equal probabilities tree and early exercise factor of 30%, the significant weighted average assumptions for these expired warrants at December 31, 2017 was as follows: expected life of 8 months; risk free interest rates of 1.5% expected volatility of 69% and; dividend yield of 0% and the December 31, 2017 fair value of these warrants was estimated to be \$28,000. Due to their expiration these warrants had no value at September 29, 2018. The fair value of warrants accounted for as derivative liabilities was decreased by \$28,000 from December 31, 2017 to September 29, 2018.

4. Loss Per Share

Basic and diluted net earnings (loss) per share is based on the weighted-average number of common shares outstanding.

Since their impact would be anti-dilutive, our net loss per common share does not include the effect of the assumed exercise or vesting of the following shares:

| | September 29, 2018 | September 30, 2017 |
|----------------------------------|--------------------|--------------------|
| Outstanding stock options | 12,323 | 12,980 |
| Unvested restricted stock awards | 2,000 | 4,433 |
| Outstanding warrants | 3,796,849 | 929,416 |
| Total | 3,811,172 | 946,829 |

Also, the preferred stock convertible into 1,827 shares of common stock was not included since its impact would be anti-dilutive.

Table of Contents**5. Commitments and Contingencies***Operating Leases*

We lease our offices and production facility under a non-cancelable operating lease in Austin, Texas that expires in April 2020. The lease contains minimum rent escalation clauses that require additional rental amounts after the first year. Rent expense for these leases is recognized on a straight line basis over the minimum lease term. This lease also requires us to pay utilities, insurance, taxes and other operating expenses and contains one five-year renewal option.

For the three and nine months ended September 29, 2018 rent expense was \$90,000 and \$269,000, respectively, and for the three and nine months ended September 30, 2017 rent expense was \$106,000 and \$305,000, respectively.

Patents and Licenses

We have entered into various licensing agreements requiring royalty payments ranging from 0.13% to 2.5% of specified product sales. Certain of these agreements contain provisions for the payment of guaranteed or minimum royalty amounts. In the event that we fail to pay minimum annual royalties, these licenses may automatically become non-exclusive or be terminated. These royalty obligations terminate at various times from 2018 to 2020. For the three and nine months ended September 29, 2018 and September 30, 2017, royalty expense totaled \$17,000 and \$43,000 and \$11,000 and \$34,000, respectively. Under the terms of certain royalty agreements, royalty payments made may be subject to audit. There have been no audits to date and we do not expect future audit adjustments to be significant.

The minimum lease payments under operating leases and license obligations as of September 29, 2018 are as follows:

| Years ending December 31, | Licenses | Operating Leases |
|----------------------------------|------------------|-------------------------|
| Remainder of 2018 | \$ | \$ 233,000 |
| 2019 | 10,000 | 935,000 |
| 2020 | 10,000 | 230,000 |
| 2021 | 10,000 | 3,000 |
| 2022 | 10,000 | 2,000 |
| Thereafter | 30,000 | |
| Total payments | \$ 70,000 | \$ 1,403,000 |

6. Contractual Guarantees and Indemnities

During our normal course of business, we make certain contractual guarantees and indemnities pursuant to which we may be required to make future payments under specific circumstances. We have not recorded any liability for these contractual guarantees and indemnities in the accompanying condensed consolidated financial statements.

Warranties

We establish reserves for future product warranty costs that are expected to be incurred pursuant to specific warranty provisions with our customers. Our warranty reserves are established at the time of sale and updated throughout the warranty period based upon numerous factors including historical warranty return rates and expenses over various warranty periods.

Intellectual Property Indemnities

We indemnify certain customers and our contract manufacturers against liability arising from third-party claims of intellectual property rights infringement related to our products. These indemnities appear in development and supply agreements with our customers as well as manufacturing service agreements with our contract manufacturers, are not limited in amount or duration and generally survive the expiration of the contract. Given that the amount of potential liabilities related to such indemnities cannot be determined until an infringement claim has been made, we are unable to determine the maximum amount of losses that we could incur related to such indemnities.

Director and Officer Indemnities and Contractual Guarantees

We have entered into indemnification agreements with our directors and executive officers which require us to indemnify such individuals to the fullest extent permitted by Delaware law. Our indemnification obligations under such agreements are not limited in amount or duration. Certain costs incurred in connection with such indemnities may be recovered under certain circumstances under various insurance policies. Given that the amount of any potential liabilities

Table of Contents

related to such indemnities cannot be determined until a lawsuit has been filed against a director or executive officer, we are unable to determine the maximum amount of losses that we could incur relating to such indemnities. Historically, any amounts payable pursuant to such director and officer indemnities have not had a material negative effect on our business, financial condition or results of operations.

We have also entered into severance and change in control agreements with certain of our executives. These agreements provide for the payment of specific compensation benefits to such executives upon the termination of their employment with us.

General Contractual Indemnities/Products Liability

During the normal course of business, we enter into contracts with customers where we agree to indemnify the other party for personal injury or property damage caused by our products. Our indemnification obligations under such agreements are not generally limited in amount or duration. Given that the amount of any potential liabilities related to such indemnities cannot be determined until a lawsuit has been filed, we are unable to determine the maximum amount of losses that we could incur relating to such indemnities. Historically, any amounts payable pursuant to such indemnities have not had a material negative effect our business, financial condition or results of operations. We maintain general and product liability insurance as well as errors and omissions insurance which may provide a source of recovery to us in the event of an indemnification claim.

7. Details of Certain Financial Statement Components and Supplemental Disclosures of Cash Flow Information and Non-Cash Activities*Balance Sheet Data:*

| | September 29, 2018 | December 31, 2017 |
|---|-------------------------------|------------------------------|
| <u>Accounts receivable:</u> | | |
| Accounts receivable-commercial products | \$ 3,000 | \$ 8,000 |
| -government contract | 108,000 | 148,000 |
| Less: allowance for doubtful accounts | (3,000) | (5,000) |
| | \$ 108,000 | \$ 151,000 |

| | September 29, 2018 | December 31, 2017 |
|----------------------------|-------------------------------|------------------------------|
| <u>Inventories:</u> | | |
| Raw materials | \$ 149,000 | \$ 102,000 |
| | \$ 149,000 | \$ 102,000 |

| | September 29, 2018 | December 31, 2017 |
|---|-------------------------------|------------------------------|
| <u>Property and Equipment:</u> | | |
| Equipment | \$ 11,912,000 | \$ 11,723,000 |
| Leasehold improvements | 1,065,000 | 1,065,000 |
| Furniture and fixtures | 205,000 | 205,000 |
| | 13,182,000 | 12,993,000 |
| Less: accumulated depreciation and amortization | (11,949,000) | (11,200,000) |
| | \$ 1,233,000 | \$ 1,793,000 |

Depreciation expense amounted to \$219,000 and \$749,000, respectively, for the three and nine months ended September 29, 2018 and \$437,000 and \$1.4 million, respectively, for the three and nine months ended September 30, 2017.

| | September 29, 2018 | December 31, 2017 |
|-------------------------------------|-------------------------------|------------------------------|
| <u>Patents and Licenses:</u> | | |
| Patents pending | \$ 45,000 | \$ 44,000 |
| Patents issued | 1,682,000 | 1,682,000 |
| Less accumulated amortization | (1,016,000) | (984,000) |
| Net patents issued | 666,000 | 698,000 |
| | \$ 711,000 | \$ 742,000 |

Table of Contents

Amortization expense related to these items totaled \$11,000 and \$32,000, respectively, for the three and nine months ended September 29, 2018 and \$9,000 and \$25,000, respectively, for the three and nine months ended September 30, 2017. Amortization expenses are expected to total \$10,000 for the remainder of 2018 and \$40,000 for 2019 and 2020.

| | September 29, 2018 | December 31, 2017 |
|--|-----------------------|----------------------|
| <u>Accrued Expenses and Other Long Term</u> | | |
| <u>Liabilities:</u> | | |
| Salaries payable | \$ 55,000 | \$ 104,000 |
| Compensated absences | 196,000 | 173,000 |
| Compensation related | 40,000 | 4,000 |
| Warranty reserve | 8,000 | 8,000 |
| Deferred rent | 42,000 | 46,000 |
| Other | 271,000 | 172,000 |
| Fair value of warrant derivatives | | 28,000 |
| | 612,000 | 535,000 |
| Less current portion | (586,000) | (481,000) |
| Long term portion | \$ 26,000 | \$ 54,000 |

| | For the nine months ended, September 29, 2018 | September 30, 2017 |
|--|---|-----------------------|
| <u>Warranty Reserve Activity:</u> | | |
| Beginning balance | \$ 8,000 | \$ 8,000 |
| Additions | | |
| Deductions | | |
| Ending balance | \$ 8,000 | \$ 8,000 |

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**General**

We are a leading company in developing and commercializing high temperature superconductor (HTS) materials and related technologies. HTS materials can substantially improve the performance characteristics of electrical systems, reducing power loss, lowering heat generation, and decreasing electrical noise.

Commercialization

Our development efforts over the last 30 years have yielded an extensive patent portfolio as well as critical trade secrets, unpatented technology and proprietary knowledge. Our strategic plan is to utilize our core proprietary technology in superconductivity and leverage our proprietary manufacturing processes to build Conductus wire for

use in electrical power devices, including NGEM s. As discussed above, we are adapting our unique HTS material deposition techniques to produce our energy efficient, cost-effective and high performance Conductus wire technology for next generation power applications. We have identified several large initial target markets for superconducting wire including energy (wind turbines, cables, fault current limiters), medical (NMR (nuclear magnetic resonance) and MRI (magnetic resonance imaging)), science (high performance magnets) and industrial (motors, generators) applications. We are working with leading industry device manufacturers to complete qualification and acceptance testing of Conductus wire. Our development efforts (including those described under Our Future Business below) can take a significant number of years to commercialize, and we must overcome significant technical barriers and deal with other significant risks, some of which are set out in our public filings, including in particular the Risk Factors included in Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2017.

Our Future Business

We have created several unique capabilities and HTS manufacturing systems related to our Conductus wire platform that we are seeking to produce by leveraging our leadership in superconducting technologies, extensive intellectual property and HTS manufacturing expertise.

Table of Contents

HTS Wire Platform

Our Conductus wire product development is focused on large markets where the advantages of HTS wire are recognized by the industry. Our initial product roadmap targets three important applications: superconducting high power transmission cable, superconducting fault current limiters (SFCL) and high field magnets, including those used in Next Generation Electrical Machines (NGEMs).

Superconducting High Power Transmission Cable:

Superconducting high power transmission and distribution cable transmit 5 to 10 times the electrical current of traditional copper or aluminum cables with significantly improved efficiency. HTS power cable systems consist of the cable, which is comprised of 100 s of strands of HTS wire wrapped around a copper core, and the cryogenic cooling system to maintain proper operating conditions. HTS power cables are particularly suited to high load areas such as the dense urban business districts of large cities, where purchases of easements and construction costs for traditional low capacity cables may be cost prohibitive. The primary application for HTS cables is medium voltage feeds to load pockets in dense urban areas. In these high demand zones the grid is often saturated with aging infrastructure. HTS technology brings a considerable amount of power to new locations where the construction of additional transmission to distribution substations, with major transformer assets, is not feasible. Another potential use of HTS power cable is to improve grid power transmission by connecting two existing substations. In dense urban environments many substations often reach capacity limits and require redundant transformer capacity; to improve reliability HTS cables can tie these existing stations together, avoiding very costly transformer upgrades and construction costs.

Superconducting Fault Current Limiter (SFCL):

With power demand on the rise and new power generation sources being added, the grid has become overcrowded and vulnerable to catastrophic faults. Faults are abnormal flows of electrical current like a short circuit. As the grid is stressed, faults and power blackouts increase in frequency and severity. SFCLs act like powerful surge protectors, preventing harmful faults from taking down substation equipment by reducing the fault current to a safer level (20-50% reduction) so that the existing switchgear can still protect the grid. Currently, electrical-utilities use massive 80kA circuit breakers, oversized transformers and fuses to prevent faults from damaging their equipment and protecting against surges. However, once a fault has occurred, standard circuit breakers suffer destructive failure and need to be replaced before service can be restored. In addition, Smart Grid and embedded alternative energy generation enhancements will increase the need for SCFLs. Grid operators face a major challenge in moving power safely and efficiently, from generators to consumers, through several stages of voltage transformation step downs and step ups. At each stage, valuable energy is lost in the form of waste heat. Moreover, while demands are continually rising, space for transformers and substations especially in dense urban areas is severely limited. Conventional oil-cooled transformers pose a fire and environmental hazard. Compact, efficient superconducting transformers, by contrast, are cooled by safe, abundant and environmentally benign liquid nitrogen. As an additional benefit, these actively-cooled devices will offer the capability of operating in overload, to twice the nameplate rating, without any loss of life to meet occasional utility peak load demands.

Superconducting High Field magnets:

There are a variety of applications that utilize superconducting magnets in order to capitalize on their unique ability to create extremely high magnetic fields. The NMR and MRI machines of today utilize such superconducting magnets for this very reason. Currently, high-field superconducting magnets are manufactured using commercially available superconducting wire such as niobium-titanium (NbTi) or niobium-tin (Nb₃Sn). NMR and MRI device manufacturers look towards advances in superconducting technologies to improve the overall performance of their systems by

dramatically increasing the magnetic fields while reducing size. High demand for a robust, high performance and low cost superconducting wire has spurred rapid development of a next generation alternative. In the last 10 years, new second generation (2G) Rare Earth, Barium, Copper Oxide (ReBCO) superconducting materials have been proven to drastically increase magnetic field strengths, especially at low temperatures. These advanced ReBCO based superconductors now provide an excellent alternative to NbTi and Nb₃Sn based materials.

Results of Operations

Three and nine months ended September 29, 2018 compared to the three and nine months ended September 30, 2017

For the three and nine months ended September 29, 2018, revenues were entirely from government contract revenues. Total revenues increased by \$387,000, to \$517,000 in the third quarter of 2018 from \$130,000 in the third quarter of 2017. Total net revenues increased by \$1,417,000, to \$1,556,000 in the first nine months of 2018 from \$139,000 in the same period of

Table of Contents

2017. For the three and nine months ended September 29, 2018, government contract revenues were 517,000 and \$1,556,000, respectively, or 100%, of our total revenues compared to \$130,000 the same periods of 2017. There have been no commercial product revenues in 2018 compared with \$0 and \$9,000, respectively, for the three and nine months ended September 30, 2017. Commercial product revenues are expected to increase as we reach commercial production of our Conductus wire.

Cost of revenues includes all direct costs, manufacturing overhead and provision for excess and obsolete inventories. The cost of revenues decreased to \$604,000 in the third quarter of 2018 compared to \$790,000 for the third quarter of 2017, a decrease of \$186,000 or 24%. The cost of revenues decreased by \$810,000, or 34%, to \$1,611,000 in the first nine months of 2018 from \$2,421,000 in the same period of 2017. Our cost of revenues includes both variable and fixed cost components. The variable component consists primarily of materials, assembly and test labor, overhead, which includes utilities, transportation costs and warranty costs. The fixed component includes equipment and leasehold depreciation, purchasing expenses and quality assurance costs. As a result, our gross profit margins decrease as revenue and production volumes decline due to lower sales volume and higher amounts of production overhead variances expensed to cost of sales; and our gross profit margins increase as our revenue and production volumes increase due to higher sales volume and lower amounts of production overhead variances expensed to cost of sales.

The following is an analysis of our product gross profit and margins:

| <i>Dollars in thousands</i> | Three Months Ended | | Nine Months Ended | |
|----------------------------------|---------------------------|--------------------|--------------------------|--------------------|
| | September 29, 2018 | September 30, 2017 | September 29, 2018 | September 30, 2017 |
| Commercial product sales | \$ 0 | \$ 0 | \$ 0 | \$ 9 |
| Cost of commercial product sales | 604 | 790 | 1,611 | 2,421 |
| Gross loss | \$ (604) | \$ (790) | \$ (1,611) | \$ (2,412) |

We had a gross loss of \$604,000 in the third quarter of 2018 from the sale of our commercial products compared to a gross loss of \$790,000 in the third quarter of 2017. We experienced a gross loss in the three and nine months ended September 29, 2018 due to: our preproduction manufacturing efforts to bring our Conductus wire to market and; our sales being insufficient to cover our overhead. For the three and nine months ended September 29, 2018, our gross loss was reduced by sharing of our production equipment with a new government contract. As we emphasize improving manufacturing processes and increasing our yields at lower than optimal capacity, we expect gross losses to continue through 2018.

In June 2017, we finalized negotiations on a \$4.5 million DOE contract and have begun work on this government contract. Our first year goals under this contract was to increase current carrying capacity and reduce costs of our Conductus wire. We are now further refining our manufacturing processes for longer lengths of wire with greater uniformity and higher yield. Our government contract revenues for the three and nine months ended September 29, 2018 were \$517,000 and \$1,556,000, respectively, and cost of government contract revenues were \$395,000 and 1,129,000, respectively.

Research and development expenses relate to development of new Conductus wire products and new wire products manufacturing processes. These expenses totaled \$0.7 million and \$1.7 million, respectively, in the three and nine months ended September 29, 2018 compared to \$0.8 million and \$2.1 million, respectively, in the three and nine month period ended September 30, 2017. These expenses were lower in the current three and nine month period

compared to the same three and nine month period in 2017 as a result of our efforts moving from research and development to manufacturing of our new Conductus wire products.

Selling, general and administrative expenses totaled \$1.0 million, and \$3.1 million, respectively, in the three and nine months ended September 29, 2018 compared to \$1.1 million and \$3.3 million in the three and nine months ended September 30, 2017. Lower, non-cash stock award expenses in 2018 were the principal cause of this decrease.

We had a gain from the adjustment to the fair value of our warrant derivatives of \$3,000 and \$52,000, respectively, in the three months and nine months ended September 29, 2018 and a gain of \$59,000 and \$67,000, respectively, in the three and nine months ended September 30, 2017. These fair value adjustments were due to multiple factors including our stock price, warrant exercises, as well as our financing activities affecting the warrant exercise price. This warrant liability was adjusted to fair value each reporting period, and any change in value was recognized in the statement of operations. Due to their August 9, 2018 expiration, these warrants had no value at September 29, 2018.

Our first quarter 2018 sale of common stock, common stock equivalents and warrants resulted in a \$24,000 price adjustment expense for of our warrants. See Note 3 Stockholders Equity: *Warrants*.

Table of Contents

Other income of \$16,000 and \$11,000 in the third quarters of 2018 and 2017, respectively, and other income of \$30,000 and \$27,000 for the nine months ended September 29, 2018 and September 30, 2017, respectively, was from interest income.

We had a net loss of \$2.2 million for the quarter ended September 29, 2018, compared to a net loss of \$2.5 million in the third quarter of 2017 and for the nine months ended September 29, 2018 our loss totaled \$5.9 million compared to a net loss of \$7.7 million for the nine months ended September 30, 2017. The net loss available to common stockholders totaled \$0.88 per common share in the quarter ended September 29, 2018, compared to a net loss of \$2.34 per common share in the same period of 2017. The net loss available to common stockholders totaled \$3.66 per common share in the first nine months of 2018, compared to \$7.34 per common share in the first nine months of 2017. For the three and nine months ended September 29, 2018, the decrease in net loss per common share available to common stockholders is due to the increase in the number of common shares outstanding and increased government contract revenues.

Liquidity and Capital Resources

Cash Flow Analysis

As of September 29, 2018, we had working capital of \$7.0 million, including \$7.6 million in cash and cash equivalents, compared to working capital of \$2.6 million at December 31, 2017, which included \$3.1 million in cash and cash equivalents. We currently invest our excess cash in short-term, investment-grade, money-market instruments with maturities of three months or less.

Cash and cash equivalents increased by \$4.5 million from \$3.1 million at December 31, 2017 to \$7.6 million at September 29, 2018. In the first nine months of 2018, cash was used principally in operations.

Cash used in operations totaled \$5.0 million in the first nine months of 2018. We used \$5.1 million to fund the cash portion of our net loss and \$0.1 million was provided by changes in our working capital.

We used \$189,000 for investing activities in the first nine months of 2018 for the purchase of equipment for our Conductus wire initiative.

In the first nine months of 2018, \$9.7 million was provided by financing activities from the sale of common stock, common stock equivalents, preferred stock and warrants. See below for more details.

Financing Activities

We have historically financed our operations through a combination of cash on hand, cash provided from operations, equipment lease financings, available borrowings under bank lines of credit and both private and public equity offerings.

On July 30, 2018 we completed a public offering of an aggregate of 2,571,429 shares of our common stock (or common stock equivalents) and warrants to purchase an aggregate of 2,571,429 shares of common stock with gross proceeds to us of \$9.0 million. The net proceeds to us from the offering, after deducting the placement agent fees and our estimated offering expenses, was \$7.98 million. The offering was priced at \$3.50 per share of common stock (or common stock equivalent), with each share of common stock (or common stock equivalent) sold with one five-year warrant to purchase one share of common stock, at an exercise price of \$3.50 per share.

In connection with the offering, we issued 1,390,000 shares of our common stock at a price of \$3.50 per share, with each share of common stock coupled with a five year warrant to purchase one share of common stock, at an exercise price of \$3.50 (the Warrants). These securities were offered in the form of a Class A Unit but were immediately separable and were issued separately at the closing.

For certain investors who would otherwise hold more than 4.99% (or at the election of a purchaser, 9.99%) of our common stock following the registered offering, we issued to such investors an aggregate of 4,135.0015 Class B Units (equivalent to 1,181,429 shares of its common stock), consisting of shares of a new class of preferred stock designated Series E Convertible Preferred Stock with a stated value of \$1,000 and which are convertible into our common stock at a conversion price equal to \$3.50 per share of common stock, together with an equivalent number of Warrants in the same form and economic terms based on the related purchase price as the purchasers of the Class A Units (the Class B Units and together with the Class A Units , the Units). These securities offered in the form of a Class B Unit were immediately separable and were issued separately at the closing. At September 29, 2018, 1,573.0015 Series E Convertible Preferred Stock had been converted into 449,429 shares of common stock and 2,562 Series E Convertible Preferred Stock, convertible into 732,000 shares of common stock, remained unconverted. From September 29, 2018 through November 8, 2018, an additional 700 Series E Convertible Preferred Stock had been converted into 200,000 shares of common stock and 1,862 Series E Convertible Preferred Stock, convertible into 532,000 shares of common stock, remained unconverted.

Table of Contents

On March 9, 2018, we issued a total of 158,100 shares of common stock (or common stock equivalents) in the form of 119,000 shares of our common stock at a price of \$12.65 per share and, for investors who would otherwise hold more than 9.99% of the Company's common stock following the registered offering, we agreed to issue to such investors pre-funded warrants to purchase 39,100 shares of the Company's common stock at a price of \$12.55 per warrant subject to payment of an additional \$0.10 upon exercise, which are common stock equivalents. This registered offering of common stock (and common stock equivalents) provided gross proceeds to us of \$2.0 million, and net proceeds to us, after deducting the placement agent fees and our estimated offering expenses, of \$1.7 million. In a concurrent private placement, we issued to the investor unregistered warrants to purchase 158,100 shares of common stock. The warrants have an exercise price of \$11.40 per share, and are exercisable immediately and will expire five years and nine months from the date of issuance.

On April 4, 2018, the 39,100 pre-funded warrants issued in connection with our March 2018 financing noted above were exercised, on a cashless basis, and we issued 38,720 shares of our common stock.

Contractual Obligations and Commercial Commitments

We lease all of our properties. All of our operations, including our manufacturing facilities, are located in Austin, Texas. We occupy 94,000 square feet in Austin, Texas under a non-cancellable long-term lease that expires in April 2020. Although we currently have excess capacity, we believe this facility can be managed in a flexible and cost effective manner and is adequate to meet current and reasonably anticipated needs for the next two years. This lease also includes a renewal option.

We have not had other material changes outside of the ordinary course of business in our contractual obligations as disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2017.

Capital Expenditures

We made a \$189,000 investment for fixed assets in the first nine months of 2018. During the remainder of 2018, we expect to make capital expenditures for the purchase of equipment and facilities improvements for our Conductus wire initiative with the actual amount of expenditures related to the levels of our customer orders. We do not plan any additional fixed asset expenditures in 2018 for our existing legacy wireless business.

Future Liquidity

For the first nine months of 2018, we incurred a net loss of \$6.0 million and had negative cash flows from operations of \$5.0 million. In the full 2017 year, we incurred a net loss of \$9.5 million and had negative cash flows from operations of \$7.4 million. Our ability to realize our investment in infrastructure is dependent on market acceptance and realization of significant revenues from Conductus wire products. Our independent registered public accounting firm has included in its audit reports for 2017 and 2016 an explanatory paragraph expressing substantial doubt about our ability to continue as a going concern within one year after the date the condensed consolidated financial statements were issued.

At September 29, 2018, we had \$7.6 million in cash and cash equivalents. In 2018, we raised \$9.7 million, net of expenses, from the sale of common stock, preferred stock and warrants. Unless we can materially grow our revenues from commercial opportunities in the remainder of 2018 and 2019, we may need to raise additional capital to continue to implement our current business plan and maintain our viability. We currently forecast that our existing cash resources will be sufficient to fund our planned operations into the third quarter of 2019. Additional financing may not be available on acceptable terms or at all. If we issue additional equity securities to raise funds, the ownership

percentage of our existing stockholders would be reduced. New investors may demand rights, preferences or privileges senior to those of existing holders of common stock. If we cannot raise any needed funds, we might be forced to make further substantial reductions in our operating expenses, which could adversely affect our ability to implement our current business plan and ultimately our viability as a company. These factors raise substantial doubt about our ability to continue as a going concern.

Our plans regarding improving our future liquidity will require us to successfully use our expertise and our technology to generate revenues in various ways, including commercial operations, joint ventures and licenses. We have invested and will continue to invest in our Austin, Texas manufacturing facility to enable us to produce our Conductus wire products. However, delays in the timing of our ability to, including but not limited to, raise additional capital, unexpected production delays, and our ability to sell our Conductus wire products in large scale could substantially impact our estimates used in the determination of expected future cash flows and/or expected future profitability.

Table of Contents

Net Operating Loss Carryforward

As of December 31, 2017, we had net operating loss carryforwards for federal and state income tax purposes. We concluded that under the Internal Revenue Code change of control limitations, a maximum of \$12.3 million of our \$353.6 net operating loss carryforwards, which expire in the years 2018 through 2037, would be available for reduction of taxable income and reduced both the deferred tax asset and valuation allowance accordingly. Due to the uncertainty surrounding their realization, we recorded a full valuation allowance against our net deferred tax assets. Accordingly, no deferred tax asset has been recorded in the accompanying condensed consolidated balance sheets.

Critical Accounting Policies and Estimates

Our discussion and analysis of our historical financial condition and results of operations are based upon our condensed consolidated financial statements, which have been prepared in accordance with generally accepted accounting principles in the United States. The preparation of these condensed consolidated financial statements in conformity with those principles requires us to make estimates of certain items and judgments as to certain future events including for example those related to bad debts, inventories, recovery of long-lived assets (including intangible assets), income taxes, warranty obligations, and contingencies. These determinations, even though inherently subjective and subject to change, affect the reported amounts of our assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. While we believe that our estimates are based on reasonable assumptions and judgments at the time they are made, some of our assumptions, estimates and judgments will inevitably prove to be incorrect. As a result, actual outcomes will likely differ from our accruals, and those differences positive or negative could be material. Some of our accruals are subject to adjustment, as we believe appropriate, based on revised estimates and reconciliation to the actual results when available.

On July 24, 2018, we effected a 1-for-10 reverse stock split of our common stock, or the Reverse Stock Split. As a result of the Reverse Stock Split, every ten shares of our pre-Reverse Stock Split common stock were combined and reclassified into one share of our common stock. The Reverse Stock Split did not change the authorized number of shares or the par value of our common stock. Share and per share data included herein has been retroactively restated for the effect of the Reverse Stock Split as applicable.

In addition, we identified certain critical accounting policies which affect certain of our more significant estimates and assumptions used in preparing our condensed consolidated financial statements in our Annual Report on Form 10-K for the fiscal year ended December 31, 2017. We have updated our revenue recognition policy since issuance of our 2017 Annual Report as a result of the adoption of ASU No. 2014-09, Revenue from Contracts with Customers, ASC 606, in the first nine months of 2018. ASC 606 has not had a material impact on our condensed consolidated financial statements. We have not made any material changes to our other policies.

Backlog

Our commercial backlog consists of accepted product purchase orders with scheduled delivery dates during the next twelve months. We had commercial backlog of \$0 and evaluation and qualification orders with unspecified delivery dates for \$80,000 at September 29, 2018. We had commercial backlog of \$48,000 and evaluation and qualification orders with unspecified delivery dates for \$80,000 at December 31, 2017.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

We do not believe that there was a material change in our exposure to market risk at September 29, 2018 compared with our market risk exposure on December 31, 2017. See *Management's Discussion and Analysis of Financial*

Condition and Results of Operations *Market Risk* in our Annual Report on Form 10-K for the fiscal year ended December 31, 2017.

Item 4. Controls and Procedures.

We have established disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended). As of the end of the period covered by this report we carried out an evaluation under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rule 13a-15 of the Securities and Exchange Act of 1934, as amended. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective.

There were no changes in our internal controls over financial reporting during the quarter ended September 29, 2018 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

We do not expect that our disclosure controls and procedures or our internal controls will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, have been detected.

Table of Contents

PART II

OTHER INFORMATION

Item 1. Legal Proceedings.

From time to time, we are party to various lawsuits, claims and other legal proceedings that arise in the ordinary course of our business. Excluding ordinary, routine litigation incidental to our business, we are not currently a party to any legal proceedings that we believe would reasonably be expected to have a material adverse effect on our business, financial condition or results of operation or cash flow.

Item 1A. Risk Factors.

A description of the risk factors associated with our business is contained in Item 1A, Risk Factors, of our Annual Report on Form 10-K for the fiscal year ended December 31, 2017 filed with the Securities and Exchange Commission on March 23, 2018. We are not aware of any material changes to those risk factors.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

None.

Item 3. Defaults Upon Senior Securities.

None.

Item 4. Mine Safety Disclosures.

None.

Item 5. Other Information.

None.

Item 6. Exhibits.

| Number | Description of Document |
|---------|---|
| 31.1 | <u>Statement of CEO Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002*</u> |
| 31.2 | <u>Statement of CFO Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002*</u> |
| 32.1 | <u>Statement of CEO Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002**</u> |
| 32.2 | <u>Statement of CFO Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002**</u> |
| 101.INS | XBRL Instance Document* |
| 101.SCH | XBRL Taxonomy Extension Schema Document* |

| | |
|---------|---|
| 101.CAL | XBRL Calculation Linkbase Document* |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document* |
| 101.LAB | XBRL Label Linkbase Document* |
| 101.PRE | XBRL Taxonomy Presentation Linkbase Document* |

* Filed herewith.

** Furnished, not filed.

Table of Contents

SIGNATURES

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

Dated: November 13, 2018

SUPERCONDUCTOR TECHNOLOGIES INC.

/s/ William J. Buchanan
William J. Buchanan
Chief Financial Officer

/s/ Jeffrey A. Quiram
Jeffrey A. Quiram
President and Chief Executive Officer