SURMODICS INC
Form 10-Q
August 09, 2007

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**UNITED STATES**
**SECURITIES AND EXCHANGE COMMISSION**
**Washington, D. C. 20549**
**FORM 10-Q**

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

**For the quarterly period ended June 30, 2007**

**OR**

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

**For the transition period from _____ to _____**

**Commission File Number 0-23837**

**SurModics, Inc.**

(Exact name of registrant as specified in its Charter)

| MINNESOTA | 41-1356149 |
|---|---|
| (State of incorporation) | (I.R.S. Employer Identification No.) |

9924 West 74th Street
Eden Prairie, Minnesota 55344
(Address of principal executive offices)

Registrant s telephone number, including area code: (952) 829-2700

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 þ No o

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

Large accelerated filer o Accelerated filer þ Non-accelerated filer o

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

Yes o No þ

The number of shares of the registrant s Common Stock, $.05 par value per share, outstanding as of July 31, 2007 was 17,995,294.

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**PART I. FINANCIAL INFORMATION**

**SURMODICS, INC.**
Condensed Balance Sheets
(In thousands, except share data)

| | June 30, 2007 (unaudited) | September 30, 2006 |
|---|---|---|
| **ASSETS** | | |
| Current Assets | | |
| Cash and cash equivalents | $ 3,960 | $ 3,751 |
| Short-term investments | 42,343 | 55,062 |
| Accounts receivable, net | 30,460 | 14,493 |
| Inventories | 1,259 | 952 |
| Deferred tax asset | 496 | 435 |
| Income tax receivable | 483 | |
| Prepaids and other | 1,754 | 1,403 |
| Total current assets | 80,755 | 76,096 |
| Property and equipment, net | 11,447 | 11,686 |
| Long-term investments | 47,785 | 47,758 |
| Deferred tax asset | 3,268 | 4,883 |
| Other assets, net | 21,603 | 16,979 |
| Total Assets | $ 164,858 | $ 157,402 |
| **LIABILITIES AND STOCKHOLDERS EQUITY** | | |
| Current Liabilities | | |
| Accounts payable | $ 1,013 | $ 963 |
| Accrued liabilities | 1,470 | 2,880 |
| Accrued income taxes payable | | 1,910 |
| Deferred revenue | 3,654 | 2,236 |
| Other current liabilities | 1,000 | 1,000 |
| Total current liabilities | 7,137 | 8,989 |
| Deferred revenue, less current portion | 20,175 | 2,210 |
| Other long-term liabilities | | 1,000 |
| Total Liabilities | 27,312 | 12,199 |
| Commitments and contingencies (Note 11) | | |
| Stockholders Equity | | |
| Series A Preferred stock- $.05 par value, 450,000 shares authorized; no shares issued and outstanding | | |
| Common stock- $.05 par value, 45,000,000 shares authorized; 17,979,280 and 18,830,455 shares issued and outstanding | 899 | 942 |

| | | |
|---|---|---|
| Additional paid-in capital | 68,728 | 96,281 |
| Accumulated other comprehensive income (loss) | 2,393 | (293) |
| Retained earnings | 65,526 | 48,273 |
| Total Stockholders Equity | 137,546 | 145,203 |
| Total Liabilities and Stockholders Equity | $ 164,858 | $ 157,402 |

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

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**Item 1. Financial Statements**

**SURMODICS, INC.**
Condensed Statements of Income
(In thousands, except per share data)
(unaudited)

| | Three Months Ended June 30 | | Nine Months Ended June 30 | |
|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 |
| Revenue | | | | |
| Royalties and license fees | $ 13,416 | $ 13,948 | $ 39,664 | $ 39,514 |
| Product sales | 2,947 | 2,659 | 9,054 | 7,914 |
| Research and development | 1,399 | 1,532 | 3,147 | 4,883 |
| Total revenue | 17,762 | 18,139 | 51,865 | 52,311 |
| Operating costs and expenses | | | | |
| Product | 1,217 | 891 | 3,396 | 2,441 |
| Research and development | 6,200 | 5,281 | 17,124 | 14,935 |
| Sales and marketing | 343 | 348 | 989 | 1,052 |
| General and administrative | 2,484 | 2,156 | 6,644 | 6,887 |
| Total operating costs and expenses | 10,244 | 8,676 | 28,153 | 25,315 |
| Income from operations | 7,518 | 9,463 | 23,712 | 26,996 |
| Other income | | | | |
| Investment income | 1,211 | 1,113 | 3,731 | 2,894 |
| Impairment loss | | | | (4,651) |
| Other loss | (10) | (11) | (29) | (112) |
| Other income (loss) | 1,201 | 1,102 | 3,702 | (1,869) |
| Income before income taxes | 8,719 | 10,565 | 27,414 | 25,127 |
| Income tax provision | (3,132) | (4,207) | (10,161) | (11,087) |
| Net income | $ 5,587 | $ 6,358 | $ 17,253 | $ 14,040 |
| Basic net income per share | $ 0.31 | $ 0.34 | $ 0.95 | $ 0.76 |
| Diluted net income per share | $ 0.31 | $ 0.34 | $ 0.95 | $ 0.75 |
| Weighted average shares outstanding | | | | |
| Basic | 17,815 | 18,570 | 18,116 | 18,494 |
| Dilutive effect of outstanding stock options | 153 | 155 | 133 | 187 |
| Diluted | 17,968 | 18,725 | 18,249 | 18,681 |

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

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**SURMODICS, INC.**
Condensed Statements of Cash Flows
(In thousands)
(unaudited)

| | Nine months ended June 30, | |
|---|---|---|
| | 2007 | 2006 |
| Operating Activities | | |
| Net income | $ 17,253 | $ 14,040 |
| Adjustments to reconcile net income to net cash provided by operating activities- | | |
| Depreciation and amortization | 2,923 | 2,726 |
| Loss on equity method investment and sales of investments | 29 | 112 |
| Amortization of discount on investments | (1,354) | (941) |
| Noncash compensation | 5,035 | 4,358 |
| Tax benefit from exercise of stock options | | (116) |
| Impairment loss | | 4,651 |
| Deferred taxes | (106) | (758) |
| Other | | 24 |
| Loss on disposals of property and equipment | 370 | 83 |
| Change in operating assets and liabilities: | | |
| Accounts receivable | 4,033 | (866) |
| Inventories | (307) | (24) |
| Accounts payable and accrued liabilities | (701) | (789) |
| Income taxes | (2,393) | 4,574 |
| Deferred revenue | (683) | (120) |
| Prepaids and other | (502) | 120 |
| Net cash provided by operating activities | 23,597 | 27,074 |
| Investing Activities | | |
| Purchases of property and equipment | (2,054) | (5,300) |
| Proceeds from sales of property and equipment | 36 | 0 |
| Purchases of available-for-sale investments | (131,971) | (135,609) |
| Sales/maturities of available-for-sale investments | 146,208 | 110,357 |
| Purchase of licenses and patents | (1,224) | (906) |
| Purchase of equity in OctoPlus, Novocell and other | (2,147) | (160) |
| Repayment of notes receivable | 395 | |
| Net cash provided by (used in) investing activities | 9,243 | (31,618) |
| Financing Activities | | |
| Tax benefit from exercise of stock options | | 116 |
| Issuance of common stock | 2,399 | 2,377 |
| Repurchase of common stock | (35,030) | |
| Net cash (used in) provided by financing activities | (32,631) | 2,493 |

| | | |
|---|---|---|
| Net change in cash and cash equivalents | 209 | (2,051) |
| Cash and Cash Equivalents | | |
| Beginning of period | 3,751 | 3,921 |
| End of period | $ 3,960 | $ 1,870 |
| Cash paid for income taxes | $ 12,606 | $ 7,365 |
| Noncash transaction-acquisition of property, plant, and equipment on account | $ 330 | $ 1,043 |
| Accrual of deferred Merck license revenue | $ 20,000 | |

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

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**SURMODICS, INC.**
**Notes to Condensed Financial Statements**
**Period Ended June 30, 2007**
**(Unaudited)**

**(1) Basis of Presentation**

In the opinion of management, the accompanying unaudited condensed financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and reflect all adjustments, consisting solely of normal recurring adjustments, needed to fairly present the financial results for the interim periods presented. These financial statements include some amounts that are based on management s best estimates and judgments. These estimates may be adjusted as more information becomes available, and any adjustment could be significant. The impact of any change in estimates is included in the determination of earnings in the period in which the change in estimate is identified. The results of operations for the three month period ended June 30, 2007 are not necessarily indicative of the results that may be expected for the entire 2007 fiscal year.

In accordance with the rules and regulations of the United States Securities and Exchange Commission, the Company has omitted footnote disclosures that would substantially duplicate the disclosures contained in the audited financial statements of the Company. These unaudited condensed financial statements should be read together with the audited financial statements for the year ended September 30, 2006, and footnotes thereto included in the Company s Form 10-K as filed with the United States Securities and Exchange Commission on December 14, 2006.

**(2) New Accounting Pronouncements**

On July 13, 2006, Financial Accounting Standards Board ( FASB ) Interpretation ( FIN ) No. 48, Accounting for Uncertainty in Income Taxes - an Interpretation of FASB Statement No. 109, was issued. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. FIN 48 also prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The new FASB standard also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. The provisions of FIN 48 are effective for the Company in fiscal 2008. The Company is currently evaluating the effect that the adoption of FIN 48 will have on its results of operations and financial condition.

In September 2006, FASB issued Statement of Financial Accounting Standards ( SFAS ) No. 157 ( SFAS No. 157 ), Fair Value Measurements. This statement establishes a consistent framework for measuring fair value and expands disclosures on fair value measurements. SFAS No. 157 is effective for the Company starting in fiscal 2008. We have not determined the impact, if any, the adoption of this statement will have on our consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities ( SFAS No. 159 ). SFAS No. 159 permits entities to choose to measure many financial assets and financial liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected will be reported in earnings. SFAS No. 159 is effective for the Company in fiscal 2009. We are currently evaluating the impact of SFAS No. 159 on our consolidated financial position and results of operations.

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**(3) Other Assets**

Other assets consist principally of investments in marketable securities, a note receivable and acquired patents. The balance in other assets increased primarily as a result of an additional investment in OctoPlus N.V. and the increased market value of OctoPlus during the year. In October 2006, we made an additional investment of $1.9 million in OctoPlus, a company based in the Netherlands active in the development of pharmaceutical formulations incorporating novel biodegradable polymers. Also in October 2006, OctoPlus common stock began trading on an international exchange following an initial public offering of its common stock. With a readily determinable fair market value, the Company now treats the investment in OctoPlus as an available-for-sale investment rather than a cost method investment. Available-for-sale investments are reported at fair value with unrealized gains and losses excluded from operations and reported as a separate component of stockholders equity, except for other-than-temporary impairments, which are reported as a charge to current operations and result in a new cost basis for the investment. Our investment in OctoPlus represents an ownership interest of less than 20%.

In September 2005, we entered into an agreement to sell a contract manufacturing facility and 27 acres of land located in Bloomington, Minnesota. The terms of the sale agreement included a $100,000 cash down payment and a note receivable of $6.9 million, which is collateralized by the property. The terms of the note call for monthly installment payments of principal and interest at 6% with the remaining amount due and payable in September 2010. The $5.3 million balance in other assets represents the long-term portion due on the note.

On July 10, 2007, we made a $3.5 million equity investment in Paragon Intellectual Properties, LLC and its wholly owned subsidiary Apollo Therapeutics, LLC. In addition to the equity investment, we entered into a licensing agreement with Apollo Therapeutics, LLC whereby we will provide coating technology. See Note 12.

The Company recorded amortization expense of $443,000 and $1.3 million for the three and nine months ended June 30, 2007, respectively. We expect to incur approximately $1.8 million of amortization each year in fiscal years 2007 and 2008, $503,000 in fiscal 2009, and $85,000 in fiscal years 2010 through 2012. Management does not believe an other-than-temporary impairment existed as of June 30, 2007, with respect to its existing investments. Other assets consisted of the following:

| *(in thousands)* | June 30, 2007 | September 30, 2006 |
|---|---|---|
| Abbott license | $ 7,037 | $ 7,037 |
| Note receivable (long-term portion) | 5,280 | 5,635 |
| Investment in Novocell | 559 | 559 |
| Investment in OctoPlus | 10,331 | 4,095 |
| Investment in ThermopeutiX | 1,185 | 1,000 |
| Patents and other | 2,051 | 2,262 |
| Less-accumulated amortization | (4,840) | (3,609) |
| Other assets, net | $ 21,603 | $ 16,979 |

**(4) Accounts Receivable**

Accounts receivable at June 30, 2007 includes a $20 million up front licensing fee due from Merck & Co., Inc. ( Merck ). Merck paid the licensing fee on July 20, 2007. See Note 10.

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**(5) Inventories**

Inventories are stated at the lower of cost or market using the specific identification method and include direct labor, materials and overhead. Inventories consisted of the following components:

| *(in thousands)* | June 30, 2007 | September 30, 2006 |
|---|---|---|
| Raw materials | $ 642 | $ 512 |
| Finished goods | 617 | 440 |
| | $ 1,259 | $ 952 |

**(6) Operating Segments**

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker, or decision making group, in deciding how to allocate resources and in assessing performance.

SurModics manages its business on the basis of the operating segments noted in the table below, which are composed of the Company s six business units. The three operating segments are aggregated into one reportable segment. The Drug Delivery operating segment contains: (1) the Drug Delivery business unit and (2) the Ophthalmology division. The Hydrophilic and Other operating segment consists of three business units: (1) Hydrophilic Technologies, (2) Regenerative Technologies, and (3) Orthopedics. The In Vitro operating segment contains the In Vitro Technologies (formerly Diagnostics and Drug Discovery) business unit. Each operating segment has similar economic characteristics, technology, manufacturing processes, customers, regulatory environments, and shared infrastructures. The Company manages its expenses on a company-wide basis, as many costs and activities are shared among the business units and a majority of the Company s employees reside in shared resource units. The focus of the business units is to provide solutions to customers and maximizing revenue over the long-term. The accounting policies for segment reporting are the same as for the Company as a whole. The table below presents revenue from the three operating segments.

| | Three months ended June 30, | | Nine months ended June 30, | |
|---|---|---|---|---|
| *(in thousands)* | 2007 | 2006 | 2007 | 2006 |
| Operating segment: | | | | |
| Drug Delivery | $ 5,772 | $ 8,647 | $ 18,607 | $ 25,580 |
| Hydrophilic and Other | 6,897 | 5,522 | 18,720 | 15,988 |
| In Vitro | 5,093 | 3,970 | 14,538 | 10,743 |
| Total revenue | $ 17,762 | $ 18,139 | $ 51,865 | $ 52,311 |

**(7) Stock-based Compensation**

Commencing October 1, 2005, the Company adopted Statement of Financial Accounting Standards No. 123(R), Share Based Payment ( SFAS 123(R) ), which requires all share-based payments, including grants of stock options, to be recognized in the income statement as an operating expense, based on their fair values, over the requisite service period. The Company recorded $2.2 million and $5.0 million of related compensation expense, before taxes, for the three and nine months ended June 30, 2007, respectively. The Company recorded $1.6 million and $4.4 million of related compensation expense, before taxes, for the three and nine months ended June 30, 2006, respectively.

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The Company uses the Black-Scholes option pricing model to determine the weighted average fair value of options. The weighted average fair value of options granted during the three month periods ended June 30, 2007 and 2006 were $16.41 and $14.37, respectively. The fair market value of each option is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions for the three months ended June 30, 2007 and June 30, 2006, respectively: risk-free interest rates of 4.61% and 5.04%; expected lives of 5.0 years and 4.6 years; and expected volatility of 41% and 42%. The weighted average fair value of options granted during the nine month periods ended June 30, 2007 and 2006 were $16.55 and $17.55, respectively. The following weighted-average assumptions were used for the nine months ended June 30, 2007 and June 30, 2006, respectively: risk-free interest rates of 4.64% and 4.67%; expected lives of 5.7 years and 4.9 years; and expected volatility of 49% and 48%.

The Company s Incentive Stock Options ( ISO ) are granted at a price of at least 100% of the fair market value of the Common Stock on the date of the grant or 110% with respect to optionees who own more than 10% of the total combined voting power of all classes of stock. Options generally expire in seven years or upon termination of employment and are exercisable at a rate of 20% per year commencing one year after the date of grant. Nonqualified stock options are also granted at fair market value on the date of grant. Options generally expire in 3 to 10 years and are exercisable at rates of 20% per year from the date of grant or 20% to 33% per year commencing one year after the date of grant.

***Restricted Stock Awards***

The Company has entered into restricted stock agreements with certain key employees, covering the issuance of Common Stock ( Restricted Stock ). The Restricted Stock will be released to the key employees if they are employed by the Company at the end of the vesting period. Compensation has been recognized for the estimated fair value of the 148,664 unvested common shares and is being charged to income over the vesting term. Stock compensation expense recognized related to these awards totaled $292,000 and $324,000 during the three month periods ended June 30, 2007 and 2006, respectively. Stock compensation expense recognized related to these awards totaled $848,000 and $648,000 during the nine month periods ended June 30, 2007 and 2006, respectively.

***Performance Share Awards***

The Company has entered into Performance Share agreements with certain key employees, covering the issuance of Common Stock ( Performance Shares ). The Performance Shares will vest upon the achievement of all or a portion of certain performance objectives which must be achieved during the performance period. Stock compensation expense related to the Performance Share awards expected to vest totaled $667,000 and $183,000 during the three month periods ended June 30, 2007 and 2006, respectively. Stock compensation expense related to these awards totaled $805,000 and $540,000 during the nine month periods ended June 30, 2007 and 2006, respectively.

***1999 Employee Stock Purchase Plan***

Under the 1999 Employee Stock Purchase Plan ( Stock Purchase Plan ) the Company is authorized to issue up to 200,000 shares of Common Stock. All full-time and part-time employees can choose to have up to 10% of their annual compensation withheld to purchase the Company s Common Stock at purchase prices defined within the provisions of the Stock Purchase Plan. As of June 30, 2007, there was approximately $184,000 of employee contributions included in accrued liabilities in the accompanying balance sheets. Stock compensation

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expense recognized related to Stock Purchase Plan totaled $38,000 and $40,000 during the three month periods ended June 30, 2007 and 2006, respectively and totaled $118,000 and $123,000 during the nine month periods ended June 30, 2007 and 2006, respectively.

**(8) Comprehensive Income**

The components of comprehensive income are as follows:

| | Three months ended June 30, | | Nine months ended June 30, | |
|---|---|---|---|---|
| *(in thousands)* | 2007 | 2006 | 2007 | 2006 |
| Net income | $ 5,587 | $ 6,358 | $ 17,253 | $ 14,040 |
| Other comprehensive income: | | | | |
| Unrealized holding gains (losses) on available-for-sale securities arising during the period, net of tax | (173) | (90) | 2,668 | (359) |
| Add reclassification adjustment for realized losses included in net income, net of tax | 6 | 7 | 18 | 70 |
| Other comprehensive income (loss) | (167) | (83) | 2,686 | (289) |
| Comprehensive income | $ 5,420 | $ 6,275 | $ 19,939 | $ 13,751 |

**(9) Share Repurchases**

In September 2006, the Board of Directors of the Company authorized the repurchase of $35 million and up to 1 million shares of SurModics common stock. In January 2007, the authorization was amended to provide for repurchases up to an aggregate cost not to exceed $35 million without restriction as to the number of shares repurchased. During the nine months ended June 30, 2007, the Company repurchased a total of 1,007,752 shares for $35 million at an average price of $34.76 per share. By the end of second quarter of fiscal 2007, the Company had purchased all the shares authorized under the repurchase program approved in September 2006 and amended in January 2007.

**(10) Arrangement with Merck & Co., Inc.**

On June 27, 2007 the Company announced a license and research collaboration agreement with Merck. The agreement calls for SurModics and Merck to pursue the joint development and commercialization of SurModics I-vation sustained drug delivery system with TA (Triamcinolone acetonide) and other products combining certain of Merck s proprietary drug compounds and the I-vation system for the treatment of serious retinal diseases. Under the terms of the agreement, Merck will lead and fund development and commercialization activities. SurModics received an up front licensing fee of $20 million and will be eligible to receive up to an additional $288 million in fees and development milestones. In addition Merck will reimburse SurModics for its development activities, and the Company will be responsible for the manufacture and supply of the jointly developed products. The Company will also receive royalties on product sales. The $20 million up front license fee was reported in accounts receivable and deferred revenue as of June 30, 2007. The Company will recognize the revenue from the up-front license fee over the life of the Merck agreement. SurModics received the $20 million license fee payment on July 20, 2007.

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**(11) Commitments and Contingencies**

On May 22, 2007, the former Stockholders of InnoRx (the Plaintiffs ) filed a declaratory judgment action (the Declaratory Judgment ) in the U.S. District Court for the Southern District of Alabama against Michael Cooney, M.D. ( Dr. Cooney ) of New York, New York. In the litigation, the Plaintiffs are seeking a determination that Dr. Cooney was not a co-founder of InnoRx, and further that he was not an inventor of certain patent rights covering technology for delivering drugs to the eye, including certain patent rights exclusively licensed by the Johns Hopkins University to InnoRx (collectively, the Patent Rights ), and now controlled by the Company as successor-in-interest to InnoRx pursuant to an agreement of merger between the Company and InnoRx made effective on January 18, 2005 (the Merger Agreement ). The Company is not a party to the litigation.

On June 8, 2007, the Company was named as a defendant in litigation filed in the U.S. District Court for the District of Minnesota by Dr. Cooney. JHU and certain former shareholders of InnoRx, among others, were also named as defendants. The complaint alleges that Dr. Cooney was a co-founder of InnoRx and an inventor of subject matter claimed in the Patent Rights. The complaint seeks an order correcting inventorship, and certain unspecified damages (including punitive damages) based on claims of unjust enrichment, fraud, and breach of fiduciary duties. A trial has not yet been scheduled. Pursuant to the Merger Agreement, the Company has submitted a demand for indemnification of losses (including without limitation, damages, expenses and costs) incurred as a result of the litigation involving Dr. Cooney, including both the Alabama and Minnesota cases described above.

On June 18, 2007, the Company was named as an involuntary plaintiff in patent litigation between Abbott Laboratories ( Abbott ) and Church & Dwight, Inc. ( Church & Dwight ). In the litigation, Abbott is alleging that certain of Church & Dwight s products utilizing lateral flow technology for diagnostic purposes infringe certain of the Company s patents that have been exclusively licensed to Abbott under the terms of a license agreement between the Company and Abbott dated May 30, 1989, as amended and restated (the License Agreement ). The suit was filed in the U.S. District Court for the Northern District of Illinois seeking a finding of infringement, monetary damages and injunctive relief. Pursuant to the terms of the License Agreement, Abbott is responsible for reimbursing the Company for at least a portion of its costs and fees incurred in connection with the suit. A trial has not yet been scheduled.

**(12) Subsequent Events**

On July 10, 2007 the Company announced its equity investment in Paragon Intellectual Properties, LLC ( Paragon ) and an equity investment in Apollo Therapeutics, LLC ( Apollo ), a Paragon subsidiary. The Paragon and Apollo investments totaled $3.5 million. The arrangement calls for SurModics to invest additional equity totaling $2.5 million upon successful completion of specified development milestones. The investment in Paragon represents an ownership interest of less than 20% and the investment in Apollo represents an ownership interest of less than 20%.

On July 31, 2007 the Company entered into a stock purchase agreement with Southern Research Institute whereby it acquired 100% of the capital stock of Brookwood Pharmaceuticals, Inc. ( Brookwood ) held by Southern Research Institute for $40 million in cash on the closing date and up to an additional $22 million in cash upon the successful achievement of specified milestones. Brookwood is a drug delivery company based in Birmingham, Alabama that provides proprietary polymer based technologies to companies developing pharmaceutical products. The Company is evaluating the purchase price allocation and expects to write off a portion of the purchase price as purchased research and development in its fourth quarter of fiscal 2007. Brookwood, a wholly owned subsidiary of SurModics, will operate as a separate business unit.

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

**Overview**

SurModics is a leading provider of surface modification and drug delivery technologies to the healthcare industry. The Company is organized into three operating segments composed of six technology-centered and industry-focused business units. The Drug Delivery operating segment contains: (1) the Drug Delivery business unit, which is responsible for technologies dedicated to site-specific delivery of drugs, and (2) the Ophthalmology division, which is dedicated to the advancement of treatments for eye diseases, such as age-related macular degeneration (AMD) and diabetic macular edema (DME), two of the leading causes of blindness. The Hydrophilic and Other operating segment consists of three business units: (1) Hydrophilic Technologies business unit, which focuses on enhancing medical devices with advanced lubricious coatings that facilitate their placement and maneuverability in the body; (2) Regenerative Technologies business unit, which is developing platforms intended to augment or replace tissue/organ function (e.g., cell encapsulation applications), or to modify medical devices to facilitate tissue/organ recovery through natural repair mechanisms (e.g., biocompatible or prohealing coatings); and (3) Orthopedics business unit, which is committed to innovative solutions for orthopedics patients using proven SurModics technologies, and creating new technology solutions to existing patient care gaps in the orthopedics field. The In Vitro operating segment contains the In Vitro Technologies (formerly Diagnostics and Drug Discovery) business unit, which includes our genomics slide technologies, our stabilization and antigen products for immunoassay diagnostic tests, our in vitro diagnostic format technology and our synthetic cell culture products.

Revenue in each of our operating segments is derived from three primary sources: (1) royalties and license fees from licensing our patented surface modification and drug delivery technologies and in vitro diagnostic formats to customers; the vast majority (typically in excess of 90%) of revenue in the royalties and license fees category is in the form of royalties; (2) the sale of reagent chemicals to licensees of our technologies, stabilization products to the diagnostics industry and coated glass slides to the genomics market; and (3) research and development fees generated on customer projects. Revenue should be expected to fluctuate from quarter to quarter depending on, among other factors: our customers success in selling products incorporating our technologies; the timing of introductions of coated products by customers; the timing of introductions of products that compete with our customers products; the number and activity level associated with customer development projects; the number and terms of new license agreements that are finalized; the value of reagent chemicals and other products sold to licensees; and the timing of future acquisitions we complete, if any.

For financial accounting and reporting purposes, we treat our three operating segments as one reportable segment. We made this determination because our operating segments currently share the same facilities; a significant percentage of our employees provide support services (including research and development) to each operating segment; technology and products from each operating segment are marketed to the same or similar customers; each operating segment uses the same sales and marketing resources; and each operating segment operates in the same regulatory environment.

**Critical Accounting Policies**

Critical accounting policies are those policies that require the application of management s most challenging subjective or complex judgment, often as a result of the need to make estimates about the effect of matters that are inherently uncertain and may change in subsequent periods. Critical accounting policies involve judgments and uncertainties that are sufficiently sensitive to result in materially different results under different assumptions and conditions. For a detailed description of our critical accounting policies, see the notes to the financial statements included in our Annual Report on Form 10-K for the year ended September 30, 2006.

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**Results of Operations**

***Three Months Ended June 30, 2007 and 2006***

| *(in thousands)* | 2007 | 2006 | Increase/ (Decrease) | % Increase/ (Decrease) |
|---|---|---|---|---|
| Revenue: | | | | |
| Drug Delivery | $ 5,772 | $ 8,647 | ($2,875) | (33%) |
| Hydrophilic and Other | 6,897 | 5,522 | 1,375 | 25% |
| In Vitro | 5,093 | 3,970 | 1,123 | 28% |
| Total revenue | $ 17,762 | $ 18,139 | ($377) | (2%) |

**Revenue.** Third quarter revenue was $17.8 million, a decrease of $377,000, or 2%, compared with the same period in fiscal 2006. Substantial growth in our Hydrophilic and Other and In Vitro operating segments was offset by a 33% decrease in Drug Delivery segment revenue. Results for each of our three operating segments are detailed in the table above and further explained in the narrative below.

*Drug Delivery.* Revenue in the Drug Delivery segment decreased 33% to $5.8 million for the three-month period ended June 30, 2007, compared with $8.6 million for the prior year period. Nearly all of the decrease is a result of lower royalties and license fees when compared with the prior year period. Drug Delivery derives a substantial majority of its revenue through licensing and product sales to Cordis Corporation, a Johnson & Johnson company, on its CYPHER® Sirolimus-eluting Coronary Stent. CYPHER® is a trademark of Cordis Corporation. The CYPHER® stent incorporates a proprietary SurModics polymer coating that delivers a therapeutic drug designed to reduce the occurrence of restenosis in coronary artery lesions. The decrease in Drug Delivery revenue reflects lower royalty revenue and reagent revenue (as a result of lower CYPHER® sales) and less research and development work performed for Cordis. Excluding Cordis activities, research and development revenue decreased 6% compared with the prior year period as a result of reduced activity with ophthalmology and other drug delivery customers.

The CYPHER® stent, from which we derive a substantial majority of our Drug Delivery revenue, faces continuing competition from Boston Scientific Corporation s Taxus drug-eluting stent, which is sold within and outside the U.S., and stents from Medtronic, Abbott Vascular, and others sold outside the U.S. In addition, several drug-eluting stents from others are expected to be approved in the U.S. over the next two years. These stents (in addition to bare metal stents) compete or will compete directly with the CYPHER® stent. Further, drug-eluting stent sales have been adversely affected by recent concerns over stent safety. Therefore, future Drug Delivery royalty and reagent sales revenue could decrease because of lower CYPHER® stent sales as a result of this ongoing and expected future competition and overall market contraction. We anticipate that quarterly royalty revenue from the CYPHER® stent may decrease for the remainder of fiscal 2007 and beyond as the various marketers of drug-eluting stents continue competing in the marketplace and as others enter the marketplace. Management expects royalties from the CYPHER® stent to continue to constitute a significant portion of our revenue in fiscal 2007. However, whether and the extent to which royalties from the CYPHER® stent continue to constitute a significant source of revenue is subject to a number of risks,

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including intellectual property litigation generally, and specifically the damages, settlements and mutual agreements that may result from various infringement suits between Boston Scientific and Cordis in which each has been found to have violated certain intellectual property rights of the other.

*Hydrophilic and Other*. Revenue in the Hydrophilic and Other segment increased 25% to $6.9 million compared with the third quarter of fiscal 2006, primarily as a result of 29% growth in royalties and license fees and a 50% increase in reagent sales. In contrast to our Drug Delivery segment, where a significant percentage of revenue is attributable to Cordis, there are several dozen licensees and an even larger number of coated products generating royalties in our Hydrophilic and Other segment. Partially offsetting the increase in royalties and license fees and reagent sales was a 23% decrease in research and development revenue. Much of the research and development revenue earned in the Hydrophilic and Other segment is related to small-scale interim coating services we provide to some of our customers as they transition to coating their products with our technology in their own manufacturing facilities. Some of our customers, who had contributed significantly to research and development revenue in the prior year period, have transitioned to in-house coating. Accordingly, we performed less of this service in the third quarter of fiscal 2007, resulting in the decrease in research and development revenue. For this same reason, we anticipate research and development revenue within this segment will continue to decrease when compared to prior year comparable periods for the remainder of fiscal 2007. We believe royalty and license fee revenue will continue to increase for the remainder of fiscal 2007 when compared to prior year comparable periods, though not necessarily at the same rate experienced in the third quarter of fiscal 2007. It is unlikely that fourth quarter fiscal 2007 reagent sales, when compared to prior year comparable periods, will grow at the rate experienced in the third quarter of fiscal 2007.

*In Vitro.* Revenue in the In Vitro segment (formerly Diagnostics) increased 28% to $5.1 million compared with the prior year period. A majority of the increase was attributable to a 44% increase in royalties and license fees compared with the same period in fiscal 2006. It is unlikely that fourth quarter fiscal 2007 In Vitro royalties and license fees, when compared with prior year comparable periods, will grow at the rate experienced in the third quarter of fiscal 2007.

Product sales in the In Vitro segment increased approximately 2% compared with the prior year. Product sales include genomics slides, stabilization products and recently launched recombinant autoimmune antigens (both stabilization products and antigens are used by diagnostic kit manufacturers in immunoassay diagnostic tests). However, when current period sales of antigens are excluded (prior year results do not include any antigen sales, as distribution of these products began in the fourth quarter of fiscal 2006) product sales decreased approximately 16%. We expect product sales in the In Vitro segment to be higher on a sequential basis in the final quarter of fiscal 2007. The In Vitro segment derives a significant percentage of its revenue from Abbott Laboratories and GE Healthcare. On January 18, 2007, Abbott announced an agreement to sell its core laboratory diagnostics business to GE. On July 11, 2007, Abbott announced that it and GE mutually agreed to terminate the sale agreement. We do not expect the termination of this transaction to have a material impact on future In Vitro operating segment results.

**Product costs.** Product costs were $1.2 million for the third quarter of fiscal 2007, a 37% increase from $891,000 in the third quarter of fiscal 2006. Overall product margins averaged 59%, compared with 66% for the comparable period last year. The decrease in product margins reflects the mix of products sold in the period (some of our stabilization and antigen products and genomics slides carry lower margins than our reagent products) and higher depreciation costs on the recently-constructed manufacturing space at our Eden Prairie facility. We anticipate that product margins will continue to be lower on a year-over-year basis throughout fiscal 2007 compared with prior year results as a result of recent trends in the mix of products sold.

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**Research and development expenses.** Research and development expenses were $6.2 million in the third quarter of fiscal 2007, an increase of 17% compared with the same period in fiscal 2006. The increase reflects higher personnel costs and an approximate $600,000 increase in stock based compensation paid to employees as a result of executing the Merck license. In addition, a $353,000 loss was recorded on the cancellation of a technology license.

**Sales and marketing expenses.** Sales and marketing expenses were $343,000 for the third quarter of fiscal 2007, a 1% decrease from the prior year period. We expect sales and marketing expenses to increase modestly on a year-over-year basis for the remainder of fiscal 2007.

**General and administrative expenses.** General and administrative expenses were $2.5 million for the third quarter of fiscal 2007, a 15% increase compared with $2.2 million in same period of fiscal 2006. The increase reflects increased legal and professional fees. General and administrative expenses will likely increase modestly in the fourth quarter of fiscal 2007.

**Other income, net.** Other income was $1.2 million in the third quarter of fiscal 2007, an increase of 9% compared with $1.1 million in the same period of fiscal 2006, reflecting higher levels of investable cash and higher yields generated from our investment portfolio.

**Income tax expense.** The Company s income tax provision was $3.1 million in the third quarter of fiscal 2007, compared with $4.2 million in the same period of fiscal 2006, resulting in an effective tax rate of 35.9% for the third quarter of fiscal 2007, compared with 39.8% for the same period last year. Current period results include a benefit from the release of certain tax reserves related to expiring statutes of limitations.

***Nine Months Ended June 30, 2007 and 2006***

| *(in thousands)* | 2007 | 2006 | Increase | % Increase |
|---|---|---|---|---|
| Revenue: | | | | |
| Drug Delivery | $ 18,607 | $ 25,580 | ($6,973) | (27%) |
| Hydrophilic and Other | 18,720 | 15,988 | 2,732 | 17% |
| In Vitro | 14,538 | 10,743 | 3,795 | 35% |
| Total revenue | $ 51,865 | $ 52,311 | ($447) | (1%) |

**Revenue**. Total revenue was $51.9 million for the first nine months of fiscal 2007, a decrease of $447,000, or 1%, compared with the same period of fiscal 2006. A significant decrease in Drug Delivery segment revenue, primarily as a result of lower CYPHER® stent royalties, offset strong revenue growth in the Hydrophilic and Other and In Vitro segments.

*Drug Delivery*. Drug Delivery revenue decreased 27% to $18.6 million through the third quarter of fiscal 2007, compared with $25.6 million for the same period last year. The decrease reflects lower revenue in all three revenue sources: royalties and license fees, product sales, and research and development revenue as a result of lower CYPHER® sales and less research and development work performed for Cordis as described above.

*Hydrophilic and Other*. Hydrophilic and Other revenue increased 17% to $18.7 million for the first nine months of fiscal 2007, driven principally by increased royalties and reagent sales. Partially offsetting the increase in royalties and reagent sales was a decrease in research and development revenue as a result of less interim contract coating work performed for certain customers as previously described.

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*In Vitro*. In Vitro revenue increased 35% to $14.5, million compared with $10.7 million for the same period last year. Approximately $2.8 million of the increase is a result of higher royalties and license fees, a portion of which was a settlement related to past due royalties. The balance of the increase reflects the 28% growth in sales of genomics slides, stabilization and antigen product sales.

**Product costs.** Product costs were $3.4 million for the nine months ended June 30, 2007, a 39% increase from $2.4 million last year. Overall product margins averaged 62% compared with 69% for the comparable period last year. The margin decrease is primarily attributable to a higher mix of genomics slides, and stabilization and antigen products, which carry lower margins than reagents.

**Research and development expenses.** Research and development expenses were $17.1 million for the first nine months of fiscal 2007, an increase of 15% compared with the same period in fiscal 2006. Approximately $600,000 of the increase reflects higher costs associated with the clinical trial on our I-vation intravitreal implant in our Ophthalmology division. The balance of the increase is a result of higher compensation and development expenses in all of our business segments.

**Sales and marketing expenses.** Sales and marketing expenses were $989,000 for the nine months ending June 30, 2007, a 6% decrease from the same period of the prior year.

**General and administrative expenses.** General and administrative expenses were $6.6 million for the first nine months of fiscal 2007, a 4% decrease compared with the same period in fiscal 2006. The decrease primarily reflects the cost savings realized since we exited our contract manufacturing facility in Bloomington in April 2006 and reduced professional fees.

**Other income, net.** Other income was $3.7 million for the first nine months of fiscal 2007, compared with a loss of $1.9 million in the same period last year. The prior year loss was primarily a result of the $4.7 million impairment loss recorded on our investment in Novocell in the second quarter of fiscal 2006. Income from investments was $3.7 million through the third quarter of fiscal 2007, an increase of $837,000, compared with $2.9 million for the same period of fiscal 2006, reflecting higher levels of investable cash and higher yields generated from our investment portfolio.

**Income tax expense.** The Company s income tax provision was $10.2 million for the first nine months of fiscal 2007 compared with $11.1 million in the same period of fiscal 2006. The effective tax rate for the first nine months of fiscal 2007 was 37.1%, compared with 37.2% for the same period last year (excluding the impact of the $4.7 million impairment loss). Without excluding the impact of the impairment loss recorded in the first nine months of fiscal 2006, the effective tax rate for such period was 44.1%.

**Liquidity and Capital Resources**

As of June 30, 2007, the Company had working capital of $73.6 million and cash, cash equivalents and investments totaling $94.1 million. The Company s investments principally consist of U.S. government and government agency obligations and investment grade, interest-bearing corporate debt securities with varying maturity dates, the majority of which are five years or less. The Company s policy requires that no more than 5% of investments be held in any one credit issue, excluding U.S. government and government agency obligations. The primary investment objective of the portfolio is to provide for the safety of principal and appropriate liquidity while meeting or exceeding a benchmark (Merrill Lynch 1-3 Year Government-Corporate Index) total rate of return. Management plans to continue to direct its investment advisors to manage the Company s investments primarily for the safety of principal for the foreseeable future as it assesses other investment opportunities and uses of its investments. We had positive cash flows from operating activities of approximately $23.6 million in the first nine months of fiscal 2007, compared with $27.1 million in the first nine months of fiscal 2006. On July 20, 2007, the Company received the $20 million up front licensing fee due from Merck. See Note 4 and Note 10.

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We conduct a significant majority of our operations at our Eden Prairie, Minnesota, headquarters. In addition to our Eden Prairie location, we lease approximately 3,000 square feet of commercial office space in Irvine, California, where our Ophthalmology division conducts a portion of its operations.

In January 2005, we entered into a merger agreement whereby SurModics acquired all of the assets of InnoRx, Inc. by paying approximately $4.1 million in cash and issuing 600,064 shares of SurModics common stock to InnoRx stockholders. In July 2005, we issued 60,002 shares of SurModics common stock to the shareholders of InnoRx upon the successful completion of the first milestone involving the InnoRx technology acquired in the purchase of InnoRx. In March 2006, we issued an additional 60,007 shares as a result of completion of the second milestone. The 60,007 shares are held in escrow pending possible indemnification per the merger agreement. Upon the successful completion of the remaining development and commercial milestones involving InnoRx technology acquired in the transaction, we will be required to issue up to approximately 480,060 additional shares of our common stock to the stockholders of InnoRx.

In September 2004, we made a commitment to purchase for $7 million certain additional sublicense rights and the accompanying future royalty revenue streams under certain sublicenses through an amendment to our diagnostic format patent license with Abbott Laboratories. Prior to such amendment, we were receiving only a portion of the royalties under such sublicenses. The first $5 million installment was paid in November 2004. We made an additional $1 million installment payment in June 2007. The remaining $1 million installment is reflected in other current liabilities at June 30, 2007.

In September 2006, our Board of Directors authorized the repurchase of up to $35 million and up to 1 million shares of the Company s stock. In November 2006, the Company entered into a Rule 10b5-1 agreement and purchased $17.5 million of the $35 million authorized at an average price of $32.87 per share. In January 2007, the Board of Directors approved an amendment to the share repurchase program to authorize the Company to repurchase up to $35 million of the Company s stock without restriction as to the total number of shares being repurchased. Pursuant to the amended share repurchase program, the Company entered into a Rule 10b5-1 agreement in January 2007 and during the second quarter of fiscal 2007 purchased the remaining $17.5 million of the $35 million repurchase authorization at an average price of $36.88 per share. In total, the Company repurchased 1,007,752 shares for $35.0 million at an average price of $34.76 per share.

On July 10, 2007 we announced the Company s equity investment in Paragon Intellectual Properties, LLC ( Paragon ) and an equity investment in Apollo Therapeutics, LLC ( Apollo ), a Paragon subsidiary. The Paragon and Apollo investments totaled $3.5 million. The arrangement calls for the SurModics to invest additional equity totaling $2.5 million upon successful completion of specified development milestones. Our investment in Paragon represents an ownership interest of less than 20% and the investment in Apollo represents an ownership interest of less than 20%. See Note 12.

On July 31, 2007 SurModics entered into a stock purchase agreement with Southern Research Institute whereby it acquired 100% of the capital stock of Brookwood Pharmaceuticals, Inc. ( Brookwood ) for $40 million in cash on the closing date and up to an additional $22 million in cash upon the successful achievement of specified milestones. Brookwood is a drug delivery company based in Birmingham, Alabama that provides proprietary polymer based technologies to companies developing pharmaceutical products. See Note 12.

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As of June 30, 2007, we had no debt, nor did we have any credit agreements. We believe that our existing capital resources will be adequate to fund our operations and material commitments into the foreseeable future.

As of June 30, 2007, the Company did not have any off-balance sheet arrangements with any unconsolidated entities.

Certain information regarding the effective tax rate in this Quarterly Report on Form 10-Q may be considered non-GAAP financial information as contemplated by Regulation G. The non-GAAP measure excluded the impact of an impairment loss recorded in the second quarter of 2006. The Company no longer provides non-GAAP financial measures for the current period, but believes that providing this non-GAAP financial measure for the prior period is still useful to investors because it provides a basis for comparison of the Company s financial condition and results of operations between quarters, which comparison is not influenced by changes in its effective tax rate. Management also uses such financial measures internally to monitor performance of the business. The potential non-GAAP financial measures should be considered in addition to, and not a substitute for, financial measures in accordance with GAAP.

**Forward-Looking Statements**

Certain statements contained in this report and other written and oral statements made from time to time by the Company do not relate strictly to historical or current facts. As such, they are considered forward-looking statements that provide current expectations or forecasts of future events. These forward-looking statements are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Such statements can be identified by the use of terminology such as anticipate, believe, could, estimate, expect, forecast, intend, may, pl project, will and similar words or expressions. Any statement that is not an historical fact, including estimates, projections, future trends and the outcome of events that have not yet occurred, are forward-looking statements. The Company s forward-looking statements generally relate to its growth strategy, financial results, product development programs, sales efforts, sufficiency of capital resources, and the impact of the Cordis agreement and other significant customer agreements. You should carefully consider forward-looking statements and understand that such statements involve a variety of risks and uncertainties, known and unknown, and may be affected by inaccurate assumptions. Consequently, no forward-looking statement can be guaranteed and actual results may vary materially. The Company undertakes no obligation to update any forward-looking statement.

Although it is not possible to create a comprehensive list of all factors that may cause actual results to differ from the Company s forward-looking statements, such factors include, among others: (i) the Company s significant dependence upon Cordis, which causes our financial results and stock price to be subject to factors affecting Cordis and its Cypher stent program, including among others, the rate of market penetration by Cordis, the timing of market introduction of competing products, product safety or efficacy concerns and intellectual property litigation generally and specifically the litigation involving Boston Scientific Scimed, Inc. and Cordis in the U.S. District Court for the District of Delaware in which each was reported in June and July 2005 to have been found to have infringed the patent rights of the other; (ii) frequent intellectual property litigation in the medical device industry that may directly or indirectly adversely affect our customers ability to market their products incorporating our technologies; (iii) our ability to protect our own intellectual property; (iv) healthcare reform efforts and reimbursement rates for medical device products that may adversely affect our customers ability to cost effectively market and sell devices incorporating our technologies; (v) the Company s ability to attract new licensees and to enter into agreements for additional product

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applications with existing licensees, the willingness of potential licensees to sign license agreements under the terms offered by the Company, and the Company s ability to maintain satisfactory relationships with its licensees; (vi) the Company s ability to increase the number of market segments and applications that use its coating technologies through its sales and marketing and research and development efforts; (vii) the Company s ability to facilitate through strategic investment and research and development support the creation of new medical device market segments and applications that incorporate its coating technologies; (viii) market acceptance of products sold by customers incorporating our technologies and the timing of new product introductions by licensees; (ix) market acceptance of products sold by customers competitors and the timing and pricing of new product introductions by customers competitors; (x) the difficulties and uncertainties associated with the lengthy and costly new product development and foreign and domestic regulatory approval processes, such as delays, difficulties or failures in achieving acceptable clinical results or obtaining foreign or FDA marketing clearances, which may result in lost market opportunities or postpone or preclude product commercialization by licensees; (xi) efficacy or safety concerns with respect to products marketed by us and our licensees, whether scientifically justified or not, that may lead to product recalls, withdrawals or declining sales; (xii) the ability to secure raw materials for reagents the Company sells; (xiii) the Company s ability to manage successfully clinical trials and related foreign and domestic regulatory processes for the I-vation intravitreal implant or other acquired products from InnoRx under development by the Company s ophthalmology division, whether delays, difficulties or failures in achieving acceptable clinical results or obtaining foreign or FDA marketing clearances postpone or preclude product commercialization of the intravitreal implant or other acquired products, and whether the intravitreal implant and any other acquired products remain viable commercial prospects; (xiv) product liability claims not covered by insurance; (xv) the development of new products or technologies by competitors, technological obsolescence and other changes in competitive factors; (xvi) the trend of consolidation in the medical device industry, resulting in more significant, complex and long term contracts than in the past and potentially greater pricing pressures; (xvii) the Company s ability to identify suitable businesses to acquire or with whom to form strategic relationships to expand its technology development and commercialization, its ability to successfully integrate the operations of companies it may acquire from time to time and its ability to create synergies from acquisitions and other strategic relationships; (xviii) the Company s ability to successfully internally perform certain product development activities and governmental and regulatory compliance activities with respect to acquired technology, including InnoRx technology, which activities the Company has not previously undertaken in any significant manner; (xix) the Company s ability to successfully perform and earn milestone payments related to contractual milestone criteria in general and specifically the $288 million in fees and development milestones in the Merck agreement; (xx) economic and other factors over which the Company has no control, including changes in inflation and consumer confidence; (xxi) acts of God or terrorism which impact the Company s personnel or facilities; and (xxii) other factors described in the Risk Factors and other sections of SurModics Annual Report on Form 10-K, which you are encouraged to read carefully. Many of these factors are outside the control and knowledge of the Company and could result in increased volatility in period-to-period results. Investors are advised not to place undue reliance upon the Company s forward-looking information and to consult any further disclosures by the Company on this subject in its filings with the Securities and Exchange Commission.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

The Company s investment policy requires investments with high credit quality issuers and limits the amount of credit exposure to any one issuer. The Company s investments principally consist of U.S. government and government agency obligations and investment-grade, interest-bearing corporate debt securities with varying maturity dates, the majority of which are five years or less. Because of the credit criteria of the Company s investment policies, the primary market risk associated with these investments is interest rate risk. SurModics does not use

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derivative financial instruments to manage interest rate risk or to speculate on future changes in interest rates. A one percentage point increase in interest rates would result in an approximate $1.4 million decrease in the fair value of the Company s available-for-sale securities as of June 30, 2007, but no material impact on the results of operations or cash flows. Management believes that a reasonable change in raw material prices would not have a material impact on future earnings or cash flows because the Company s inventory exposure is not material.

Although we conduct business in foreign countries, our international operations consist primarily of sales of reagent and stabilization chemicals. Additionally, all sales transactions are denominated in U.S. dollars. Accordingly, we do not expect to be subject to material foreign currency risk with respect to future costs or cash flows from our foreign sales. To date, we have not entered into any foreign currency forward exchange contracts or other derivative financial instruments to hedge the effects of adverse fluctuations in foreign currency exchange.

**Item 4. Controls and Procedures**

**Evaluation of Disclosure Controls and Procedures**

As of the end of the period covered by this report, the Company conducted an evaluation under the supervision and with the participation of the Company s management, including the Company s Chief Executive Officer and Chief Financial Officer regarding the effectiveness of the design and operation of the Company s disclosure controls and procedures pursuant to Rule 13a-15(b) of the Securities Exchange Act of 1934 (the Exchange Act ). Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company s disclosure controls and procedures are effective to ensure that information that is required to be disclosed by the Company in reports that it files under the Exchange Act is recorded, processed, summarized and reported within the time period specified in the rules of the Securities and Exchange Commission.

**Changes in Internal Controls**

There were no changes in the Company s internal control over financial reporting that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

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**PART II - OTHER INFORMATION**

**Item 1. Legal Proceedings.**

On May 22, 2007, the former Stockholders of InnoRx (the Plaintiffs ) filed a declaratory judgment action (the Declaratory Judgment ) in the U.S. District Court for the Southern District of Alabama against Michael Cooney, M.D. ( Dr. Cooney ) of New York, New York. In the litigation, the Plaintiffs are seeking a determination that Dr. Cooney was not a co-founder of InnoRx, and further that he was not an inventor of certain patent rights covering technology for delivering drugs to the eye, including certain patent rights exclusively licensed by the Johns Hopkins University to InnoRx (collectively, the Patent Rights ), and now controlled by the Company as successor-in-interest to InnoRx pursuant to an agreement of merger between the Company and InnoRx made effective on January 18, 2005 (the Merger Agreement ). The Company is not a party to the litigation.

On June 8, 2007, the Company was named as a defendant in litigation filed in the U.S. District Court for the District of Minnesota by Dr. Cooney. JHU and certain former shareholders of InnoRx, among others, were also named as defendants. The complaint alleges that Dr. Cooney was a co-founder of InnoRx and an inventor of subject matter claimed in the Patent Rights. The complaint seeks an order correcting inventorship, and certain unspecified damages (including punitive damages) based on claims of unjust enrichment, fraud, and breach of fiduciary duties. A trial has not yet been scheduled. Pursuant to the Merger Agreement, the Company has submitted a demand for indemnification of losses (including without limitation, damages, expenses and costs) incurred as a result of the litigation involving Dr. Cooney, including both the Alabama and Minnesota cases described above.

On June 18, 2007, the Company was named as an involuntary plaintiff in patent litigation between Abbott Laboratories ( Abbott ) and Church & Dwight, Inc. ( Church & Dwight ). In the litigation, Abbott is alleging that certain of Church & Dwight s products utilizing lateral flow technology for diagnostic purposes infringe certain of the Company s patents that have been exclusively licensed to Abbott under the terms of a license agreement between the Company and Abbott dated May 30, 1989, as amended and restated (the License Agreement ). The suit was filed in the U.S. District Court for the Northern District of Illinois seeking a finding of infringement, monetary damages and injunctive relief. Pursuant to the terms of the License Agreement, Abbott is responsible for reimbursing the Company for at least a portion of its costs and fees incurred in connection with the suit. A trial has not yet been scheduled.

**Item 1A. Risk Factors.**

There have been no material changes from risk factors as previously disclosed in the Company s Form 10-K for the fiscal year ended September 30, 2006 in response to Item 1A to Part I of Form 10-K.

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

The following table presents information with respect to purchases of common stock of the Company made during the three months ended June 30, 2007, by the Company or on behalf of the Company or any affiliated purchaser of the Company, as defined in Rule 10b-18(a)(3) under the Exchange Act.

| Period | (a) Total Number of Shares Purchased(1) | (b) Average Price Paid Per Share | (c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | (d) Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs |
|---|---|---|---|---|
| 4/01/07 - 4/30/07 | 1,537 | $39.94 | NA | NA |
| 5/01/07 - 5/31/07 | 0 | NA | NA | NA |
| 6/01/07 - 6/30/07 | 5,296 | $49.42 | NA | NA |
| Total | 6,833 | $47.29 | | |

(1) All of the Shares were repurchased by the Company to pay the exercise price and/or to satisfy tax withholding obligations in connection with so-called stock swap exercises of employee stock options issued to employees.

**Item 3. Defaults Upon Senior Securities.**

None.

**Item 4. Submission of Matters to a Vote of Security Holders.**

None

**Item 5. Other Information.**

None.

**Item 6. Exhibits.**

Exhibits

10.1+ Exclusive License and Research Collaboration Agreement with Merck & Co., Inc. dated June 26, 2007

10.2+ Supply Agreement with Merck & Co., Inc. dated June 26, 2007

31.1** Certification of Chief Executive Officer Pursuant to Section 302 of Sarbanes-Oxley Act of 2002

31.2** Certification of Chief Financial Officer Pursuant to Section 302 of Sarbanes-Oxley Act of 2002

32.1** Certification of Chief Executive Officer Pursuant to Section 906 of Sarbanes-Oxley Act of 2002

32.2** Certification of Chief Financial Officer Pursuant to Section 906 of Sarbanes-Oxley Act of 2002

+ Confidential treatment requested as to portions of the exhibit. Confidential portions omitted and provided separately to the Securities and Exchange Commission.

** Filed herewith.

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**SIGNATURES**

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

**SurModics, Inc.**

August 9, 2007

By: /s/ Philip D. Ankeny
Philip D. Ankeny
Chief Financial Officer

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**SECURITIES AND EXCHANGE COMMISSION**
**WASHINGTON, D.C. 20549**
**EXHIBIT INDEX TO FORM 10-Q**
**For the Quarter Ended June 30, 2007**
**SURMODICS, INC.**

| Exhibit | Description |
|---|---|
| 10.1+ | Exclusive License and Research Collaboration Agreement with Merck & Co., Inc. dated June 26, 2007 |
| 10.2+ | Supply Agreement with Merck & Co., Inc. dated June 26, 2007 |
| 31.1** | Certification of Chief Executive Officer Pursuant to Section 302 of Sarbanes-Oxley Act of 2002 |
| 31.2** | Certification of Chief Financial Officer Pursuant to Section 302 of Sarbanes-Oxley Act of 2002 |
| 32.1** | Certification of Chief Executive Officer Pursuant to Section 906 of Sarbanes-Oxley Act of 2002 |
| 32.2** | Certification of Chief Financial Officer Pursuant to Section 906 of Sarbanes-Oxley Act of 2002 |

\+ Confidential treatment requested as to portions of the exhibit. Confidential portions omitted and provided separately to the Securities and Exchange Commission.

** Filed herewith.