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SPACEDEV INC
Form 10QSB/A
December 02, 2005

FORM 10-QSB/A
(AMENDMENT NO. 1)
U.S. SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20429

(Mark One)

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

For the quarterly period ended September 30, 2005

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

For the transition period from _____ to _____
Commission File Number 000-28947.

SPACEDEV, INC.
(Exact name of registrant as specified in its charter)

Colorado

84-1374613

(State or other jurisdiction of
incorporation or organization)

(IRS Employer
Identification No.)

13855 Stowe Drive, Poway, California 92064

(Address of principal executive offices)

(Issuer's telephone number) (858) 375-2030.

(Former name, former address and former fiscal year,
if changed since last report)

Checkmark whether the issuer (1) has filed all reports required to be filed by Sections 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 is a shell company (as defined in Rule 12b-2 of the Exchange Act) Yes No

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: 24,359,156 shares of Issuer's voting common stock were outstanding on November 1, 2005.

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EXPLANATORY NOTE: This Amendment No. 1 corrects a typographical error in the Form 8-K filed on October 26, 2005. The merger agreement provides that the number of shares issuable upon the earnout potentially payable for the fiscal year ending December 31, 2005 is based on a dollar amount of \$3,000,000, which is the numerator in the stated quotient formula for the number of shares issuable. This dollar amount was erroneously reported as \$3,500,000 in the original filing. Except for such correction, this Amendment No. 1 does not otherwise modify or update the original Form 8-K filing. For convenience of the reader, this Amendment No. 1 repeats the complete text of the Form 8-K, including the items which have not been amended.

SPACEDEV, INC.
AMENDMENT NO. 1 TO FORM 10-QSB
FOR THE QUARTER ENDED SEPTEMBER 30, 2005

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PART I -- FINANCIAL INFORMATION

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ITEM 1. FINANCIAL STATEMENTS

SPACEDEV, INC. AND SUBSIDIARY
 CONSOLIDATED BALANCE SHEETS
 (UNAUDITED)

At September 30,	2005	
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents.	\$4,022,243	\$4,
Accounts receivable.	1,096,645	
Work in progress	10,412	
Note receivable (Note 5)	1,326,453	
Total current assets.	6,455,753	4,
FIXED ASSETS - NET.	822,980	
OTHER ASSETS.	64,469	
	\$7,343,202	\$4,

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

SPACEDEV, INC. AND SUBSIDIARY
 CONSOLIDATED BALANCE SHEETS
 (UNAUDITED)

At September 30,	2005	
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LIABILITIES AND STOCKHOLDERSEQUITY

CURRENT LIABILITIES

Current portion of notes payable (Note 3(a))	\$	18,797	\$
Current portion of capitalized lease obligations		2,479	
Accounts payable and accrued expenses		398,443	1
Accrued payroll, vacation and related taxes		350,145	2
Deferred revenue		126,453	
Employee stock purchase plan		9,974	
Other accrued liabilities		168,470	2

TOTAL CURRENT LIABILITIES \$ 1,074,761 7

NOTES PAYABLE, LESS CURRENT MATURITIES (NOTE 3(A)) -

CAPITALIZED LEASE OBLIGATIONS, LESS CURRENT MATURITIES -

DEFERRED GAIN - ASSETS HELD FOR SALE (NOTE 3(A)) 859,996 9

TOTAL LIABILITIES 1,934,757 1,7

COMMITMENTS AND CONTINGENCIES

STOCKHOLDERSEQUITY

Convertible preferred stock, \$.001 par value, 10,000,000 shares authorized, 248,460 and 250,000 shares issued and outstanding, respectively (Note 4)		248	
Common stock, \$.0001 par value; 50,000,000 shares authorized, and 22,319,156 and 20,026,263 shares issued and outstanding, respectively (Note 4)		2,231	
Additional paid-in capital (Note 4)		20,091,408	16,7
Additional paid-in capital - stock options		-	7
Deferred compensation		-	(2
Accumulated deficit		(14,685,442)	(14,1

TOTAL STOCKHOLDERSEQUITY 5,408,445 3,0

TOTAL LIABILITIES AND STOCKHOLDERS EQUITY \$ 7,343,202 \$ 4,8

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

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Three and Nine Months Ending	Three-Months Ending				
	September 30,	2005	%	2004	%
NET SALES	\$ 2,234,010	100.0%	\$ 1,230,126	100.0%	\$ 5,942,558
TOTAL COST OF SALES	1,709,077	76.5%	952,944	77.5%	4,571,505
GROSS MARGIN	524,933	23.5%	277,182	22.5%	1,371,053
OPERATING EXPENSES					
Marketing and sales expense . . .	188,655	8.4%	120,367	9.8%	493,344
General and administrative. . .	253,341	11.3%	108,049	8.8%	654,524
TOTAL OPERATING EXPENSES	441,996	19.8%	288,416	18.6%	1,147,868
INCOME FROM OPERATIONS	82,937	3.7%	48,766	4.0%	223,185
NON-OPERATING (INCOME) EXPENSE					
Interest income	(24,848)	-1.1%	(69,632)	-0.5%	(69,632)
Interest expense.	452	0.0%	23,110	1.9%	2,283
Gain on building sale (Note 3(a))	(29,318)	-1.3%	(29,318)	-2.4%	(87,953)
Non-Cash loan fee - equity conversions (Note 3(c)).	-	0.0%	663,481	53.9%	28,875
TOTAL NON-OPERATING (INCOME) EXPENSE	(53,714)	-2.4%	651,654	53.0%	(126,427)
INCOME (LOSS) BEFORE TAXES	136,651	6.1%	(602,888)	-49.0%	349,612
INCOME TAX PROVISION	400	0.0%	-	0.0%	1,200
NET INCOME (LOSS).	\$ 136,251	6.1%	(602,888)	-49.0%	\$ 348,412
NET INCOME (LOSS) PER SHARE:					
Net income (loss)	\$ 0.01		\$ (0.03)		\$ 0.02
Weighted-Average Shares					
Outstanding	21,241,448		19,228,019		21,777,211
FULLY DILUTED NET INCOME (LOSS) PER SHARE:					
Net income (loss)	\$ 0.00		(\$0.03)		\$ 0.01
Fully Diluted Weighted-Average					
Shares Outstanding	29,362,131		19,228,019		21,719,369

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

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SPACEDEV, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

Nine-Months Ended September 30,	2005	2004
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income (loss)	\$ 348,412	\$(2,332,304)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization.	108,265	55,236
Gain on disposal of building sale.	(87,953)	(87,954)
Non-cash loan fees	28,875	2,456,794
Change in operating assets and liabilities	(84,760)	(25,552)
NET CASH PROVIDED BY OPERATING ACTIVITIES.	312,839	66,220
CASH FLOWS FROM INVESTING ACTIVITIES		
Notes Receivable.	(1,326,453)	-
Purchases of fixed assets	(651,864)	(165,770)
NET CASH USED IN INVESTING ACTIVITIES	(1,978,317)	(165,770)
CASH FLOWS FROM FINANCING ACTIVITIES		
Principal payments on notes payable	(27,330)	(32,555)
Principal payments on capitalized lease obligations . .	(2,774)	(9,163)
Employee Stock Purchase Plan.	48,343	-
Payments on notes payable - related party	-	(614,778)
Proceeds from issuance of common and preferred stock. .	600,881	3,783,725
Proceeds from revolving credit facility	-	458,908
NET CASH PROVIDED BY FINANCING ACTIVITIES.	619,120	3,586,137
Net (decrease) increase in cash and cash equivalents	(1,046,358)	3,486,587

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CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	5,068,601	592,006
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$ 4,022,243	\$ 4,078,593

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

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SPACEDEV, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS, CONT'D.
(UNAUDITED)

Nine-Months Ended September 30,	2005	2004
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SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:

Cash paid during the period for:

Interest	\$2,283	\$305,038
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NONCASH INVESTING AND FINANCING ACTIVITIES:

During the nine-months ending September 30, 2005 and 2004, the Company converted \$47,702 and \$12,628 of employee stock purchase plan contributions into 34,040 and 14,070 shares of common stock, respectively.

During the nine-months ending September 30, 2005, the Company declared dividends payable of \$128,057 to the holders of its preferred stock.

During the nine-months ending September 30, 2005, the Company converted dividends payable of \$174,976 into 113,621 shares of common stock to the holders of its preferred stock.

During the nine-months ending September 30, 2005, the Company did not maintain a balance under its revolving credit facility, therefore the Company recorded no non-cash loan fees.

During the nine-months ending September 30, 2004, the Company issued 1,954,661 shares of its common stock to the Laurus Master Fund from conversions under

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its revolving credit facility, thereby realizing a corresponding reduction in current liabilities of approximately \$1,240,500. The Company recorded additional non-cash loan fees of approximately \$1,718,000 and charged these fees to expense.

During the nine-months ending September 30, 2004, the Company issued 589,212 shares of its common stock to the participants in our convertible debt program in 2003 from conversions of warrants thereby receiving cash in the amount of \$227,500. The Company recorded additional non-cash loan fees of approximately \$738,700 and charged these fees to expense.

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. BASIS OF PRESENTATION

The accompanying consolidated financial statements of SpaceDev, Inc. (the "Company") include the accounts of the Company and its inactive subsidiary, SpaceDev, Inc., an Oklahoma corporation. In the opinion of management, the consolidated financial statements reflect all normal and recurring adjustments, which are necessary for a fair presentation of the Company's financial position, results of operations and cash flows as of the dates and for the periods presented. The consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information. Consequently, these statements do not include all disclosures normally required by generally accepted accounting principles of the United States of America for annual financial statements nor those normally made in an Annual Report on Form 10-KSB. Accordingly, reference should be made to the Company's Form 10-KSB filed on March 28, 2005 and other reports the Company filed with the U.S. Securities and Exchange Commission for additional disclosures, including a summary of the Company's accounting policies, which have not materially changed. The consolidated results of operations for the three- and nine month periods ending September 30, 2005 are not necessarily indicative of results that may be expected for the fiscal year ending December 31, 2005 or any future period, and the Company makes no representations related thereto.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities, disclosures of contingent assets and liabilities and the results of operations during the reporting period. Actual results could differ materially from those estimates.

2. REVENUE RECOGNITION

The Company's revenues for the nine months ended September 30, 2005 and 2004 were derived primarily from United States government cost plus fixed fee (CPFF). Revenues from the CPFF contracts during the nine months ended September

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30, 2005 and 2004 were recognized as expenses as incurred. Estimated contract profits are taken into earnings in proportion to revenues recorded. Time and material revenues are recognized as services are performed and costs incurred. Actual results of contracts may differ from management's estimates and such differences could be material to the consolidated financial statements. Professional fees are billed to customers on a time and materials basis. Time and material revenues are recognized as services are performed and costs incurred.

3. NOTES PAYABLE

a) Building and Settlement Notes

In December 2002, the Company entered an agreement to sell its interest in its facility. The transaction closed in January 2003. The escrow transaction included the sale of the land and building. Net fixed assets were reduced by approximately \$1.9 million and notes payable were reduced by approximately \$2.4 million while a deferred gain was recorded. In conjunction with the sale, the Company entered into a lease agreement with the buyer to leaseback its facilities. The Company's Chief Executive Officer provided a guarantee for the leaseback. The gain on the sale of the facility was deferred and amortized in proportion to the gross rental charged to expense over the lease term. Deferred gain of \$1,172,720 is being amortized at the rate of \$117,272 per year for ten (10) years ending in January 2013. As of September 30, 2005, the deferred gain was \$859,996. This amortization is included in the Company's occupancy and facility expense, included in the Company's non-operating expenses, and totaled \$87,953 and \$87,954 for the nine months ended September 30, 2005 and 2004, respectively.

Deferred gain consisted of the following:

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Nine Months Ended September 30, 2005

Original Deferred Gain	\$1,172,720
Less Amortization 2003	(107,499)
Less Amortization 2004	(117,272)
Less Amortization 2005	(87,953)
-----	-----
	\$ 859,996
-----	-----

In 2001, the Company entered into three settlement loan agreements with various vendors. The total of \$171,402 for all three loans called for payments between 24 and 50 months with interest that ranges from 0% to 8%. At September 30, 2005 and 2004, the outstanding balances on these notes were \$18,797 and \$55,036, respectively, with interest expense for the nine months ended September 30, 2005 and 2004 of \$1,277 and \$3,691, respectively. As of September 30, 2005, only one note remained outstanding.

Future -minimum principal payments on settlement notes are as follows:

For the twelve months ended September 30,

2006	\$ 18,797
2007	-
2008	-
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Total Settlement Notes \$ 18,797

b) Related Parties

The Company had a note payable to its CEO. As part of the Company's preferred stock offering (see Note 5), the note was paid in full during the third quarter of 2004 and no amounts were outstanding at September 30, 2005 or 2004.

Interest expense on this note was \$0 and \$29,256 for the nine months ended September 30, 2005 and 2004, respectively.

c) Revolving Credit Facility.

In June 2003, the Company entered into a Security Agreement, Secured Convertible Note, Registration Rights Agreement and Common Stock Purchase Warrant with Laurus Master Fund, Ltd. ("Laurus"). Pursuant to the agreements, the Company received a \$1 million revolving credit facility in the form of a three-year Convertible Note secured by the Company's assets subject to the amount of eligible accounts receivables. The net proceeds from the Convertible Note were used for general working capital purposes. Advances on the Convertible Note may be repaid at the Company's option, in cash or through the issuance of shares of the Company's common stock provided the market price of the common stock was 118% of the fixed conversion price or greater. The Convertible Note carries an interest rate of Wall Street Journal Prime plus 0.75% on any outstanding balance. In addition, the Company is required to pay a collateral management payment of 0.55% of the average aggregate outstanding balance during each month plus an unused line payment of 0.20% per annum. Approximately \$29,600 in interest and approximately \$4,000 in fees were recorded under the revolving credit facility in the first nine months of 2004. There was no outstanding balance on the revolving credit facility at any time during the nine months ended September 30, 2005.

The Convertible Note includes a right of conversion in favor of Laurus. Laurus exercised its conversion rights from time to time in 2004 on outstanding balances. There have been no outstanding balances in 2005. When Laurus chooses

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to exercise its conversion rights, the Convertible Note is converted into shares of the Company's common stock at a fixed conversion price, subject to adjustments for stock splits, combinations and dividends and for shares of common stock issued for less than the fixed conversion price (unless exempted pursuant to the agreements). The Agreement was modified on March 31, 2004 to provide for a six-month waiver of the accounts receivable restrictions and a fixed conversion price to Laurus of \$0.85 per share on the first \$500,000 after the first \$1 million. The agreement was further modified on August 25, 2004 to provide for a fixed conversion price to Laurus of \$1.00 per share on the next \$1 million. Thereafter, the fixed conversion price will be adjusted to 103% of the then fair market value of the Company's common stock ("Adjusted Fixed Conversion Price").

Laurus converted \$1,240,507 under the Convertible Note into 1,954,661 shares during the nine months ended September 30, 2004. Laurus has converted a total of \$2,500,000 into 3,406,417 shares under the Convertible Note since the inception of the revolving credit facility. For the nine month period ending September 30, 2004, the Company recorded \$1,718,120 in expense for the non-cash loan fee based on the fair market value of the stock when Laurus converted and \$2,607,099 in expense for the non-cash loan fee since the inception of the revolving credit facility. There have been no conversions during the first nine months of 2005.

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The fair market value of the common stock used in 2004 was established using the closing price on the date of conversion.

Availability of funds under the revolving credit facility is based on the Company's accounts receivable, except as waivers are provided by Laurus. In 2003, an initial three-month waiver was offered by Laurus, under which Laurus permitted a credit advance up to \$300,000, which amount would have otherwise exceeded eligible accounts receivable. Laurus subsequently extended the waiver for two additional six-month periods into 2004, under which Laurus permitted a credit advance up to \$1 million, which amount would have otherwise exceeded eligible accounts receivable. The revolving credit facility is secured by all of the assets of the Company.

In conjunction with the 2004 waiver, Laurus was paid a fee of \$10,000, which was recorded as additional interest expense in 2004. The Company is required to pay a continuation fee of \$10,000 for 2005. In addition, Laurus received a warrant to purchase 200,000 shares of the Company's common stock for the initial \$1 million revolving credit facility. The warrant exercise price was computed as follows: \$0.63 per share for the purchase of up to 125,000 shares; \$0.69 per share for the purchase of an additional 50,000 shares; and \$0.80 per share for the purchase of an additional 25,000 shares. The warrant exercise price may be paid in cash, in shares of the Company's common stock, or by a combination of both. Laurus exercised the warrant in part for 25,000 shares in April 2005. The warrant may be exercised for the balance of the shares any time or from time to time until June 3, 2008. The warrant exercise price and the number of shares underlying the warrant are subject to adjustments for stock splits, combinations and dividends.

In addition to the initial warrant, the Company was obligated to issue an additional five-year warrant to Laurus to purchase one share of common stock at an exercise price equal to 125% of the Adjusted Fixed Conversion Price for every ten dollars (\$10) in principal of the Convertible Note converted into common stock if and when over \$1 million was converted under the revolving credit facility. On June 18, 2004, the Company issued an additional warrant to purchase 50,000 shares at an exercise price of \$1.0625 per share in relation to the March 31, 2004 credit facility modification. This additional warrant was exercised by Laurus in April 2005 and resulted in a non-cash interest expense of \$28,875 for the nine months ended September 30, 2005. Since no more than an aggregate of 100,000 shares of the Company's common stock were authorized as additional warrants under the Laurus Agreements, on August 25, 2004, the Company issued an additional warrant to purchase 50,000 shares at an exercise price of \$1.925 per share in relation to the August 25, 2004 credit facility modification, i.e., there was a 100,000 share ceiling on the number of warrants to be issued regardless of the amount converted under the revolving credit facility.

The Company may terminate its agreements with Laurus before the end of the initial three-year term, i.e., June 3, 2006, and Laurus will release its security interests upon payment to Laurus of all obligations, if the Company has: (i) provided Laurus with an executed release of all claims which the Company may have under the agreements; and, (ii) paid to Laurus an early payment fee in an amount equal to two percent (2%) of the total amount available under

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the revolving credit facility if such payment occurs after June 3, 2005 and prior to June 3, 2006. The early payment fee is also due and payable by the Company to Laurus if the Company terminates its Agreement after the occurrence of an Event of Default, as defined in the agreements.

As a result of the amendments and modifications discussed above, at September

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30, 2005 the revolving credit facility provided for up to a maximum of \$1.5 million in principal amount of aggregate borrowing. The fixed conversion price for future amounts under the revolving credit facility will be set at 103% of the fair market value of our common stock. There was no balance on the revolving credit facility for the nine months ended September 30, 2005.

4. STOCKHOLDER'S EQUITY - PREFERRED STOCK, COMMON STOCK AND WARRANTS PREFERRED STOCK

In August 2004, the Company entered into a Securities Purchase Agreement with Laurus, whereby the Company issued 250,000 shares of its Series C Convertible Preferred Stock, par value \$0.001 per share, to Laurus for an aggregate purchase price of \$2,500,000 or \$10.00 per share (the "Stated Value"). The preferred shares are convertible into shares of the Company's common stock at a rate of \$1.54 per share at any time after the date of issuance, and are entitled to quarterly, cumulative dividends at a rate of 6.85% beginning on January 1, 2005. For the nine months ended September 30, 2005, approximately \$128,000 has been accrued for dividends earned in 2005. Approximately \$175,000 of accrued dividends were satisfied by the issuance of the Company's common stock during the nine months ended September 30, 2005. Dividends are payable in cash or shares of the Company's common stock at the holder's option with the exception that dividends must be paid in shares of the Company's common stock for up to 25% of the aggregate dollar trading volume if the fair market value of the Company's common stock for the 20-days preceding the conversion date exceeds \$1.85 per share. In January 2005, \$60,967 was converted into 39,589 shares of the Company's common stock from previous dividend accruals. In May 2005, \$56,300 was converted into 36,559 shares of the Company's common stock from dividends accrued from January through April 2005 and in September 2005, \$57,708 was converted into 37,473 shares of the Company's common stock from dividends accrued from May through August 2005. The preferred shares are redeemable by the Company in whole or in part at any time after issuance for (a) 115% of the Stated Value if the average closing price of the common stock for the 22 days immediately preceding the date of conversion does not exceed the conversion rate or (b) the Stated Value if the average closing price of the common stock for the 22 days immediately preceding the date of preferred stock conversion exceeds the Stated Value. The preferred shares have a liquidation preference equal to the Stated Value upon the Company's dissolution, liquidation or winding-up. The preferred shares have no voting rights. As of September 30, 2005, 1,540 preferred shares had been converted into 10,000 shares of the Company's common stock.

In conjunction with the preferred stock, the Company issued a five-year common stock purchase warrant to Laurus for the purchase of 487,000 shares of the Company's common stock at an exercise price of \$1.77 per share. The Company filed a registration statement for the resale of all of the shares of its common stock issuable upon conversion of the preferred shares and the warrant, as well as an estimated number of shares payable as dividends on the preferred shares, which was declared effective in November 2004.

COMMON STOCK AND WARRANTS

The Company has elected to account for its stock-based compensation plans under APB 25. However, the Company has computed, for pro forma disclosure purposes, the value of all options granted during the nine months ended September 30, 2005 and 2004 using the minimum value method as prescribed by SFAS 123 and amended by SFAS 148. Under this method, the Company used the risk-free interest rate at the date of grant, the expected volatility, the expected dividend yield and the expected life of the options to determine the fair value of options granted. The risk-free interest rates ranged from 6.0% to 6.5%, expected volatility was 117%,

the dividend yield was assumed to be zero, and the expected life of the options was assumed to be three to five years based on the average vesting period of options granted.

If the Company had accounted for these options in accordance with SFAS 123, the total value of options granted during the nine months ended September 30, 2005 and 2004 would be amortized on a pro forma basis over the vesting period of the options. Thus, the Company's consolidated net income (loss) would have been as follows:

NET INCOME (LOSS)	2005	2004
As reported	\$ 348,412	\$ (2,332,304)
Add: Stock based employee compensation expense included in reported net income	\$ -	\$ -
Deduct: Stock based employee compensation expense determined under the fair value based method for all awards	\$ 553,989	\$ 303,425
Pro forma	\$ (205,577)	\$ (2,635,729)
NET INCOME (LOSS) PER SHARE:		
As reported	\$ 0.02	\$ (0.13)
Pro forma	\$ (0.01)	\$ (0.15)

Beginning January 2006, the Company plans to adopt SFAS 123R as currently required by the Securities and Exchange Commission. See Note 7 below. As of September 30, 2005, the Company had not yet determined the impact of SFAS 123(R) on its financial statements.

November 1997, the Company entered into a five-year employment agreement with Mr. James W. Benson, its CEO. On July 16, 2000, the Company amended the employment agreement with Mr. Benson extending the term until July 16, 2005. As part of the original employment agreement, the Company granted options to Mr. Benson to purchase up to 2,500,000 of non-plan, non-registered shares of the Company's common stock. Options for 500,000 of these shares were vested prior to the expiration of Mr. Benson's employment agreement and those options remain outstanding, and the balance expired unvested. The vested options have an exercise price of \$1.00 and expire in July 2010. The Compensation Committee of the Board of Directors is currently negotiating a new agreement with Mr. Benson.. Mr. Benson is currently continuing as an employee "at will" under the laws of the State of California.

The options previously granted to Mr. Benson, as part of his employment contract were subject to the following vesting conditions, which were amended in January 2000 and later ratified by the Board in July 2000. The agreement provided the Board flexibility to award options for an additional 1,500,000 of non-plan,

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non-registered shares of [restricted] common stock to Mr. Benson, which additional options were not granted.

5. NOTES RECEIVABLE

On September 8, 2005, the Company made a secured loan in the principal amount of \$1.2 million to Starsys Research Corporation ("Starsys"), a design, engineering, and manufacturing company located in Boulder, Colorado which provides mechanical systems to the aerospace industry. The loan accrues interest at 8% per annum and matures on December 31, 2005 or earlier in certain circumstances. No principal or interest payments are due before maturity. The maturity date may be accelerated upon the occurrence of certain events of default. The loan is secured by a security interest in all of the assets of Starsys, subject to an intercreditor agreement with Vectra Bank Colorado, National Association

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("Vectra"), described below. In addition, Starsys has agreed to pay the Company a placement agent fee and to reimburse the Company expenses in the aggregate amount of \$120,000. This amount was deferred until the closing of the Plan of Merger (see Note 7) and added to the principal balance of the note evidencing the loan.

In connection with making the loan, the Company entered into an exclusivity agreement with Starsys which provides that Starsys will not discuss a material sale of its assets, a material sale of its stock, a merger, or similar transaction with any other party until October 31, 2005. Prior to completion of the loan described above, the Company and Starsys entered into a non-binding letter of intent concerning a transaction of the nature described in the exclusivity agreement. The structure and economic terms of a potential transaction, however, remained subject to further negotiations and due diligence by both parties; however, on October 26, 2005, the Company and Starsys entered into a definitive merger agreement (see Note 7, Subsequent Events).

6. NEW ACCOUNTING PRONOUNCEMENTS

In December 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 153, Exchanges of Nonmonetary Assets- An Amendment of APB Opinion No. 29. The guidance in APB Opinion No. 29, Accounting for Nonmonetary Transactions, is based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. The guidance in that Opinion, however, included certain exceptions to that principle. SFAS No. 153 amends Opinion No. 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. The provisions of SFAS No. 153 are effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. Early application was permitted and companies must apply the standard prospectively. The adoption of this standard is not expected to have a material effect on the Company's financial position or results of operations.

In December 2004, FASB issued Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (SFAS No. 123R). FAS No. 123R revised SFAS No. 123, Accounting for Stock-Based Compensation, and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees, and its related implementation guidance. SFAS No. 123R will require compensation costs related to share-based payment transactions to be recognized in the financial statement (with limited exceptions). The amount of compensation cost will be measured

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based on the grant-date fair value of the equity or liability instruments issued. Compensation cost will be recognized over the period that an employee provides service in exchange for the award.

In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 (SAB No. 107), Share-Based Payment, providing guidance on option valuation methods, the accounting for income tax effects of share-based payment arrangements upon adoption of SFAS No. 123R, and the disclosures in MD&A subsequent to the adoption. In April 2005, the Securities and Exchange Commission adopted a rule which delayed the compliance date for small business issuers to the start of the first fiscal year beginning after December 15, 2005. The Company will provide SAB No. 107 required disclosures upon adoption of SFAS No. 123R in January 2006 and is currently evaluating the impact the adoption of the standard will have on the Company's financial condition and results of operations.

In June 2005, FASB issued SFAS No. 154, Accounting Changes and Errors Corrections, a replacement of APB Opinion No. 20 and FAS No. 3. The Statement applies to all voluntary changes in accounting principle, and changes the requirements for accounting for and reporting of a change in accounting principle. SFAS No. 154 requires retrospective application to prior periods' financial statements of a voluntary change in accounting principle unless it is impractical. APB Opinion No. 20 previously required that most voluntary changes in accounting principle be recognized by including in net income of the period of the change the cumulative effect of changing to the new accounting principle. SFAS No. 154 is not expected to have a material adverse effect on the Company's financial position or results of operations.

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7. SUBSEQUENT EVENTS

In October 2005, the Company entered into an Agreement and Plan of Merger and Reorganization ("merger agreement"), with Starsys Research Corporation ("Starsys"), a Colorado corporation, and Scott Tibbitts, its largest shareholder. Pursuant to the merger agreement, Starsys will merge with and into a newly-created, wholly-owned subsidiary of the Company. Holders of Starsys common stock will become holders of the Company's common stock following the merger. The merger agreement is subject to a number of conditions described below, including effectiveness of a Form S-4 registration statement and approval of the respective shareholders of SpaceDev and Starsys.

Merger Consideration. The Company will pay and issue the following consideration at the effective time of the merger, subject to adjustment as provided in the merger agreement:

- cash in the aggregate amount of \$1,500,000; and
- an aggregate number of shares of the Company's common stock equal to the quotient of (A) \$7,500,000 divided by (B) the greater of (1) \$1.40 and (2) the lesser of (x) \$1.90 and (y) the volume weighted average price of the Company's common stock for the preceding 20 trading days.

Fifty percent (50%) of the number of shares of the Company's common stock issued at closing will be deposited in escrow as security for the payment of indemnification claims under the merger agreement, which escrow will generally last until ten (10) days following the date of audited financial statements prepared for the surviving corporation for the fiscal year ending 2006 (i.e., approximately April 2007).

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Following the merger, Starsys shareholders may also be entitled to receive, based on the achievement by the surviving corporation of certain performance criteria for each of the fiscal years ending December 31, 2005, December 31, 2006 and December 31, 2007, additional earnout consideration consisting of up to:

- For the fiscal year ended December 31, 2005, \$350,000 in cash and an aggregate number of shares of the Company's common stock equal to the quotient of (A) \$3,000,000 divided by (B) the greater of (1) \$2.00 and (2) the volume weighted average price of the Company's common stock for the twenty (20) trading days preceding the date of the audit opinion for Starsys' fiscal year ended December 31, 2005;
- For the fiscal year ended December 31, 2006, \$350,000 in cash and an aggregate number of shares of the Company's common stock equal to the quotient of (A) \$7,500,000 divided by (B) the greater of (1) \$2.50 and (2) the volume weighted average price of the Company's common stock for the twenty (20) trading days preceding the date of the audit opinion for Starsys' fiscal year ended December 31, 2006; and,
- For the fiscal year ended December 31, 2007, \$350,000 in cash and an aggregate number of shares of the Company's common stock equal to the quotient of (A) \$7,500,000 divided by (B) the greater of (1) \$3.00 and (2) the volume weighted average price of the Company's common stock for the twenty (20) trading days preceding the date of the audit opinion for Starsys' fiscal year ended December 31, 2007.

If any shares of the Company's common stock are payable as earnout consideration for the fiscal year ending December 31, 2005, fifty percent (50%) of those shares will be deposited in the escrow described above.

Each outstanding share of the Company's common stock will remain unchanged in the merger.

Working Capital Contribution. The Company will contribute \$2.5 million to the working capital of the surviving corporation through the end of 2006.

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Treatment of Stock Options and Warrants. The holders of options, warrants and other rights to purchase Starsys common stock must exercise such rights on or before the closing of the merger. Any options, warrants or other rights to purchase Starsys common stock which are not exercised prior to the closing of the merger will be cancelled and will terminate and expire as of that closing of the merger. The Company will assume no options, warrants or other rights to purchase Starsys common stock pursuant to the merger.

Loan Repayments. At the closing of the merger, the Company will (i) pay off the remaining principal and interest of all loans to Starsys from Vectra Bank Colorado, together with any other costs incurred in connection with those loans, (ii) cancel and terminate the secured loan of \$1.2 million and all accrued interest and fees, from the Company to Starsys (the "SpaceDev loan"), and (iii) pay off subordinated loans in the aggregate amount of approximately \$920,000 owed by Starsys to certain Starsys shareholders. The Company will not be obligated to pay off more than \$4,600,000 in the aggregate (excluding the amount of the SpaceDev loan) for all of the loans and related costs described above.

Reservation of Options. The Company has agreed to reserve for issuance to Starsys officers, employees and consultants options to buy a number of shares of the Company's common stock equal to at least 15% of the number of shares of the

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Company's common stock issued at the closing and as earnout consideration. The Company will seek approval of its shareholders to increase the amount of shares available under the Company's 2004 Equity Incentive Plan, or under a new stock or equity plan to be adopted, to provide sufficient reserves for the issuance of the options referenced above.

Representations, Warranties and Covenants. The Company and Starsys have made customary representations, warranties and covenants in the merger agreement, including, among others, covenants (i) not to (A) solicit proposals relating to alternative business combination transactions or (B) subject to certain exceptions, enter into discussions concerning or provide information in connection with alternative business combination transactions, (ii) to cause shareholder meetings to be held to consider approval of the merger agreement (in the case of Starsys and the Company), and (iii) subject to certain exceptions, for the board of directors of Starsys to recommend adoption by its shareholders of the merger agreement and for our board of directors to recommend adoption by its shareholders of the merger agreement.

Conditions to Closing. Consummation of the merger is subject to certain closing conditions, including, among others, shareholder approvals, absence of governmental restraints, effectiveness of a Form S-4 registration statement, and accuracy of representations. The merger agreement allows Starsys and us to terminate the merger agreement upon the occurrence (or non-occurrence) of certain events.

Following the effective time of the merger, Scott Tibbitts, who is currently the Chief Executive Officer of Starsys, will become a director and executive officer of the Company.

In October 2005, the Company entered into a Securities Purchase Agreement with Laurus Master Fund, Ltd. whereby the Company issued 2,032,520 shares of its common stock to Laurus for an aggregate purchase price of \$2,500,000, or \$1.23 per share, representing 80% of the 20-day volume weighted average price of the Company's common stock through October 28, 2005. In conjunction with the Securities Purchase Agreement, the Company issued a five-year common stock purchase warrant to Laurus for the purchase of 450,000 shares of common stock at an exercise price of \$1.93 per share. The Company has committed to register all of the shares of stock underlying the common stock and the warrant after the Form S-4 (described above) becomes effective. Also in conjunction with the agreement, the Company has agreed to pay Laurus a fee equal to 3.5% of the proceeds raised from them, exclusive of the proceeds obtained from the exercise of the warrants.

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

THIS QUARTERLY REPORT ON FORM 10-QSB CONTAINS FORWARD-LOOKING STATEMENTS WITHIN THE MEANING OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995, WHICH REFLECT MANAGEMENT'S CURRENT VIEWS WITH RESPECT TO FUTURE EVENTS AND FINANCIAL PERFORMANCE. IN THIS REPORT, THE WORDS "ANTICIPATES," "BELIEVES," "EXPECTS," "INTENDS," "FUTURE," "MAY," "SHOULD," "PLAN," "CONTINUE," OR "WILL," AND SIMILAR EXPRESSIONS IDENTIFY FORWARD-LOOKING STATEMENTS. THESE AND OTHER FORWARD-LOOKING STATEMENTS ARE SUBJECT TO CERTAIN RISKS AND UNCERTAINTIES, INCLUDING THOSE DISCUSSED IN THE BUSINESS RISKS SECTION OF THIS ITEM 2 AND ELSEWHERE IN THIS FORM 10-QSB, THAT COULD CAUSE ACTUAL RESULTS TO DIFFER MATERIALLY FROM HISTORICAL RESULTS OR THOSE ANTICIPATED. READERS ARE CAUTIONED NOT TO PLACE UNDUE RELIANCE ON THESE FORWARD-LOOKING STATEMENTS, WHICH SPEAK ONLY AS OF THE DATE HEREOF. WE UNDERTAKE NO OBLIGATION TO PUBLICLY RELEASE THE RESULTS OF ANY REVISIONS TO THESE FORWARD-LOOKING STATEMENTS WHICH MAY BE MADE TO REFLECT

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EVENTS OR CIRCUMSTANCES OCCURRING SUBSEQUENT TO THE FILING OF THE FORM 10-QSB WITH THE SECURITIES AND EXCHANGE COMMISSION.

OVERVIEW

We are engaged in the conception, design, development, manufacture, integration and operation of space technology systems, products and services. We are currently focused on the commercial and military development of low-cost microsattellites, nanosatellites and related subsystems, hybrid rocket propulsion for space, launch and human flight vehicles as well as associated engineering and technical services which are provided primarily to government agencies, and specifically the Department of Defense. Our products and solutions are sold, mainly on a project-basis, directly to these customers and include sophisticated micro- and nanosatellites, hybrid rocket-based launch vehicles, maneuvering and orbital transfer vehicles and safe sub-orbital and orbital hybrid rocket-based propulsion systems. Although we believe there will be a commercial market for our microsattellite and nanosatellite products and services in the future, virtually all of our current work is for branches of the United States military. We are also developing commercial hybrid rocket motors for use in small launch vehicles, targets and sounding rockets, and small, high-performance space vehicles and subsystems for commercial customers.

During the first nine months of 2005, 93% of our net sales were generated from direct government contracts and 7% were generated from government-related work through subcontracts with others. In 2004, approximately 90% of our net sales were generated by government or government-related work. We anticipate that over 90% of net sales generated during the remainder of 2005 will be generated by government or government-related work. We will continue to seek both government and commercial business and anticipate that net sales from government sources will to continue to represent in excess of 70% of our net sales for the next several years as we increase our government and commercial marketing efforts for both of our technology and product areas. Currently, we are focusing on the domestic United States government market, which we believe is only about one-half of the global government market for our technology, products and services. Although we are interested in exploring international revenue and contract opportunities, we are restricted by export control regulations, including International Traffic in Arms Regulations, which may limit our ability to develop market opportunities outside the United States.

At this time, over 90% of our forecasted sales for 2005 are under contract or near contract award. We may not be able to win enough new business to achieve our targeted growth projection or to maintain a positive cash flow position. During the first nine months of 2005, we submitted five bids for government or commercial programs and continued our work with the United States Congress to identify directed funding for our programs.

In order to perform the Missile Defense Agency contract on schedule and successfully execute other existing and new business opportunities, we must substantially increase our staff and hire new engineers or subcontract the work to third parties. We are actively seeking to hire spacecraft and propulsion engineers, and we are investigating various partnership arrangements to increase resource availability.

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RECENT DEVELOPMENTS

In October 2005, we entered into an Agreement and Plan of Merger and Reorganization, which we refer to as the merger agreement, with Starsys Research Corporation, a Colorado corporation, and Scott Tibbitts, its largest shareholder. Pursuant to the merger agreement, Starsys will merge with and into

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a newly-created, wholly-owned subsidiary of SpaceDev. Holders of Starsys common stock will become holders of our common stock following the merger. The merger agreement is subject to a number of conditions described below, including effectiveness of a Form S-4 registration statement and approval of the respective shareholders of SpaceDev and Starsys.

Merger Consideration. We will pay and issue the following consideration at the effective time of the merger, subject to adjustment as provided in the merger agreement:

- cash in the aggregate amount of \$1,500,000; and
- an aggregate number of shares of our common stock equal to the quotient of (A) \$7,500,000 divided by (B) the greater of (1) \$1.40 and (2) the lesser of (x) \$1.90 and (y) the volume weighted average price of our common stock for the preceding 20 trading days.

Fifty percent (50%) of the number of shares of our common stock issued at closing will be deposited in escrow as security for the payment of indemnification claims under the merger agreement, which escrow will generally last until ten days following the date of audited financial statements prepared for the surviving corporation for the fiscal year ending 2006 (i.e., approximately April 2007).

Following the merger, Starsys shareholders may also be entitled to receive, based on the achievement by the surviving corporation of certain performance criteria for each of the fiscal years ending December 31, 2005, December 31, 2006 and December 31, 2007, additional earnout consideration consisting of up to:

- For the fiscal year ended December 31, 2005, \$350,000 in cash and an aggregate number of shares of our common stock equal to the quotient of (A) \$3,000,000 divided by (B) the greater of (1) \$2.00 and (2) the volume weighted average price of our common stock for the twenty trading days preceding the date of the audit opinion for Starsys' fiscal year ended December 31, 2005;
- For the fiscal year ended December 31, 2006, \$350,000 in cash and an aggregate number of shares of our common stock equal to the quotient of (A) \$7,500,000 divided by (B) the greater of (1) \$2.50 and (2) the volume weighted average price of our common stock for the twenty trading days preceding the date of the audit opinion for Starsys' fiscal year ended December 31, 2006; and,
- For the fiscal year ended December 31, 2007, \$350,000 in cash and an aggregate number of shares of our common stock equal to the quotient of (A) \$7,500,000 divided by (B) the greater of (1) \$3.00 and (2) the volume weighted average price of our common stock for the twenty trading days preceding the date of the audit opinion for Starsys' fiscal year ended December 31, 2007.

If any shares of our common stock are payable as earnout consideration for the fiscal year ending December 31, 2005, fifty percent (50%) of those shares will be deposited in the escrow described above.

Each outstanding share of our common stock will remain unchanged in the merger.

Working Capital Contribution. We will contribute \$2.5 million to the working capital of the surviving corporation through the end of 2006.

Treatment of Stock Options and Warrants. The holders of options, warrants and other rights to purchase Starsys common stock must exercise such rights on or

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before the closing of the merger. Any options, warrants or other rights to purchase Starsys common stock which are not exercised prior to the closing of

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the merger will be cancelled and will terminate and expire as of that closing of the merger. We will assume no options, warrants or other rights to purchase Starsys common stock pursuant to the merger.

Loan Repayments. At the closing of the merger, we will (i) pay off the remaining principal and interest of all loans to Starsys from Vectra Bank Colorado, together with any other costs incurred in connection with those loans, (ii) cancel and terminate the secured loan of \$1.2 million and all accrued interest and fees, from us to Starsys, and (iii) pay off subordinated loans in the aggregate amount of approximately \$920,000 owed by Starsys to certain Starsys shareholders. We will not be obligated to pay off more than \$4,600,000 in the aggregate (excluding the amount of our loan to Starsys) for all of the loans and related costs described above.

Reservation of Options. We have agreed to reserve for issuance to Starsys officers, employees and consultants options to buy a number of shares of our common stock equal to at least 15% of the number of shares of our common stock issued at the closing and as earnout consideration. We will seek approval of our shareholders to increase the amount of shares available under our 2004 Equity Incentive Plan, or under a new stock or equity plan to be adopted, to provide sufficient reserves for the issuance of the options referenced above. In September 2005, we made a secured loan to Starsys in the principal amount of \$1.2 million. The loan accrues interest at 8% per annum and matures on December 31, 2005, or earlier in certain circumstances. Principal or interest payments are due before maturity. The maturity date may be accelerated upon the occurrence of certain events of default. The loan is secured by a security interest in all of the assets of Starsys, subject to an intercreditor agreement with Vectra Bank Colorado, National Association.

Our proposed acquisition of Starsys exposes us to a number of risks, including those described below under "Risks Related to the Proposed Acquisition of Starsys."

In July 2005, we were awarded a small contract by Lunar Enterprise Corporation, a wholly owned subsidiary of Space Age Publishing Company to perform the work necessary to create a conceptual mission architecture and mission design for a human servicing mission to the Lunar south pole targeted for the period of 2010 to 2015. We were awarded an earlier phase by Lunar Enterprise for a conceptual mission and spacecraft design for a lunar lander program to further analyze launch opportunities, spacecraft design, trajectory possibilities, potential landing areas, available technologies for a small radio astronomy system, and communications and data handling requirements. These contracts are expected to result in revenues of \$125,000 and \$150,000, respectively. The current contract calls for us to identify and evaluate existing technology, technology currently under development, and proposed technology that could be developed by NASA, other countries or the private sector in time to be incorporated into the mission.

On July 18, 2005, we were awarded a subcontract to provide scientific, engineering, development and programmatic support to the development and demonstration of innovative SSA (space situational awareness) nanosatellite
(