NEVRO CORP
Form 10-Q
May 07, 2018
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 March 31, 2018

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
Commission File Number: 001-36715

Nevro Corp.

(Exact name of registrant as specified in its charter)

Delaware	56-2568057
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

1800 Bridge Parkway

Redwood City, CA

(Address of principal executive offices)

94065

(Zip Code)

(650) 251-0005

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See 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	(Do not check if a smaller reporting company)	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 No

As of April 30, 2018 there were 29,978,926 shares of the registrant’s common stock, par value $0.001 per share, outstanding.

Nevro Corp.

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PART I—FINANCIAL INFORMATION

Item 1. Condensed Consolidated Financial Statements

Nevro Corp.

Condensed Consolidated Balance Sheets

(unaudited)

(in thousands, except share and per share data)

	March 31, 2018	December 31, 2017
Assets		
Current assets		
Cash and cash equivalents	$27,650	$ 42,845
Short-term investments	231,960	226,467
Accounts receivable, net of allowance for doubtful accounts of $1,021 and $1,333 at March 31, 2018 and December 31, 2017, respectively	62,664	67,287
Inventories	97,497	98,119
Prepaid expenses and other current assets	7,751	6,463
Total current assets	427,522	441,181
Property and equipment, net	12,773	8,819
Other assets	3,744	3,250
Restricted cash	806	806
Total assets	$444,845	$ 454,056
Liabilities and stockholders' equity		
Current liabilities		
Accounts payable	$22,224	$ 18,492
Accrued liabilities	31,139	39,390
Other current liabilities	134	122
Total current liabilities	53,497	58,004
Long-term debt	146,821	145,019
Other long-term liabilities	1,905	1,861
Total liabilities	202,223	204,884
Commitments and contingencies (Note 6)		
Stockholders' equity		
Preferred stock, $0.001 par value, 10,000,000 shares authorized at March 31, 2018 and December 31, 2017; zero shares issued and outstanding at March 31, 2018 and December 31, 2017	—	—
Common stock, $0.001 par value, 290,000,000 shares authorized at March 31, 2018 and December 31, 2017; 29,943,768 and 29,737,561 shares issued and outstanding at March 31, 2018 and December 31, 2017, respectively	30	30

Additional paid-in capital	518,198	508,228
Accumulated other comprehensive loss	(1,016)	(1,242)
Accumulated deficit	(274,590)	(257,844)
Total stockholders' equity	242,622	249,172
Total liabilities and stockholders' equity	$444,845	$ 454,056

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

Nevro Corp.

Condensed Consolidated Statements of Operations and Comprehensive Loss

(unaudited)

(in thousands, except share and per share data)

	Three Months Ended March 31,	
	2018	2017
Revenue	$87,635	$68,439
Cost of revenue	25,634	22,071
Gross profit	62,001	46,368
Operating expenses		
Research and development	11,085	8,699
Sales, general and administrative	66,618	50,720
Total operating expenses	77,703	59,419
Loss from operations	(15,702)	(13,051)
Interest income	1,013	709
Interest expense	(2,558)	(2,435)
Other income (expense), net	(123)	531
Loss before income taxes	(17,370)	(14,246)
Provision for income taxes	343	261
Net loss	(17,713)	(14,507)
Other comprehensive loss:		
Changes in foreign currency translation adjustment	577	(222)
Changes in unrealized gains on short-term investments, net	(351)	44
Net change in other comprehensive loss	226	(178)
Comprehensive loss	$(17,487)	$(14,685)
Net loss per share, basic and diluted	$(0.59)	$(0.50)
Weighted average number of common shares used to compute basic and diluted net loss per share	29,836,277	29,159,509

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

Nevro Corp.

Condensed Consolidated Statements of Cash Flows

(unaudited)

(in thousands)

	Three Months Ended March 31,	
	2018	2017
Cash flows from operating activities		
Net loss	$(17,713)	$(14,507)
Adjustments to reconcile net loss to net cash used in operating activities		
Depreciation and amortization	815	485
Stock-based compensation expense	8,243	6,071
Accretion of discount on short-term investments	(42)	(44)
Provision for doubtful accounts	(316)	268
Write-down of inventory	(116)	2,071
Non-cash interest expense	1,803	1,680
Unrealized (gains) losses on foreign currency transactions	464	(851)
Changes in operating assets and liabilities		
Accounts receivable	6,561	2,053
Inventories	765	(686)
Prepaid expenses and other current assets	(1,840)	(1,742)
Other assets	(492)	46
Accounts payable	3,791	(4,476)
Accrued liabilities	(8,205)	(4,231)
Other long-term liabilities	44	96
Net cash used in operating activities	(6,238)	(13,767)
Cash flows from investing activities		
Purchases of short-term investments	(50,106)	(73,115)
Proceeds from maturity of short-term investments	44,305	63,202
Purchases of property and equipment	(5,016)	(711)
Net cash provided by (used in) investing activities	(10,817)	(10,624)
Cash flows from financing activities		
Minimum tax withholding paid on behalf of employees for net share settlement	(215)	—
Proceeds from issuance of common stock to employees	1,941	2,109
Net cash provided by financing activities	1,726	2,109
Effect of exchange rate changes on cash and cash equivalents	134	72
Net increase (decrease) in cash, cash equivalents and restricted cash	(15,195)	(22,210)
Cash, cash equivalents and restricted cash		
Cash, cash equivalents and restricted cash at beginning of period	43,651	42,212
Cash, cash equivalents and restricted cash at end of period	$28,456	$20,002
Significant non-cash transactions		
Purchases of property and equipment in accounts payable	$346	$758
Vesting of early-exercised stock options	$—	$4

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

Nevro Corp.

Notes to Condensed Consolidated Financial Statements

(unaudited)

1. Formation and Business of the Company

Nevro Corp. (the Company) was incorporated in Minnesota on March 10, 2006 to manufacture and market innovative active implantable medical devices for the treatment of neurological disorders initially focusing on the treatment of chronic pain. Subsequently, the Company was reincorporated in Delaware on October 4, 2006 and relocated to California.

Since inception, the Company has incurred net losses and negative cash flows from operations. During the year ended December 31, 2017, the Company incurred a net loss of $36.7 million and used $14.3 million of cash in operations. For the three months ended March 31, 2018, the Company incurred a net loss of $17.7 million and used $6.2 million of cash in operations. At March 31, 2018 and December 31, 2017, the Company had an accumulated deficit of $274.6 million and $257.8 million, respectively. The Company has financed operations to date primarily through private placements of equity securities, borrowings under a debt agreement, the issuance of common stock in its November 2014 initial public offering, its June 2015 underwritten public offering and its June 2016 underwritten public offering of convertible senior notes due 2021. The Company's ability to continue to meet its obligations and to achieve its business objectives for the foreseeable future is dependent upon, amongst other things, generating sufficient revenues and its ability to continue to control expenses. Failure to increase sales of its products, manage discretionary expenditures or raise additional financing, if required, may adversely impact the Company's ability to achieve its intended business objectives.

The accompanying interim condensed consolidated financial statements as of March 31, 2018 and for the three months ended March 31, 2018 and 2017, and the related interim information contained within the notes to the financial statements, are unaudited. The unaudited interim condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States (U.S. GAAP) for interim financial information and on the same basis as the audited financial statements included on the Company's Annual Report on Form 10-K (Annual Report) filed with the Securities and Exchange Commission (SEC) on February 22, 2018. In the opinion of management, the accompanying unaudited interim condensed consolidated financial statements contain all adjustments (consisting of normal recurring adjustments) necessary to state fairly the Company's financial position as of March 31, 2018, and the results of its operations and cash flows for the three months ended March 31, 2018 and 2017. All such adjustments are of a normal and recurring nature. The interim financial data as of March 31, 2018 is not necessarily indicative of the results to be expected for the year ending December 31, 2018, or for any future period.

The accompanying condensed consolidated financial statements and related financial information should be read in conjunction with the audited consolidated financial statements and the related notes thereto for the year ended December 31, 2017 included in the Annual Report.

2. Summary of Significant Accounting Policies

Basis of Presentation

These condensed consolidated financial statements have been prepared in accordance with U.S. GAAP. The condensed consolidated financial statements include the Company's accounts and those of its wholly-owned subsidiaries. All intercompany accounts and transactions have been eliminated.

Segments

The chief operating decision maker for the Company is the Chief Executive Officer. The Chief Executive Officer reviews financial information presented on a consolidated basis, accompanied by information about revenue by geographic region, for purposes of allocating resources and evaluating financial performance. The Company has one business activity and there are no segment managers who are held accountable for operations, operating results or plans for levels or components below the consolidated unit level, other than revenue. Accordingly, the Company has determined that it has a single reportable and operating segment structure. The Company and its Chief Executive Officer evaluate performance based primarily on revenue in the geographic locations in which the Company operates.

Revenue by geography is based on the billing address of the customer. The United States was the only country with revenue accounting for more than 10% of the total revenue in any of the periods presented, as follows:

	Three Months Ended March 31,	
	2018	2017
United States	81%	78%

Long-lived assets and operating income located outside the United States are not material; therefore, disclosures have been limited to revenue.

Foreign Currency Translation

The Company's consolidated financial statements are prepared in U.S. dollars (USD). Its foreign subsidiaries use their local currency as their functional currency and maintain their records in the local currency. Accordingly, the assets and liabilities of these subsidiaries are translated into USD using the current exchange rates in effect at the balance sheet date and equity accounts are translated into USD using historical rates. Revenues and expenses are translated using the monthly average exchange rates during the period when the transaction occurs. The resulting foreign currency translation adjustments from this process are recorded in accumulated other comprehensive income (loss) on the consolidated balance sheets.

Unrealized foreign exchange gains and losses from the remeasurement of assets and liabilities denominated in currencies other than the functional currency of the reporting entity are recorded in other income (expense), net. Additionally, realized gains and losses resulting from transactions denominated in currencies other than the local currency are recorded in other income (expense), net in the condensed consolidated statements of operations and comprehensive loss. The Company recorded net unrealized and net realized foreign currency transaction gains (losses) during the periods presented as follows (in thousands):

	Three Months Ended March 31,	
	2018	2017
Net unrealized foreign currency gain (loss)	$(473)	$850
Net realized foreign currency gain (loss)	420	(261)

As the Company's international operations grow, its risks associated with fluctuations in currency rates will become greater, and the Company will continue to reassess its approach to managing this risk. In addition, currency fluctuations or a weakening USD can increase the costs of the Company's international expansion. To date, the Company has not entered into any foreign currency hedging contracts. Based on its current international structure, the Company does not plan on engaging in hedging activities in the near future.

Use of Estimates

The preparation of financial statements in accordance with U.S. GAAP requires management to make estimates and assumptions that affect the amounts reported in the condensed consolidated financial statements and accompanying

notes. Significant accounting estimates and management judgments reflected in the condensed consolidated financial statements include items such as allowances for doubtful accounts; warranty obligations; clinical accruals; stock-based compensation; depreciation and amortization periods; inventory valuation; valuation of investments; and accounting for income taxes. Estimates are based on historical experience, where applicable, and other assumptions believed to be reasonable by the management. Actual results may differ from those estimates under different assumptions or conditions.

Concentration of Credit Risk and Other Risks and Uncertainties

Financial instruments that potentially subject the Company to a concentration of credit risk consist of cash, cash equivalents and investments. The majority of the Company's cash is held by one financial institution in the United States and is in excess of federally insured limits. The Company maintained investments in money market funds that were not federally insured during the periods ended March 31, 2018 and December 31, 2017. The Company also held cash in foreign banks of approximately $4.4 million at March 31, 2018 and $4.5 million at December 31, 2017 that was not federally insured. The Company has not experienced any losses on its deposits of cash and cash equivalents.

The Company's convertible note hedge transactions, entered into in connection with the 2021 Notes, subject the Company to credit risk such that the counterparties may be unable to fulfill the terms of the transactions. The associated risk is mitigated by limiting the counterparties to major financial institutions.

In the international markets in which the Company participates, the Company uses a combination of a direct sales force, sales agents and independent distributors to sell its products, while in the United States the Company utilizes a direct sales force. The Company performs ongoing credit evaluations of its direct customers and distributors, does not require collateral, and maintains allowances for potential credit losses on customer accounts when deemed necessary.

During the three months ended March 31, 2018 and 2017, no single customer accounted for 10% or more of the Company's revenue. As of March 31, 2018 and December 31, 2017, no single customer accounted for 10% or more of the accounts receivable balance.

The Company is subject to risks common to medical device companies, including, but not limited to, new technological innovations, dependence on key personnel, protection of proprietary technology, compliance with government regulations, product liability, manufacturing quality and scaling, continued reimbursement from third-party payors, uncertainty of market acceptance of products and the need to obtain additional financing. The Company is dependent on third-party manufacturers and suppliers, which, in some cases, are sole- or single-source suppliers.

There can be no assurance that the Company's products or services will continue to be accepted in its existing marketplaces, nor can there be any assurance that any future products or services can be developed or manufactured at an acceptable cost and with appropriate performance characteristics, or that such products or services will be successfully marketed, if at all.

The Company may choose to raise additional funds to further enhance its research and development efforts, for product expansion opportunities or to acquire a new business or products that are complementary to its business. There can be no assurance that such financing will be available or will be at terms acceptable by the Company.

Fair Value of Financial Instruments

The carrying amounts of certain of the Company's financial instruments, including cash equivalents, short-term investments, accounts receivable, accounts payable and accrued liabilities, approximate fair value due to their relatively short maturities.

Cash and Cash Equivalents

The Company considers all highly-liquid investments purchased with an original maturity of three months or less at the date of purchase to be cash equivalents. Cash and cash equivalents include money market funds in the amount of $11.0 million and $30.3 million as of March 31, 2018 and December 31, 2017, respectively. At March 31, 2018 and December 31, 2017, the Company's cash equivalents were held at institutions in the United States and include deposits in a money market fund which was unrestricted as to withdrawal or use.

Restricted Cash

Restricted cash as of March 31, 2018 and December 31, 2017 consists of a letter of credit of $0.6 million representing collateral for the Company's Redwood City, California building lease pursuant to an agreement dated March 5, 2015 and certificates of deposit of $0.2 million collateralizing payment of charges related to the Company's credit cards.

Investment Securities

The Company classifies its investment securities as available-for-sale. Those investments with original maturities greater than three months at the date of purchase and remaining maturities of less than 12 months are considered short-term investments. Those investments with remaining maturities greater than 12 months at the date of purchase are also classified as short-term investments as management considers them to be available for current operations if

needed. The Company’s investment securities classified as available-for-sale are recorded at fair value. Unrealized gains and losses, deemed temporary in nature, are reported as a separate component of accumulated comprehensive income (loss).

A decline in the fair value of any security below cost that is deemed other than temporary results in a charge to earnings and the corresponding establishment of a new cost basis for the security. Premiums (discounts) are amortized (accreted) over the life of the related security as an adjustment to yield using the straight-line interest method. Dividend and interest income are recognized when earned. Realized gains and losses are included in earnings and are derived using the specific identification method for determining the cost of securities sold.

Inventories

Inventories are stated at the lower of cost to purchase or manufacture the inventory or the net realizable value of such inventory. Cost is determined using the standard cost method which approximates the first-in, first-out basis. Net realizable value is determined as the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal and transportation. The Company regularly reviews inventory quantities in consideration of actual loss experiences, projected future demand and remaining shelf life to record a provision for excess and obsolete inventory when appropriate.

The Company writes down inventory that has become obsolete, inventory that has a cost basis in excess of its expected net realizable value, and inventory that is in excess of expected requirements. The estimate of excess quantities is subjective and primarily dependent on the Company's estimates of future demand for a particular product. If the estimate of future demand is inaccurate based on actual sales, the Company may increase the write down for excess inventory for that component and record a charge to inventory impairment in the accompanying consolidated statements of operations and comprehensive loss. The Company periodically evaluates the carrying value of inventory on hand for potential excess amounts over demand using the same lower of cost or net realizable value approach that has been used to value inventory. The Company also periodically evaluates inventory quantities in consideration of actual loss experience. In addition, the Company determines at times that there may be certain inventory that does not meet its product requirements. As a result of these evaluations, the Company recognized total write downs of $2.1 million of its inventories for the three months ended March 31, 2017. The amount of write downs for the three months ended March 31, 2018 was not significant. The Company's estimation of the future demand for any given particular component of the Senza product may vary and may result in changes in estimates of inventory values in any particular period.

Shipping and Handling Costs

The Company has made the accounting policy election under ASC 606 to account for shipping and handling costs as a fulfillment activity. These costs are accrued when the related revenue is recognized.

Revenue Recognition

The Company has revenue arrangements that generally consist of a single performance obligation. The Company recognizes revenue at the point in time when it transfers control of promised goods to its customers. Revenue is measured as the amount of consideration it expects to receive in exchange for transferring goods

See Note 3 for further discussion on Revenue Recognition.

Allowance for Doubtful Accounts

The Company makes estimates of the collectability of accounts receivable. In doing so, the Company analyzes historical bad debt trends, customer credit worthiness, current economic trends and changes in customer payment patterns when evaluating the adequacy of the allowance for doubtful accounts.

Warranty Obligations

The Company provides a limited one- to five-year warranty and warrants that its products will operate substantially in conformity with product specifications. The Company records an estimate for the provision for warranty claims in cost of revenue when the related revenues are recognized. This estimate is based on historical and anticipated rates of warranty claims, the cost per claim and the number of units sold. The Company regularly assesses the adequacy of its recorded warranty obligations and adjusts the amounts as necessary.

Property and Equipment

Property and equipment are stated at cost less accumulated depreciation and amortization. Depreciation of property and equipment, other than leasehold improvements, is computed using the straight-line method over the assets' estimated useful lives of three to five years. Leasehold improvements are amortized on a straight-line basis over the shorter of the estimated useful life of the asset or the life of the lease. Upon retirement or sale, the cost and related accumulated depreciation are removed from the consolidated balance sheet and the resulting gain or loss is reflected in operations. Maintenance and repairs are charged to operations as incurred.

Impairment of Long-Lived Assets

The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset or asset group might not be recoverable. When such an event occurs, management determines whether there has been impairment by comparing the anticipated undiscounted future net cash flows to the related asset group's carrying value. If an asset is considered impaired, the asset is written down to fair value, which is based either on discounted cash flows or appraised value, depending on the nature of the asset. There were no impairment charges or changes in estimated useful lives recorded through March 31, 2018.

Income Taxes

During the three months ended March 31, 2018 and 2017, the Company calculated its interim tax provision to record taxes incurred on a discrete basis due to the variability of taxable income in the jurisdictions in which it operates. The provision for income taxes for the three months ended March 31, 2018 and 2017 is primarily comprised of foreign and state taxes based upon income earned during the period with no tax benefit recorded for the loss jurisdictions.

The Company records uncertain tax positions on the basis of a two-step process whereby (1) a determination is made as to whether it is more likely than not that the tax positions will be sustained based on the technical merits of the position and (2) for those tax positions that meet the more-likely-than-not recognition threshold, the Company recognizes the largest amount of tax benefit that is greater than 50% likely to be realized upon ultimate settlement with the related tax authority. The Company's policy is to recognize interest and penalties related to income taxes as a component of income tax expense. No interest or penalties related to income taxes have been recognized in the statements of operations and comprehensive loss for the three months ended March 31, 2018 and 2017.

On December 22, 2017, the 2017 Tax Cuts and Jobs Act (the 2017 Tax Act) was enacted into law. The 2017 Tax Act contains several key tax law changes, including a reduction of the corporate income tax rate to 21% effective January 1, 2018, and a one-time mandatory transition tax on accumulated foreign earnings, among others. Consistent with guidance issued by the SEC, which provides for a measurement period of one year from the enactment date to finalize the accounting for effects of the 2017 Tax Act, as of December 31, 2017, the Company has made a reasonable estimate of the effects on its existing deferred taxes and related disclosures and the one-time transition tax. Due to its taxable losses and its federal valuation allowance position, the Company did not recognize any income tax expense or benefit as a result of the 2017 Tax Act.

During the three months ended March 31, 2018, the Company did not make any adjustments to its provisional amounts included in its consolidated financial statements for the year ended December 31, 2017. The Company will continue to complete its analysis of these provisional amounts, which are still subject to change during the measurement period, and anticipates further guidance on accounting interpretations from the FASB and application of the law from the Department of the Treasury. The accounting is expected to be completed when the 2017 U.S. corporate income tax return is filed in 2018.

At March 31, 2018, the Company has not yet determined its policy election with respect to whether to record deferred taxes for basis differences expected to reverse as a result of the global intangible low-taxed income (GILTI) provisions in future periods or use the period cost method. The Company has, however, considered the potential effects of GILTI in estimating its tax provision for 2018. Due to its forecasted taxable losses for 2018 and its federal valuation allowance position, the Company is not forecasting any income tax expense or benefit as a result of the GILTI provisions.

Comprehensive Income (Loss)

Comprehensive income (loss) represents all changes in the stockholders' equity except those resulting from distributions to stockholders. The Company's changes in unrealized gains and losses on available-for-sale investment

securities and foreign currency translation adjustments represent the components of other comprehensive income (loss) that are excluded from the reported net loss and have been presented in the consolidated statements of operations and comprehensive loss.

Research and Development

Research and development costs, including new product development, regulatory compliance and clinical research, are charged to operations as incurred in the consolidated statements of operations and comprehensive loss. Such costs include personnel-related costs, including stock-based compensation, supplies, services, depreciation, allocated facilities and information services, clinical trial and related clinical manufacturing expenses, fees paid to investigative sites and other indirect costs.

Stock-Based Compensation

The Company accounts for stock-based compensation arrangements with employees in accordance with Accounting Standards Codification (ASC) 718, Compensation - Stock Compensation. ASC 718 requires the recognition of compensation expense, using a fair value-based method, for costs related to all share-based payments including stock options.

In March 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2016-09, Stock Compensation (Topic 718): Improvements to Employee Shared-Based Payment Accounting, which the Company adopted on January 1, 2017. Under ASU 2016-09, entities are permitted to make an accounting policy election to either estimate forfeitures on share-based payment awards, as previously required, or to recognize forfeitures as they occur. The Company has elected to continue to estimate forfeitures expected to occur to determine the amount of compensation cost recognized in each period. ASU 2016-09 also requires that entities recognize, on a prospective basis, all excess tax benefits and tax deficiencies as income tax expense or benefit in the income statement as discrete items in the reporting period in which they occur. The adoption did not result in a cumulative-effect adjustment to accumulated deficit as of January 1, 2017 using the modified retrospective method. Additionally, under ASU 2016-09, excess tax benefits are classified as an operating activity in the statement of cash flows. The Company has elected the presentation of excess tax benefits in the statement of cash flows using the prospective transition method.

The Company’s determination of the fair value of stock options on the date of grant utilizes the Black-Scholes option-pricing model, and is impacted by its common stock price as well as changes in assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to, the expected term that options will remain outstanding, the expected common stock price volatility over the term of the option awards, risk-free interest rates and expected dividends. Changes in the assumptions can materially affect the fair value and ultimately how much stock-based compensation expense is recognized.

The fair value of stock options is recognized over the period during which an optionee is required to provide services in exchange for the option award, known as the requisite service period (usually the vesting period), on a straight-line basis. Stock-based compensation expense recognized at fair value includes the impact of estimated forfeitures. The Company estimates future forfeitures at the date of grant and revises the estimates, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

The Company estimates the fair value of the rights to purchase shares by employees under the Employee Stock Purchase Plan using the Black-Scholes option pricing formula. The Employee Stock Purchase Plan provides for consecutive six-month offering periods and the Company uses its own historical volatility data in the valuation.

Equity instruments issued to non-employees are recorded at their fair value on the measurement date and are subject to periodic adjustments as the underlying equity instruments vest. The fair value of options granted to consultants is expensed when vested.

The Company accounts for stock-based compensation for the restricted stock units at their fair value, based on the closing market price of the Company’s common stock on the grant date. These costs are recognized on a straight-line basis over the requisite service period, which is generally the vesting term of four years.

The Company also issues stock options and restricted stock units with vesting based upon completion of performance goals. The fair value for these performance-based awards is recognized over the period during which the goals are to be achieved. Stock-based compensation expense recognized at fair value includes the impact of estimated probability that the goals would be achieved, which is assessed prior to the requisite service period for the specific goals.

Upon adoption of ASU 2016-09 as described above, excess tax benefits or deficiencies from share-based award activity are reflected in the consolidated statements of operations as a component of the provision for income taxes, whereas they were previously recognized as additional paid-in capital.

Net Loss per Share of Common Stock

Basic net loss per common share is calculated by dividing net loss by the weighted average number of common shares outstanding during the period, without consideration for potentially dilutive securities. Diluted net loss per share is computed by dividing net loss by the weighted average number of common shares and potentially dilutive securities outstanding for the period. For purposes of the diluted net loss per share calculation, the Company’s restricted stock units and options to purchase shares of common stock are considered to be potentially dilutive securities. Because the Company has reported a net loss in all periods presented, diluted net loss per common share is the same as basic net loss per common share for those periods.

Recent Accounting Pronouncements

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842). This update requires an entity to recognize assets and liabilities for leases with lease terms of more than 12 months on the balance sheet. ASU 2016-02 is effective for public entities for fiscal years beginning after December 15, 2018. The Company is in the process of developing a project plan and establishing teams to implement the guidance. Although the Company is currently evaluating the impact of this guidance on its consolidated financial statements and related disclosures, the Company expects that all of its operating lease commitments with a term will be subject to the new standard and recognized as operating lease liabilities and right-of-use assets upon adoption.

In March 2017, the FASB issued ASU No. 2017-08, Receivables – Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities. This update shortens the premium amortization period for certain purchased callable debt securities held at a premium. ASU 2017-08 is effective for public entities for annual periods beginning after December 15, 2018. The Company has not determined the potential effects of the guidance on its consolidated financial statements.

In February 2018, the FASB issued ASU No. 2018-02, Income Statement – Reporting Comprehensive Income (Topic 220). This update provides companies with the option to reclassify stranded tax effects caused by the 2017 Tax Cuts and Jobs Act (the 2017 Tax Act) from accumulated other comprehensive income to retained earnings. ASU 2018-02 is effective for public entities for annual periods beginning after December 15, 2018, with early adoption permitted. The Company has not determined the potential effects of the guidance on its consolidated financial statements.

In March 2018, the FASB issued ASU No. 2018-05, Income Taxes (Topic 740). This update amends the certain paragraphs in ASC 740 to reflect the provisions of SEC Staff Accounting Bulletin (SAB) 118, which provides guidance for companies that are not able to complete their accounting for income tax effects of the 2017 Tax Act in the period of enactment. ASU 2018-05 is effective immediately. The adoption of this ASU did not have a material impact on the Company’s consolidated financial statements.

3. Revenue

Adoption of ASC 606

On January 1, 2018, the Company adopted the new accounting standard ASC 606, Revenue from Contracts with Customers, using the modified retrospective method applied to contracts which were not completed as of that date. Results for reporting periods beginning after January 1, 2018 are presented under ASC 606, while prior period amounts are not adjusted and continue to be reported in accordance with the Company’s historic accounting under ASC 605, Revenue Recognition. Under ASC 606, assuming all other revenue recognition criteria have been met, the Company will recognize revenue earlier for arrangements where the Company has satisfied its performance obligations but have not issued invoices. These amounts are recorded as unbilled receivables, which are included in accounts receivable on the consolidated balance sheet, as the Company has an unconditional right to payment as of the end of the applicable period.

The Company recognized the cumulative effect of initially applying ASC 606 as an adjustment to the opening balance of accumulated deficit. The cumulative effect of the changes made to the consolidated balance sheet as of January 1, 2018 for the adoption of ASC 606 were as follows (in thousands):

	Balance at December 31, 2017	Adjustments Due to ASC 606	Balance at January 1, 2018
Balance Sheet:			
Accounts receivable, net	$67,287	$ 1,447	$68,734
Prepaid expenses and other current assets	6,463	(476)	5,987
Accumulated other comprehensive loss	(1,242)	4	(1,238)
Accumulated deficit	(257,844)	967	(256,877)

In accordance with ASC 606, the disclosure of the impact of adoption on the Consolidated Balance Sheet and Statement of Operations were as follows (in thousands):

	Three Months Ended March 31, 2018		
	Balance As Reported	Balance Before ASC 606 Adoption	Effect of Change
Balance Sheet:			
Accounts receivable, net	$62,664	$61,500	$1,164
Prepaid expenses and other current assets	7,751	8,797	(1,046)
Statement of Operations:			
Revenue	87,635	87,916	(281)
Cost of revenue	25,634	25,063	571

Revenue Recognition

Revenue is recognized when obligations under the terms of a contract with customers are satisfied, which occurs with the transfer of control of the Company's goods to its customers. Revenue is measured as the amount of consideration the Company expects to receive in exchange for transferring the goods.

For a majority of sales, where the Company's sales representative delivers its product at the point of implantation at hospitals or medical facilities, the Company recognizes revenue upon completion of the procedure and authorization, which represents the point in time when control transfers to the customers.

For the remaining sales, which are sent from the Company's distribution centers directly to hospitals and medical facilities, as well as distributor sales, where product is ordered in advance of an implantation, the transfer of control occurs at the time of shipment of the product. These customers are obligated to pay within specified terms regardless of when or if they ever sell or use the products. The Company does not offer rights of return or price protection and it has no post-delivery obligations.

Sales, value add, and other taxes the Company collects concurrent with revenue-producing activities are excluded from revenue. The expected costs associated with warranty obligations continue to be recognized as expense when the products are sold (see Note 6). The Company periodically provides incentive offers, in the form of rebates, to customers based on their aggregate levels of purchases. Product revenue is recorded net of such incentive offers.

The following table presents revenue by geography, based on the billing address of the customer (in thousands):

	Three Months Ended March 31,	
	2018	2017
United States	$70,623	$53,104
International	17,012	15,335
Total revenue	$87,635	$68,439

Practical Expedients and Exemptions

The Company recognizes revenue upon the transfer of control of the product and there are no future performance obligations upon such transfer. As a result, the Company does not disclose the value of unsatisfied performance obligations for (i) contracts with an original expected length of one year or less and (ii) contracts for which it recognizes revenue at the amount to which it has the right to invoice for services performed. The Company does not

capitalize incremental costs when the amortization period of the asset is less than a year.

4. Fair Value Measurements

Fair value is defined as the exchange price that would be received for an asset or an exit price paid to transfer a liability in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Valuation techniques used to measure fair value must maximize the use of observable inputs and minimize the use of unobservable inputs.

The fair value hierarchy defines a three-level valuation hierarchy for disclosure of fair value measurements as follows:

- Level 1—Observable inputs, such as quoted prices in active markets for identical assets or liabilities.
- Level 2—Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.
- Level 3—Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

Cash Equivalents and Short-Term Investments

The Company's cash equivalents are comprised of investments in money market funds that are classified as Level 1 of the fair value hierarchy. The Company's money market funds are classified within Level 1 of the fair value hierarchy and are valued based on quoted prices in active markets for identical securities. The Company's short-term investments are comprised of commercial paper and corporate notes. All short-term investments have been classified within Level 1 or Level 2 of the fair value hierarchy because of the sufficient observable inputs for revaluation. The Company's Level 2 investments are valued using third-party pricing sources. The pricing services utilize industry-standard valuation models, including both income and market-based approaches, for which all significant inputs are observable, either directly or indirectly, to estimate fair value. These inputs include reported trades of and broker/dealer quotes on the same or similar investments, issuer credit spreads, benchmark investments, prepayment/default projections based on historical data and other observable inputs. The following table sets forth the Company's financial instruments that were measured at fair value on a recurring basis by level within the fair value hierarchy (in thousands):

Balance as of March 31, 2018	Level 1	Level 2	Level 3	Total
Assets:				
Money market funds (i)	$10,952	$—	$ —	$10,952
Commercial paper (ii)	—	69,959	—	69,959
Corporate notes (iii)	—	165,996	—	165,996
Total assets	$10,952	$235,955	$ —	$246,907

Balance as of December 31, 2017	Level 1	Level 2	Level 3	Total
Assets:				
Money market funds (i)	$30,278	$—	$ —	$30,278
Commercial paper (iii)	—	61,086	—	$61,086
Corporate notes (iii)	—	165,381	—	$165,381
Total assets	$30,278	$226,467	$ —	$256,745

(i) Included in cash and cash equivalents on the condensed consolidated balance sheets.
(ii) Included in either cash and cash equivalents or short-term investments on the consolidated balance sheets.
(iii) Included in short-term investments on the condensed consolidated balance sheets.

Convertible Senior Notes

As of March 31, 2018 and December 31, 2017, the fair value of the 1.75% convertible senior notes due 2021 was $198.7 million and $180.3 million, respectively. The fair value was determined on the basis of market prices observable for similar instruments and is considered Level 2 in the fair value hierarchy (See Note 6).

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5. Balance Sheet Components

Investments

The fair value of the Company's cash equivalents and short-term investments approximates their respective carrying amounts due to their short-term maturity. The following is a summary of the gross unrealized gains and unrealized losses on the Company's investment securities, excluding investments in money market funds (in thousands):

	March 31, 2018			
	Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Aggregate Fair Value
Investment Securities				
Commercial paper (i)	$70,036	$ 7	$ (84)	$69,959
Corporate notes	166,682	—	(686)	165,996
Total securities	$236,718	$ 7	$ (770)	$235,955

	December 31, 2017			
	Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Aggregate Fair Value
Investment Securities				
Commercial paper	$61,167	$ —	$ (81)	$61,086
Corporate notes	165,712	1	(332)	165,381
Total securities	$226,879	$ 1	$ (413)	$226,467

i) Includes $4.0M of commercial paper that is classified as cash and cash equivalents on the consolidated balance sheet.

Realized gains or losses and other-than-temporary impairments, if any, on available-for-sale securities are reported in other income (expense), net as incurred. The cost of securities sold is determined based on the specific identification method. The amount of realized gains and realized losses on investments recorded for the periods presented has not been material.

The contractual maturities of the Company's investment securities as of March 31, 2018 were as follows (in thousands):

	Amortized Cost	Fair Value
Amounts maturing within one year	$236,718	$235,955
Amounts maturing after one year through five years	—	—
Total investment securities	$236,718	$235,955

Inventories (in thousands)

	March 31, 2018	December 31, 2017
Raw materials	$45,693	$ 51,602
Finished goods	51,804	46,517
Total inventories	$97,497	$ 98,119

Property and Equipment, Net (in thousands)

	March 31, 2018	December 31, 2017
Laboratory equipment	$ 2,535	$ 2,416
Computer equipment and software	6,804	5,076
Furniture and fixtures	2,241	2,241
Leasehold improvements	1,221	1,221
Construction in process	5,656	2,734
Total	18,457	13,688
Less: Accumulated depreciation and amortization	(5,684)	(4,869)
Property and equipment, net	$ 12,773	$ 8,819

The Company recognized depreciation and amortization expense on property and equipment as follows (in thousands):

	Three Months Ended March 31,	
	2018	2017
Depreciation and amortization expense	$815	$485

Accrued Liabilities (in thousands)

	March 31, 2018	December 31, 2017
Accrued payroll and related expenses	$ 17,609	$ 26,108
Accrued professional fees	4,635	4,734
Accrued taxes	2,794	2,827
Accrued clinical and research expenses	876	1,279
Accrued interest	998	243
Accrued warranty	820	708
Accrued other	3,407	3,491
Total accrued liabilities	$ 31,139	$ 39,390

6. Commitments and Contingencies

Operating Leases

In March 2015, the Company entered into a lease agreement for approximately 50,000 square feet of office space located in Redwood City, California for a period beginning on June 30, 2015 and ending in May 2022, with initial annual payments of approximately $2.0 million, increasing to $2.4 million annually during the final year of the lease term. In December 2016, the Company entered into a first amendment to the lease for an additional approximately 50,000 square feet of office space adjacent to the premises under the original lease (the Expansion Premises), with initial annual payments of $1.2 million, increasing to $2.9 million in the final year of the amended lease term. The lease for the Expansion Premises commences on the earlier of (i) the date the Company commences business operations in the Expansion Premises, or (ii) the date upon which the Landlord substantially completes certain improvements to, and permitting for, the Expansion Premises (the Commencement Date). The first amendment also extends the lease term for the original premises to terminate on the same date as the amended lease. Under the first amendment, if the Company is unable to move into the Expansion Premises before the Scheduled Delivery Date, as defined in the amendment, the Company may terminate the lease for the Expansion Premises. In April 2017, the Company entered into a second amendment to the lease for a temporary space for a period beginning in May 2017 and ending on the Commencement Date of the Expansion Premises. As of March 31, 2018, the Commencement Date of the Expansion Premises has not occurred.

In August 2014, the Company entered into a facility lease for warehouse space beginning on August 21, 2014 through May 31, 2015. In March 2015, the Company extended the warehouse lease through February 2017, at which time the lease terminated.

The Company entered into a separate non-cancellable facility lease for warehouse space beginning on March 1, 2017 through February 28, 2022, under which it is obligated to pay approximately $0.4 million in lease payments over the term of the lease.

The Company recognized rent expense during the periods indicated as follows (in thousands):

	Three Months Ended March 31,	
	2018	2017
Rent expense	$654	$583

Warranty Obligations

The Company warrants that its products will operate substantially in conformity with product specifications and has a limited one- to five-year warranty to most customers. Activities related to warranty obligations were as follows (in thousands):

	Three Months Ended March 31,	
	2018	2017
Beginning balance	$708	$645
Provision for warranty	500	267
Utilization	(388)	(284)
Ending balance	$820	$628

License Agreement

In October 2006, the Company entered into an amended and restated license agreement with the Mayo Foundation for Medical Education and Research (Mayo) and the Venturi Group LLC (VGL), which provides the Company access to certain know-how and licensed patents owned by Mayo and VGL for treatment of central, autonomic and peripheral nervous system disorders, including pain, using devices to modulate nerve signaling. The licenses granted are exclusive and the Company has the right to sub-license. The agreement will terminate upon the expiration of (1) the last to expire of the licensed patents or (2) the Company's obligations to pay royalties, whichever is later, unless terminated earlier. The agreement can be terminated by the Company, Mayo or VGL upon 60 days' notice of a party's material breach if such breach remains uncured after such 60-day period.

Per the terms of the license, the Company is required to pay royalties based on the greater of earned royalties or a minimum royalty. The earned royalty is based on a percentage of net sales of licensed products either by the Company or the sub-licensee. The minimum royalty payment is based on royalty periods as defined in the agreement.

In March 2011, the Company entered into a Phase II License Agreement with Mayo which provides the Company access to the certain know-how and licensed patents owned by Mayo. The licenses granted are exclusive and the Company has the right to sub-license.

Per terms of the license, the Company is required to:

- Pay a retainer fee of $40,000 per annum starting March 2011 and ending on February 2013; and
- Pay royalties based on the greater of earned royalties or a minimum royalty. The earned royalties are based on a percentage of net sales of licensed products either by the Company or the sub-licensee. The minimum annual royalty payment is $200,000.

The Company recognized royalty expense during the periods indicated as follows (in thousands):

	Three Months Ended March 31,	
	2018	2017
Royalty expense	$693	$468

Contingencies

From time to time, the Company may have certain contingent liabilities that arise in the ordinary course of business activities related to, for example, employment matters and patent issues. The Company accrues a liability for such matters when it is probable that future expenditures will be made and such expenditures can be reasonably estimated. There were no contingent liabilities requiring accrual at March 31, 2018 and December 31, 2017.

Indemnification

The Company enters into standard indemnification arrangements in the ordinary course of business. Pursuant to these arrangements, the Company indemnifies, holds harmless and agrees to reimburse the indemnified parties for losses suffered or incurred by the indemnified party, in connection with any trade secret, copyright, patent or other intellectual property infringement claim by any third-party with respect to the Company's technology. The term of these indemnification agreements is generally perpetual. The maximum potential amount of future payments the Company could be required to make under these agreements is not determinable because it involves claims that may be made against the Company in the future, but have not yet been made.

The Company has entered into indemnification agreements with its directors and officers that may require the Company to indemnify its directors and officers against liabilities that may arise by reason of their status or service as directors or officers, other than liabilities arising from willful misconduct of the individual. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited; however, the Company has director and officer insurance coverage that reduces the Company's exposure and enables the Company to recover a portion of any future amounts paid. The Company believes the estimated fair value of these indemnification agreements in excess of applicable insurance coverage is minimal.

The Company has not incurred costs to defend lawsuits or settle claims related to these indemnification agreements. No liability associated with such indemnifications has been recorded to date.

Legal Matters

On November 28, 2016, the Company filed a lawsuit for patent infringement against Boston Scientific Corporation and Boston Scientific Neuromodulation Corporation (collectively, Boston Scientific). The lawsuit, filed in the United States District Court for the Northern District of California, asserts that Boston Scientific is infringing the Company's patents covering inventions relating to the Senza system and HF10 therapy. The lawsuit seeks preliminary and permanent injunctive relief against further infringement as well as damages and attorney's fees.

On December 9, 2016, Boston Scientific filed a patent infringement lawsuit alleging the Company's manufacture, use and sale of the Senza system infringes certain of Boston Scientific's patents covering spinal cord stimulation technology related to stimulation leads, rechargeable batteries and telemetry. The lawsuit, filed in the United States District Court for the District of Delaware, seeks unspecified damages and attorney's fees, as well as preliminary and permanent injunctive relief against further infringement. As of March 31, 2018, the Company is unable to determine an outcome or potential range of loss. In relation to this lawsuit, the Company filed a total of ten petitions for inter partes review at the U.S. Patent and Trademark Office (USPTO) against all of Boston Scientific's asserted claims. Specifically, the Company filed three petitions for inter partes review on July 21, 2017, one petition for inter partes review on July 31, 2017, one petition for inter partes review on August 11, 2017, two petitions for inter partes review on November 2, 2017, two petitions for inter partes review on November 3, 2017, and one petition for inter partes review on November 10, 2017. Every asserted claim in Boston Scientific's lawsuit has thus been petitioned for inter partes review at the USPTO.

On April 27, 2018, Boston Scientific filed a patent lawsuit alleging patent infringement, theft of trade secrets, and tortious interference with contract. The lawsuit, filed in the United States District Court for the District of Delaware, seeks unspecified damages and attorney's fees, as well as preliminary and permanent injunctive relief against further infringement. As of this time, the Company is unable to determine an outcome or potential range of loss.

The Company is and may from time to time continue to be involved in various legal proceedings of a character normally incident to the ordinary course of its business, including several pending European patent oppositions at the European Patent Office (EPO) initiated by the Company's competitors Medtronic and Boston Scientific, which the Company does not believe to be material to its business and consolidated financial statements at this stage.

7. Long-term Debt

1.75% Convertible Senior Notes and Convertible Note Hedge and Warrant Transactions

In June 2016, the Company issued $150.0 million aggregate principal amount of 1.75% convertible senior notes due 2021 in a registered underwritten public offering and an additional $22.5 million aggregate principal amount of such notes pursuant to the exercise in full of the over-allotment options of the underwriters (the 2021 Notes). The interest rates are fixed at 1.75% per annum and are payable semi-annually in arrears on June 1 and December 1 of each year, commencing on December 1, 2016. The total net proceeds from the debt offering, after deducting initial purchase discounts and debt issuance costs, were approximately $166.2 million.

Each $1,000 principal amount of the 2021 Notes will initially be convertible into 10.3770 shares of the Company's common stock, which is equivalent to an initial conversion price of approximately $96.37 per share, subject to adjustment upon the occurrence of specified events. The 2021 Notes will be convertible at the option of the holders at any time prior to the close of business on the business day immediately preceding December 1, 2020, only under the following circumstances: (1) during any calendar quarter commencing after the calendar quarter ending on September 30, 2016 (and only during such calendar quarter), if the last reported sale price of the Company's common stock for at least 20 trading days (whether or not consecutive) during a period of 30 consecutive trading days ending on the last trading day of the immediately preceding calendar quarter is greater than or equal to 130% of the conversion price on each applicable trading day; (2) during the five business day period after any ten consecutive trading day period (the measurement period) in which the trading price (as defined in the indenture to the 2021 Notes) per $1,000 principal amount of notes for each trading day of the measurement period was less than 98% of the product of the last reported sale price of the Company's common stock and the conversion rate on each such trading day; or (3) upon the occurrence of specified corporate events. On or after December 1, 2020 until the close of business on the second scheduled trading day immediately preceding the maturity date, holders may convert their 2021 Notes at any time, regardless of the foregoing circumstances. Upon conversion, the Company will pay or deliver, as the case may be, cash, shares of the Company's common stock or a combination of cash and shares of the Company's common stock, at the Company's election. If the Company undergoes a fundamental change prior to the maturity date, holders of the notes may require the Company to repurchase for cash all or any portion of their notes at a repurchase price equal to 100% of the principal amount of the notes to be repurchased, plus accrued and unpaid interest to, but excluding, the fundamental change repurchase date. In addition, if specific corporate events occur prior to the applicable maturity date, the Company will increase the conversion rate for a holder who elects to convert their notes in connection with such a corporate event in certain circumstances. It is the Company's current intent and policy to settle conversions through combination settlement with a specified dollar amount per $1,000 principal amount of notes of $1,000. During the three months ended March 31, 2018 the conditions allowing holders of the 2021 Notes to convert have not been met. The 2021 Notes are therefore not convertible during the three months ended June 30, 2018 and are classified as long-term debt. Should the sale price condition be met in a future quarter, the 2021 Notes will be convertible at the holders' option during the immediately following quarter. As of March 31, 2018, the if-converted value of the 2021 Notes did not exceed the principal value of those notes.

In accounting for the issuance of the convertible senior notes, the Company separated the 2021 Notes into liability and equity components. The carrying amount of the liability component was calculated by measuring the fair value of a similar debt instrument that does not have an associated convertible feature. The carrying amount of the equity component representing the conversion option was $32.9 million and was determined by deducting the fair value of the liability component from the par value of the 2021 Notes. The equity component is not remeasured as long as it continues to meet the conditions for equity classification. The excess of the principal amount of the liability component over its carrying amount ("debt discount") is amortized to interest expense over the term of the 2021 Notes expense at an effective interest rate of 6.29% over the contractual terms of the notes.

In accounting for the debt issuance costs of $6.2 million related to the 2021 Notes, the Company allocated the total amount incurred to the liability and equity components of the 2021 Notes based on their relative values. Issuance costs attributable to the liability component were $5.0 million and will be amortized to interest expense using the effective interest method over the contractual terms of the 2021 Notes. Issuance costs attributable to the equity component were netted with the equity component in stockholders' equity.

The net carrying amount of the liability component of the 2021 Notes was as follows (in thousands):

	March 31, 2018	December 31, 2017
Principal	$ 172,500	$ 172,500

Unamortized discount	(22,162)	(23,737)
Unamortized issuance cost	(3,517)	(3,744)
Net carrying amount	$146,821	$ 145,019

The net carrying amount of the equity component of the 2021 Notes was as follows (in thousands):

	March 31, 2018	December 31, 2017
Debt discount related to value of conversion option	$ 32,945	$ 32,945
Debt issuance cost	(1,179)	(1,179)
Net carrying amount	$ 31,766	$ 31,766

The following table sets forth the interest expense recognized related to the 2021 Notes (in thousands):

	Three Months Ended March 31,	
	2018	2017
Contractual interest expense	$755	$755
Amortization of debt discount	1,575	1,481
Amortization of debt issuance costs	226	200
Total interest expense related to the 2021 Notes	$2,556	$2,436

In connection with the offering of the 2021 Notes, the Company entered into convertible note hedge transactions with certain bank counterparties in which the Company has the option to purchase initially (subject to adjustment for certain specified events) a total of approximately 1.8 million shares of the Company's common stock at a price of approximately $96.37 per share. The total cost of the convertible note hedge transactions was $45.1 million. In addition, the Company sold warrants to certain bank counterparties whereby the holders of the warrants have the option to purchase initially (subject to adjustment for certain specified events) a total of approximately 1.8 million shares of the Company's common stock at a price of $127.28 per share. The Company received $33.1 million in cash proceeds from the sale of these warrants. Taken together, the purchase of the convertible note hedges and the sale of warrants are intended to offset any actual dilution from the conversion of these notes and to effectively increase the overall conversion price from $96.37 to $127.28 per share. As these transactions meet certain accounting criteria, the convertible note hedges and warrants are recorded in stockholders' equity and are not accounted for as derivatives. The net cost of $12.0 million incurred in connection with the convertible note hedge and warrant transactions was recorded as a reduction to additional paid-in capital on the consolidated balance sheet.

8. Net Loss Per Share

The following table summarizes the computation of basic and diluted net loss per share (in thousands, except share and per share data):

	Three Months Ended March 31,	
	2018	2017
Net loss, basic and diluted	$(17,713)	$(14,507)
Weighted average shares outstanding	29,836,277	29,160,611
Less: weighted average shares subject to repurchase	—	(1,102)
Weighted average shares used to compute basic and diluted net loss per share	29,836,277	29,159,509
Net loss per share, basic and diluted	$(0.59)	$(0.50)

Basic net loss per share is computed by dividing the net loss by the weighted average number of common shares outstanding for the period. Diluted net loss per share is computed by dividing the net loss by the weighted average number of common shares and dilutive common stock equivalents outstanding for the period, if inclusion of these is dilutive. Since the Company expects to settle the principal amount of its outstanding convertible senior notes in cash, the Company uses the treasury stock method for calculating any potential dilutive effect of the conversion spread on diluted net income per share, if applicable. The conversion spread will have a dilutive impact on diluted net income per share of common stock when the average market price of the Company's common stock for a given period exceeds the conversion price of $96.37 per share for the 2021 Notes, which has not occurred as of March 31, 2018. In connection with the issuance of the 2021 Notes, the Company entered into convertible bond hedges. The convertible bond hedges are not included for purposes of calculating the number of diluted shares outstanding, as their effect would be anti-dilutive. The convertible bond hedges are generally expected, but not guaranteed, to reduce the potential dilution and/or offset the cash payments the Company is required to make upon conversion of the 2021 Notes. Because the Company has reported a net loss for all periods presented, diluted net loss per common share is the same as basic net loss per common share for those periods.

The following potentially dilutive securities outstanding at the end of the periods presented have been excluded from the computation of diluted shares outstanding, as the effect would be anti-dilutive:

	March 31, 2018	2017
Unreleased restricted stock	697,143	514,060
Options to purchase common stock	2,421,760	2,584,911
Convertible senior notes	1,790,033	1,790,033
Warrants related to the issuance of convertible senior notes	1,790,033	1,790,033
Total	6,698,969	6,679,037

9. Employee Benefit Plans

401(k) Plan

In 2007, the Company adopted a 401(k) plan for its employees whereby eligible employees may contribute up to the maximum amount permitted by the Internal Revenue Code. In June 2016, the Company adopted a policy to match a portion of employee contributions for all qualified employees participating in the 401(k) plan. For the three months ended March 31, 2018 and 2017, the Company recorded an expense of $1.5 million and $1.0 million, respectively, for matching contributions.

Employee Stock Purchase Plan

The Company's 2014 Employee Stock Purchase Plan (ESPP) allows eligible employees to purchase shares of the Company's Class A common stock at a discount through payroll deductions of up to 15% of their eligible compensation, subject to any plan limitations. The ESPP generally provides for six-month offering periods, and at the end of each offering period, employees are able to purchase shares at 85% of the lower of the fair market value of the Company's Class A common stock on the first trading day of the offering period or on the last trading day of the offering period.

No shares of common stock were issued under the ESPP for the three months ended March 31, 2018 and 2017. Shares available for future purchase under the ESPP were 1,134,010 at March 31, 2018.

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

You should read the following management's discussion and analysis of our financial condition and results of operations in conjunction with our unaudited condensed consolidated financial statements and notes thereto included in Part I, Item 1 of this Quarterly Report on Form 10-Q (Quarterly Report) and with our audited consolidated financial statements and notes thereto for the year ended December 31, 2017, included in our Annual Report on Form 10-K filed with the U.S. Securities and Exchange Commission (SEC) on February 22, 2018.

Special note regarding forward-looking statements

This report contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those discussed in the forward-looking statements. The statements contained in this report that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the Securities Act), and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act). Forward-looking statements are often identified by the use of words such as, but not limited to, "anticipate," "believe," "can," "continue," "could," "estimate," "expect," "intend,"

"may," "plan," "project," "seek," "should," "strategy," "target," "will," "would" and similar expressions or variations intended forward-looking statements. These statements are based on the beliefs and assumptions of our management based on information currently available to management. Such forward-looking statements are subject to risks, uncertainties and other important factors that could cause actual results and the timing of certain events to differ materially from future results expressed or implied by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those identified below and those discussed in the section titled "Risk Factors" included under Part II, Item 1A below. Furthermore, such forward-looking statements speak only as of the date of this report. Except as required by law, we undertake no obligation to update any forward-looking statements to reflect events or circumstances after the date of such statements.

Overview

We are a global medical device company focused on providing innovative products that improve the quality of life of patients suffering from chronic pain. We have developed and commercialized the Senza spinal cord stimulation (SCS) system, an evidence-based neuromodulation platform for the treatment of chronic pain. Our proprietary paresthesia-free HF10 therapy, delivered by our Senza system, was demonstrated in our SENZA-RCT study to be superior to traditional SCS therapy, with Senza being nearly twice as successful in treating back pain and 1.5 times as successful in treating leg pain when compared to traditional SCS therapy. Comparatively, traditional SCS therapy has limited efficacy in treating back pain and is used primarily for treating leg pain, limiting its market adoption. Our SENZA-RCT study, along with our European studies, represents what we believe is the most robust body of clinical evidence for any SCS therapy. We believe the superiority of HF10 therapy over traditional SCS therapies will allow us to capitalize on and expand the approximately $2.0 billion existing global SCS market by treating both back and leg pain without paresthesia.

We launched Senza commercially in the United States in May 2015, after receiving a label from the U.S. Food and Drug Administration (FDA) supporting the superiority of our HF10 therapy over traditional SCS. The Senza system has been commercially available in certain European markets since November 2010 and in Australia since August 2011. We have experienced significant revenue growth in the United States since commercial launch. Senza is currently reimbursed by all of the major insurance providers. In early 2017, we commenced a controlled commercial launch of our surgical lead, marketed as the Surpass surgical lead, which we believe will provide us access to approximately an additional 30% of the U.S. SCS market that we previously did not address. In January 2018, we received FDA approval of our next generation Senza II SCS system. The tables below set forth our revenue from U.S. and international sales the past nine quarters on a quarterly basis and total revenue for each of the past three years.

	Q1 2016	Q2 2016	Q3 2016	Q4 2016	Q1 2017	Q2 2017	Q3 2017	Q4 2017	Q1 2018
Revenue from:	(in millions)								
U.S. sales	$29.5	$40.6	$47.2	$56.0	$53.1	$63.0	$66.3	$81.1	$70.6
International sales	12.2	14.8	13.7	14.5	15.3	15.0	16.0	16.9	17.0
Total sales revenue	$41.7	$55.4	$60.9	$70.5	$68.4	$78.0	$82.3	$98.0	$87.6

				Three Months Ended
				March 31,
	2015	2016	2017	2018

	(in millions)			
Total revenue	$69.6	$228.5	$326.7	$ 87.6

Since inception, we have financed our operations primarily through equity and debt financings and borrowings under a debt facility. Our accumulated deficit as of March 31, 2018 was $274.6 million. A significant amount of our capital resources has been used to support the development of Senza and our HF10 therapy and we have also made a significant investment building our U.S. commercial infrastructure and sales force to support our commercialization efforts in the United States. We intend to continue to make significant investments in our U.S. commercial infrastructure, as well as in research and development (R&D) to develop Senza to treat other chronic pain indications, including conducting clinical trials to support our future regulatory submissions. In order to further enhance our R&D efforts, pursue product expansion opportunities or acquire a new business or products that are complementary to our business, we may choose to raise additional funds, which may include future equity and debt financings.

We rely on third-party suppliers for all of the components of Senza and for the assembly of the system. Several of these suppliers are currently single-source suppliers. During 2015, 2016 and 2017, we entered into and/or amended several supply agreements in an effort to reinforce our supply chain. We are also required to maintain high levels of inventory, and, as a result, we are subject to the risk of inventory obsolescence and expiration, which may lead to inventory impairment charges. In particular, we have substantially increased our levels of inventory in order to meet our estimated demand in the United States and, as a result, incur significant expenditures associated with such increases in our inventory. Additionally, as compared to direct manufacturers, our dependence on third-party manufacturers exposes us to greater lead times, increasing our risk of inventory obsolesce.

Our initial public offering (IPO) closed in November 2014 at which time we received cash proceeds of approximately $131.6 million, net of underwriting discounts and commissions and offering costs paid by us. In June 2015, we completed an underwritten public offering of our common stock and we received cash proceeds of approximately $118.4 million, net of underwriting discounts and commissions and offering costs paid by us. In June 2016, we issued $172.5 million aggregate principal amount of 1.75% convertible senior notes due 2021 (the 2021 Notes) in a registered underwritten public offering for total net proceeds, after deducting transaction costs, of approximately $166.2 million.

In November 2016, we filed a lawsuit for patent infringement against Boston Scientific, asserting that Boston Scientific is infringing our patents covering inventions related to our HF10 therapy and the Senza system. In December 2016, Boston Scientific, filed its own lawsuit alleging that we infringed Boston Scientific's patents covering technology related to stimulation leads, batteries and telemetry units. Each of the lawsuits seek preliminary and permanent injunctive relief against further infringement as well as damages and attorney fees. In relation to our defense of Boston Scientific's allegations, we filed a total of ten petitions for inter partes review at the U.S. Patent and Trademark Office (USPTO) against all of Boston Scientific's asserted patents. Specifically, we filed three petitions for inter partes review on July 21, 2017, one petition for inter partes review on July 31, 2017, one petition for inter partes review on August 11, 2017, two petitions for inter partes review on November 2, 2017, two petitions for inter partes review on November 3, 2017, and one petition for inter partes review on November 10, 2017. Every asserted claim in Boston Scientific's lawsuit has thus been petitioned for inter partes review at the USPTO. In April 2018, Boston Scientific filed a patent lawsuit alleging patent infringement, theft of trade secrets, and tortious interference with contract. The lawsuit, filed in the United States District Court for the District of Delaware, seeks unspecified damages and attorney's fees, as well as preliminary and permanent injunctive relief against further infringement. We believe pursuing our lawsuit and defending ourselves against Boston Scientific's lawsuit will continue to require significant cash resources over the immediate and near long term.

Important Factors Affecting our Results of Operations

We believe that the following factors have impacted and we expect will continue to impact our results of operations.

Importance of Physician Awareness and Acceptance of Senza

We continue to invest in programs to educate physicians who treat chronic pain about the advantages of Senza. This requires significant commitment by our marketing team and sales organization, and can vary depending upon the physician's practice specialization, personal preferences and geographic location. Further, we are competing with well-established companies in our industry that have strong existing relationships with many of these physicians. Educating physicians about the advantages of Senza, and influencing these physicians to use Senza to treat chronic pain, is required to grow our revenue.

Reimbursement and Coverage Decisions by Third-Party Payors

Healthcare providers in the United States generally rely on third-party payors, principally federal Medicare, state Medicaid and private health insurance plans, to cover and reimburse all or part of the cost of Senza and the related implant procedure for patients. The revenue we are able to generate from sales of Senza depends in large part on the availability of reimbursement from such payors. While we currently have a favorable reimbursement decision from federal Medicare, decisions of coverage and reimbursement for Senza and the related implant procedure from private health insurance providers can vary. In general, these decisions require that such payors perform analyses to determine if the procedure is medically necessary and if our technology is covered under their existing coverage policies. These payors may deny reimbursement if they determine that the device or procedure was not used in accordance with the payor's coverage policy. A significant component of our commercial efforts includes working with private payors to ensure positive coverage and reimbursement decisions for Senza. Favorable reimbursement decisions from federal Medicare and certain commercial payors, such as Aetna, Cigna, Humana, Blue Cross Blue Shield and Kaiser, have

contributed to our increase in revenue to date, while we continue to engage in efforts to educate payors on the advantages of HF10 therapy. Although the largest commercial payors and federal Medicare cover Senza, there can be no assurance that all private health insurance plans will cover the product. A significant number of negative coverage and reimbursement decisions by private insurers may impair our ability or delay our ability to grow our revenue.

Inventory Buildup and Supply Chain Management

Our Senza product consists of a substantial number of individual components and, in order to market and sell Senza effectively, we must maintain high levels of inventory. In particular, since our commercial launch of Senza in the United States, we have continued to add suppliers to fortify our supply chain and we have substantially increased our levels of inventory. As a result, a significant amount of our cash used in operations has been associated with the increases in our inventory, as demand for Senza in the United States is developing. There may also be times in which we determine that our inventory does not meet our product requirements, as was the case for the year ended December 31, 2017, wherein we recorded a write down of inventory of $3.6 million. We have not recorded any material write downs of inventory in 2018. Further, the manufacturing process for Senza requires lengthy

lead times, during which components may become obsolete. We may also over- or under-estimate the quantities of required components, in which case we may expend extra resources or be constrained in the amount of end product that we can produce. These factors subject us to the risk of inventory obsolescence and expiration, which may lead to inventory impairment charges.

Investment in Research and Clinical Trials

We intend to continue investing in R&D to expand into new indications and chronic pain conditions for Senza, as well as develop product enhancements to improve outcomes and enhance the physician and patient experience. For example, in early 2017, we commenced a controlled commercial launch of Surpass, our surgical lead product, and we are continuing to invest in product improvements to Senza, including enhanced MRI capabilities and a next generation IPG. While R&D and clinical testing are time consuming and costly, we believe expanding into new indications, implementing product improvements and continuing to demonstrate HF10 efficacy, safety and cost effectiveness through clinical data are all critical to increasing the adoption of HF10 therapy.

Significant Investment in U.S. Sales Organization

We are continuing to make significant investments in building our U.S. commercial infrastructure and recruiting and training our U.S. sales force. This is a lengthy process that requires recruiting appropriate sales representatives, establishing a commercial infrastructure in the United States and training our sales representatives, and will continue to require significant investment. Following initial training for Senza, our sales representatives typically require lead time in the field to grow their network of accounts and produce sales results. Successfully recruiting and training a sufficient number of productive sales representatives is required to achieve growth at the rate we expect. As we gain U.S. market share, we expect that growth rates will moderate.

Access to Hospital Facilities

In the United States, in order for physicians to use Senza, the hospital facilities where these physicians treat patients typically require us to enter into purchasing contracts. This process can be lengthy and time-consuming and requires extensive negotiations and management time. In Europe, we may be required to engage in a contract bidding process in order to sell Senza, where the bidding processes are only open at certain periods of time, and we may not be successful in the bidding process.

We Do Not Expect Our Worldwide Revenue Growth Rate to Continue at Historic Rates

Our worldwide revenue has increased from $23.5 million for the year ended December 31, 2013 to $326.7 million for the year ended December 31, 2017. Since May 2015 when we commenced the commercial launch of Senza in the U.S., our worldwide revenue growth has been substantially driven by sales of Senza in the United States. In addition, over the past two years, our revenue growth in international markets has slowed significantly. Despite the significant growth in sales in the U.S., we do not expect to continue this historic rate of revenue growth in the U.S. or on a worldwide basis. Further, due to governmental reimbursement constraints in the European SCS market limiting the number of annual SCS implants and our current penetration in these markets, we expect to grow less rapidly in the future than we have in the past in this market.

Critical Accounting Policies, Significant Judgments and Use of Estimates

Our management’s discussion and analysis of financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP). The preparation of these consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. On an ongoing basis, we evaluate our critical accounting policies and estimates. We base our estimates on

historical experience and on various other assumptions that we believe to be reasonable in the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions and conditions. Our significant accounting policies are more fully described in Note 2 of the accompanying unaudited condensed consolidated financial statements. Other than the adoption of ASC 606, Revenue Recognition, there have been no other significant or material changes in our critical accounting policies during the three months ended March 31, 2018.

Components of Results of Operations

Revenue

Our revenue is generated primarily from sales to two types of customers: hospitals and outpatient medical facilities, with each being served primarily through a direct sales force. Sales to these entities are billed to, and paid by, the hospitals and outpatient medical facilities as part of their normal payment processes, with payment received by us in the form of an electronic transfer, check

or credit card payment. Product sales to third-party distributors are billed to and paid by the distributors as part of their normal payment processes, with payment received by us in the form of an electronic transfer.

Revenue from sales of Senza fluctuate based on the selling price of the system, as the average sales price of a system varies geographically, and based on the mix of sales by geography. In addition, our revenue may fluctuate based on the ratio of trials to permanent implants. Our revenue from international sales can also be significantly impacted by fluctuations in foreign currency exchange rates, as our sales are denominated in the local currency in the countries in which we sell our products.

We expect our revenue to fluctuate from quarter to quarter due to a variety of factors, including seasonality. For example, the industry generally experiences lower revenues in the first and third quarters of the year, and higher revenues in the fourth quarter. As we grow, we expect our revenue to experience these industry trends. Further, the impact of the buying patterns and implant volumes of hospitals and medical facilities, and third-party distributors may vary, and as a result could have an effect on our revenue from quarter to quarter. In addition, in the second quarter of 2015, we commenced commercial sales of Senza in the United States and recorded revenue of approximately $263.5 million, $173.3 million and $24.4 million for the years ended December 31, 2017, 2016 and 2015, respectively, for sales in the United States. We anticipate that our total revenue will increase as we continue our commercialization in the United States.

Cost of Revenue

We utilize contract manufacturers for the production of Senza. Cost of revenue consists primarily of acquisition costs of the components of Senza, allocated manufacturing overhead, royalty payments, scrap and inventory obsolescence, as well as distribution-related expenses, such as logistics and shipping costs, net of costs charged to customers.

We calculate gross margin as revenue less cost of revenue divided by revenue. Our gross margin has been and will continue to be affected by a variety of factors, but it is primarily affected by the costs to have our products manufactured and the period of time between a trial and the related permanent implant. While costs are primarily incurred in U.S. dollars, international revenue may be impacted by the appreciation or depreciation of the U.S. dollar, which may impact our overall gross margin. We expect our gross margin to be positively affected over time to the extent we are successful in reducing manufacturing costs as our sales volume increases. However, our gross margin may fluctuate from period to period.

Operating Expenses

Our operating expenses consist of R&D expense, and sales, general and administrative (SG&A) expense. Personnel costs are the most significant component of operating expenses and consist primarily of salaries, bonus incentives, benefits, stock-based compensation and sales commissions. We expect operating expenses to increase in absolute dollars, as we continue to invest in growing our business.

Research and Development. R&D costs are expensed as incurred. R&D expense consists primarily of personnel costs, including salary, employee benefits and stock-based compensation expenses for our R&D employees. R&D expense also includes costs associated with product design efforts, development prototypes, testing, clinical trial programs and regulatory activities, contractors and consultants, equipment and software to support our development, facilities and information technology. We expect R&D expense to increase in absolute dollars as we continue to develop product enhancements to Senza and develop our HF10 therapy to treat other chronic pain indications, including conducting additional clinical studies for other indications such as chronic upper limb and neck pain, painful neuropathies and non-surgical refractory back pain. Our R&D expenses may fluctuate from period to period due to the timing and extent of our R&D and clinical trial expenses.

Sales, General and Administrative. SG&A expense consists primarily of personnel costs, including salary, employee benefits and stock-based compensation expenses for our sales and marketing personnel, including sales commissions, and for administrative personnel that support our general operations, such as information technology, executive management, financial accounting, customer services and human resources personnel. We expense commissions at the time of the sale. SG&A expense also includes costs attributable to marketing, as well as travel, intellectual property and other legal fees, financial audit fees, insurance, fees for other consulting services, depreciation and facilities.

In the last three years, we significantly increased the size of our sales presence worldwide and have increased marketing spending in order to generate additional sales opportunities. Additionally, we have made substantial investments in our U.S. commercial infrastructure to support our commercialization efforts in the United States. We expect SG&A expenses to continue to increase in absolute dollars as we build up our sales and marketing personnel to support commercialization of Senza in the United States, continue to increase the size of our sales and marketing organizations and increase our international presence and develop and assist our channel partners.

Our SG&A expenses have increased significantly compared to the same period in the prior year. During 2017 and through the first quarter of 2018, we had a significant increase in SG&A headcount and experienced a significant increase in legal expenses associated with our ongoing intellectual property litigation with Boston Scientific. We anticipate significant continued expenses associated with these legal activities. We also expect our administrative expenses to continue to increase as we increase our headcount and expand our facility and information technology to support our growing operations. Additionally, we continue to incur significant expenses related to audit, legal, regulatory and tax-related services associated with maintaining compliance with exchange listing and SEC requirements, including compliance under the Sarbanes-Oxley Act of 2002 (the Sarbanes-Oxley Act) as a large accelerated filer, director and officer insurance premiums and investor relations costs associated with being a growing public company. Our SG&A expense may fluctuate from period to period due to the seasonality of our revenue and the timing and extent of our SG&A expense.

Interest Income and Interest Expense

Interest income consists primarily of interest income earned on our investments and interest expense consists of interest paid on our outstanding debt and the amortization of debt discount and debt issuance costs.

Other Income (Expense), Net

Other income (expense), net consists primarily of foreign currency transaction gains and losses and the gains and losses from the remeasurement of foreign-denominated balances to the U.S. dollar.

Provision for Income Taxes

The provision for income taxes consists primarily of income taxes in foreign jurisdictions in which we conduct business as well as states where we have determined we have state nexus. We maintain a full valuation allowance for our deferred tax assets including net operating loss (NOL) carryforwards and R&D credits and other tax credits.

Allowance for Doubtful Accounts

We make estimates as to the overall collectability of accounts receivable and provide an allowance for accounts receivable considered uncollectible. We specifically analyze accounts receivable based on historical bad debt experience, customer concentrations, customer credit-worthiness, the age of the receivable, current economic trends, and changes in customer payment terms when evaluating the adequacy of the allowance for doubtful accounts. We record the adjustment in general and administrative expense.

Consolidated Results of Operations

Comparison of the three months ended March 31, 2018 and 2017

Revenue, Cost of Revenue, Gross Profit and Gross Margin

	Three Months Ended March 31,		
	2018	2017	Change
(in thousands)			
Revenue	$87,635	$68,439	$19,196
Cost of revenue	25,634	22,071	3,563
Gross profit	$62,001	$46,368	$15,633

Gross margin	71%	68%	3%

Revenue. Revenue increased to $87.6 million in the three months ended March 31, 2018 from $68.4 million in the three months ended March 31, 2017, an increase of approximately $19.2 million, or 28%. The revenue increase was primarily due to a period over period increase of Senza system sales in the United States, which was $70.6 million in the three months ended March 31, 2018, compared to $53.1 million in the three months ended March 31, 2017, as well as continued adoption of the Senza system in our international markets.

Cost of Revenue, Gross Profit and Gross Margin. Cost of revenue increased to $25.6 million in the three months ended March 31, 2018 from $22.1 million in the three months ended March 31, 2017, an increase of approximately $3.6 million, or 16%. This was primarily due to a $5.5 million increase in the costs of manufactured product components as sales volumes increased in the most recent period, offset by a decrease of $2.2 million in charges for inventory-related write-downs. Gross profit increased to $62.0 million in the three months ended March 31, 2018 from $46.4 million in the three months ended March 31, 2017, an increase of $15.6 million, or 34%. Gross profit as a percentage of revenue, or gross margin, increased to 71% in the three months ended March 31,

2018, compared to 68% in the three months ended March 31, 2017. The gross margin increase is primarily attributed to a decrease in charges for inventory-related write-downs.

Operating Expenses

	Three Months Ended March 31,