NETGEAR, INC
Form 10-Q
August 08, 2012
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.
For the quarterly period ended July 1, 2012.
¨ 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: 000-50350
NETGEAR, Inc.
(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	77-0419172 (IRS Employer Identification No.)
350 East Plumeria Drive, San Jose, California (Address of principal executive offices)	95134 (Zip Code)

(408) 907-8000
(Registrant's telephone number including area code)
Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer, or a smaller reporting company. See definition of "accelerated filer," "large accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated filer	x	Accelerated filer	¨
Non-Accelerated filer	¨	Smaller reporting company	¨

Indicate by check mark whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2). Yes o No x
The number of outstanding shares of the registrant's Common Stock, $0.001 par value, was 38,050,876 as of July 30, 2012.

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PART I: FINANCIAL INFORMATION
Item 1. Financial Statements
NETGEAR, INC.
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands)

	July 1, 2012	December 31, 2011
ASSETS		
Current assets:		
Cash and cash equivalents	$157,155	$208,898
Short-term investments	203,273	144,797
Accounts receivable, net	271,769	261,307
Inventories	152,820	163,724
Deferred income taxes	22,482	23,088
Prepaid expenses and other current assets	36,226	32,415
Total current assets	843,725	834,229
Property and equipment, net	17,282	15,884
Intangibles, net	23,088	20,956
Goodwill	88,985	85,944
Other non-current assets	15,058	14,357
Total assets	$988,138	$971,370
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$101,176	$117,285
Accrued employee compensation	19,157	26,896
Other accrued liabilities	120,519	120,480
Deferred revenue	25,478	40,093
Income taxes payable	—	4,207
Total current liabilities	266,330	308,961
Non-current income taxes payable	16,818	18,657
Other non-current liabilities	5,443	4,995
Total liabilities	288,591	332,613
Commitments and contingencies (Note 9)		
Stockholders' equity:		
Common stock	38	38
Additional paid-in capital	379,086	364,243
Cumulative other comprehensive income	116	23
Retained earnings	320,307	274,453
Total stockholders' equity	699,547	638,757
Total liabilities and stockholders' equity	$988,138	$971,370

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

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NETGEAR, INC.
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share data)

	Three Months Ended		Six Months Ended	
	July 1, 2012	July 3, 2011	July 1, 2012	July 3, 2011
Net revenue	$320,655	$291,240	$646,275	$570,063
Cost of revenue	226,017	200,863	451,788	391,900
Gross profit	94,638	90,377	194,487	178,163
Operating expenses:				
Research and development	14,757	11,350	28,878	22,364
Sales and marketing	37,677	39,036	76,647	75,684
General and administrative	11,219	10,548	21,632	20,193
Restructuring and other charges	—	2,094	—	2,094
Litigation reserves, net	—	(225)	151	(278)
Total operating expenses	63,653	62,803	127,308	120,057
Income from operations	30,985	27,574	67,179	58,106
Interest income	116	106	235	235
Other income (expense), net	354	(341)	(247)	(671)
Income before income taxes	31,455	27,339	67,167	57,670
Provision for income taxes	9,933	6,742	20,498	15,884
Net income	$21,522	$20,597	$46,669	$41,786
Net income per share:				
Basic	$0.57	$0.56	$1.23	$1.14
Diluted	$0.56	$0.54	$1.21	$1.11
Weighted average shares outstanding used to compute net income per share:				
Basic	37,978	37,017	37,886	36,712
Diluted	38,595	37,968	38,612	37,680

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

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NETGEAR, INC.
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(In thousands)

	Three Months Ended		Six Months Ended	
	July 1, 2012	July 3, 2011	July 1, 2012	July 3, 2011
Net income	$21,522	$20,597	$46,669	$41,786
Other comprehensive income (loss), before tax:				
Unrealized gain (loss) on derivative instruments	172	94	116	(247)
Unrealized (loss) gain on available-for-sale securities	(1)	29	(35)	39
Other comprehensive income (loss), before tax	171	123	81	(208)
Tax benefit (expense) related to items of other comprehensive income	—	(7)	12	(10)
Other comprehensive income (loss), net of tax	171	116	93	(218)
Comprehensive income	$21,693	$20,713	$46,762	$41,568

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

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NETGEAR, INC.
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Six Months Ended	
	July 1, 2012	July 3, 2011
Cash flows from operating activities:		
Net income	$46,669	$41,786
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	7,493	7,453
Purchase premium amortization on investments	1,468	390
Non-cash stock-based compensation	6,787	6,880
Income tax benefit associated with stock option exercises	808	3,157
Excess tax benefit from stock-based compensation	(1,093)	(3,330)
Deferred income taxes	(176)	482
Changes in assets and liabilities, net of effect of acquisitions:		
Accounts receivable	(10,462)	16,771
Inventories	10,904	(4,105)
Prepaid expenses and other assets	(3,681)	(12,579)
Accounts payable	(16,110)	(16,779)
Accrued employee compensation	(7,739)	(4,454)
Other accrued liabilities	428	(8,567)
Deferred revenue	(14,614)	(4,695)
Income taxes payable	(6,046)	(2,446)
Net cash provided by operating activities	14,636	19,964
Cash flows from investing activities:		
Purchases of short-term investments	(153,862)	(135,949)
Proceeds from maturities of short-term investments	93,883	131,690
Purchase of property and equipment	(6,864)	(3,920)
Payments made in connection with business acquisitions	(7,100)	(37,509)
Net cash used in investing activities	(73,943)	(45,688)
Cash flows from financing activities:		
Purchase and retirement of treasury stock	(815)	(899)
Proceeds from exercise of stock options	6,331	25,834
Proceeds from issuance of common stock under employee stock purchase plan	955	709
Excess tax benefit from stock-based compensation	1,093	3,330
Net cash provided by financing activities	7,564	28,974
Net (decrease) increase in cash and cash equivalents	(51,743)	3,250
Cash and cash equivalents, at beginning of period	208,898	126,173
Cash and cash equivalents, at end of period	$157,155	$129,423

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

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NETGEAR, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1. The Company and Basis of Presentation

NETGEAR, Inc. (“NETGEAR” or the “Company”) was incorporated in Delaware in January 1996. The Company is a global networking company that delivers innovative products to consumers, businesses and service providers. For consumers, the Company makes high performance, dependable and easy-to-use home networking, storage and digital media products to connect people with the Internet and their content and devices. For businesses, the Company provides networking, storage and security solutions without the cost and complexity of Big IT. The Company also supplies leading service providers with made-to-order and retail proven, whole home networking solutions for sale to their customers. The Company’s products are built on a variety of proven technologies such as wireless, Ethernet and powerline, with a focus on reliability and ease-of-use. The Company sells products primarily through a global sales channel network, which includes traditional retailers, online retailers, wholesale distributors, direct market resellers ("DMRs"), value added resellers ("VARs"), and broadband service providers.

The accompanying unaudited condensed consolidated financial statements include the accounts of NETGEAR, Inc., and its wholly owned subsidiaries. They have been prepared in accordance with established guidelines for interim financial reporting and with the instructions of Form 10-Q and Article 10 of Regulation S-X. All significant intercompany balances and transactions have been eliminated in consolidation. The balance sheet dated December 31, 2011, has been derived from audited financial statements at such date. In the opinion of management, the unaudited condensed consolidated financial statements reflect all adjustments considered necessary (consisting only of normal recurring adjustments) to fairly state the Company’s financial position, results of operations, comprehensive income and cash flows for the periods indicated. These unaudited condensed consolidated financial statements should be read in conjunction with the notes to the consolidated financial statements included in the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

The Company’s fiscal year begins on January 1 of the year stated and ends on December 31 of the same year. The Company reports its interim results on a fiscal quarter basis rather than on a calendar quarter basis. Under the fiscal quarter basis, each of the first three fiscal quarters ends on the Sunday closest to the calendar quarter end, with the fourth quarter ending on December 31.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect (i) the reported amounts of assets and liabilities, (ii) the disclosure of contingent assets and liabilities at the date of the financial statements, and (iii) the reported amounts of revenues and expenses during the reported period. Actual results could differ materially from those estimates and operating results for the three and six months ended July 1, 2012 are not necessarily indicative of the results that may be expected for the year ending December 31, 2012.

2. Summary of Significant Accounting Policies

The Company’s significant accounting policies are disclosed in the Company’s Annual Report on Form 10-K for the year ended December 31, 2011. The Company’s significant accounting policies have not materially changed during the six months ended July 1, 2012.

Recent Accounting Pronouncements

In May 2011, the Financial Accounting Standards Board (“FASB") issued Accounting Standards Update (“ASU") 2011-04, “Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs”, which amends current fair value measurement and disclosure guidance to converge with International Financial Reporting Standards (“IFRS”) and provides increased transparency around valuation inputs and investment categorization. ASU 2011-04 became effective prospectively for the Company in the first quarter of fiscal 2012. The Company's adoption of ASU 2011-04 did not have an impact on the Company’s consolidated financial position, results of operations or cash flows.

In June 2011, the FASB issued ASU 2011-05, “Presentation of Comprehensive Income.” ASU 2011-05 eliminates the current option to report other comprehensive income and its components in the statement of changes in equity. ASU 2011-05 allows two presentation alternatives: present items of net income and other comprehensive income (1) in one continuous statement, referred to as the statement of comprehensive income or (2) in two separate, but consecutive, statements of net income and other comprehensive income. ASU 2011-05 is effective retrospectively starting in the first quarter of fiscal 2012. In December 2011, the FASB issued ASU 2011-12, which defers the ASU 2011-05 requirement to present components of reclassifications of other comprehensive income on the face of the income statement. The amendments in ASU 2011-12 are effective at the same time as the amendments in Update 2011-05. All other requirements of ASU 2011-05 are not affected by ASU 2011-12. Since the adoption

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of the authoritative guidance only required additional disclosures, the adoption did not impact the Company's consolidated financial position, results of operations or cash flows.

3. Business Acquisitions

Firetide, Inc.

On June 4, 2012, the Company acquired certain intellectual property of Firetide, Inc. ("Firetide") for an aggregate purchase price of $7.2 million. The acquisition included intangible assets that existed at the closing date, including IP contracts, technology assets, business technology, and goodwill. The Company believes the acquisition will bolster its wireless product offerings in its commercial business unit and strengthen its market position in the small to medium size campus wireless LAN market. The acquisition qualified as a business combination and was accounted for using the acquisition method of accounting.

The Company paid $6.6 million of the aggregate purchase price in the second quarter of 2012, and expects to pay the remaining $0.6 million, less amounts used to satisfy certain claims, twelve months after the closing of the acquisition. The ongoing costs of developing these assets subsequent to the date of acquisition have been included in the consolidated financial statements since the date of acquisition. The historical results of operations related to the acquired assets prior to the acquisition were not material to the Company's results of operations.

The allocation of the purchase price was as follows (in thousands):

Intangibles, net	$4,159
Goodwill	3,041
Total consideration	$7,200

Of the $3.0 million of goodwill recorded on the acquisition of Firetide, approximately $1.6 million and $3.0 million is deductible for U.S. federal and state income tax purposes, respectively. The goodwill recognized, which was assigned to the Company's commercial business unit, is primarily attributable to expected synergies and the assembled workforce of Firetide.

The Company designated the $4.2 million in acquired intangible assets as existing technology. The value was calculated based on the present value of the future estimated cash flows derived from estimated savings attributable to the existing technology and discounted at 22.0%. The acquired existing technology is being amortized over its estimated useful life of five years.

Customer Networking Solutions Division of Westell Technologies, Inc.

On April 15, 2011, the Company completed the acquisition of certain intellectual property and other assets of the Customer Networking Solutions division ("CNS") of Westell Technologies, Inc. ("Westell") at a purchase price of $37.0 million in cash. The acquisition included inventories, property and equipment, intangible assets, and liabilities that existed at the closing date, including employee bonuses and product warranties. The acquisition qualifies as a business combination and was accounted for using the acquisition method of accounting. The Company believes the acquisition will bolster its service provider revenue growth and strengthen its market position among U.S. telecommunications operators.

The results of CNS's operations have been included in the consolidated financial statements since the date of acquisition. The historical results of operations of CNS prior to the acquisition were not material to the Company's results of operations.

The allocation of the purchase price was as follows (in thousands):

Inventories	$6,290
Property and equipment, net	119
Intangibles, net	19,500
Current liabilities	(646)
Goodwill	11,746
Total consideration	$37,009

Of the $11.7 million of goodwill recorded on the acquisition of CNS, approximately $10.6 million and $11.7 million was deductible for U.S. federal and state income tax purposes, respectively. The goodwill recognized, which was assigned to the

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Company's service provider business unit, is primarily attributable to expected synergies and the assembled workforce of CNS.

A total of $15.7 million of the $19.5 million in acquired intangible assets was designated as customer contracts and related relationships. The value was calculated based on the present value of the future estimated cash flows derived from projections of future operations attributable to existing customer contracts and related relationships and discounted at 19.0%. This $15.7 million is being amortized over its estimated useful life of eight years.

A total of $3.7 million of the $19.5 million in acquired intangible assets was designated as core technology. The value was calculated based on the present value of the future estimated cash flows derived from estimated savings attributable to the core technology and discounted at 16.0%. This $3.7 million is being amortized over its estimated useful life of four years.

A total of $0.1 million of the $19.5 million in acquired intangible assets was designated as order backlog. The value was calculated based on an estimate of order backlog using the expected cash flow for the orders and discounted at 3.3%. This $0.1 million was fully amortized in the third quarter of 2011.

Leaf Networks, LLC

On January 15, 2010, the Company completed the acquisition of certain intellectual property and other assets of Leaf Networks, LLC (“Leaf”), a developer of virtual networking software. The acquisition qualified as a business acquisition and was accounted for using the purchase method of accounting. The Company believes the acquisition will accelerate the Company’s continuing networking technology research and development initiatives. The aggregate purchase price was $2.1 million, of which $2.0 million was paid in cash in the first quarter of 2010 and $0.1 million was paid in the first quarter of 2011.

Additionally, the acquisition agreement specified that Leaf shareholders may receive a total additional payout of up to $0.9 million in cash over the three years following the closing of the acquisition if developed products pass certain acceptance criteria. During the first quarter of 2010, the Company initially determined that the present value of the $0.9 million potential additional payout was approximately $0.8 million. For each subsequent reporting period, the Company remeasured fair value of the potential payout and recorded a liability. The Company paid $0.4 million for the first portion of this additional payout in the first quarter of 2011 and the remaining $0.5 million in the first quarter of 2012.

The results of Leaf’s operations have been included in the consolidated financial statements since the date of acquisition. The historical results of operations of Leaf prior to the acquisition were not material to the Company’s results of operations.

In accordance with the acquisition method of accounting for business combinations, the Company allocated the total purchase price to identifiable intangible assets based on each element’s estimated fair value. Acquisition costs were expensed as incurred, and were immaterial for this transaction. Purchased intangibles, representing the existing technology acquired from Leaf, will be amortized on a straight-line basis over their respective estimated useful lives. Goodwill was recorded based on the residual purchase price after allocating the purchase price to the fair market value of intangible assets acquired. Goodwill arose as a result of the $0.8 million present valuation of the $0.9 million potential additional payout, plus $0.1 million in additional payment consideration.

The allocation of the purchase price was as follows (in thousands):

Intangibles, net	$2,000
Goodwill	900
Total purchase price allocation	$2,900

Of the $0.9 million of goodwill recorded on the acquisition of Leaf, approximately $0.5 million and $0.9 million was deductible for federal and state income tax purposes, respectively. The goodwill recognized, is primarily attributable to expected synergies and the assembled workforce of Leaf.

The $2.0 million in acquired intangible assets was designated as existing technology. The value was calculated based on the present value of the future estimated cash flows derived from projections of future revenue attributable to existing technology. This $2.0 million is being amortized over its estimated useful life of seven years.

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4. Balance Sheet Components (in thousands)

Short-Term Investments

	As of July 1, 2012				December 31, 2011			
	Cost	Unrealized Gain	Unrealized Loss	Estimated Fair Value	Cost	Unrealized Gain	Unrealized Loss	Estimated Fair Value
U.S. Treasuries	$200,499	$1	$(7)	$200,493	$144,673	$34	$(4)	$144,703
Certificates of Deposits	2,780	—	—	2,780	94	—	—	94
Total	$203,279	$1	$(7)	$203,273	$144,767	$34	$(4)	$144,797

All of the Company's marketable securities are classified as available-for-sale and consist of government securities with an original maturity or remaining maturity at the time of purchase of greater than three months and no more than 12 months. Accordingly, none of our investments have unrealized losses greater than 12 months. There were no material realized gains or losses from the maturity of available-for-sale securities in three and six months ended July 1, 2012 and July 3, 2011.

Accounts receivable, net

	As of July 1, 2012	December 31, 2011
Gross accounts receivable	$289,935	$279,932
Less: Allowance for doubtful accounts	(1,317)	(1,335)
Allowance for sales returns	(13,866)	(13,360)
Allowance for price protection	(2,983)	(3,930)
Total allowances	(18,166)	(18,625)
Total accounts receivable, net	$271,769	$261,307

Inventories

	As of July 1, 2012	December 31, 2011
Raw materials	$3,347	$4,676
Finished goods	149,473	159,048
Total inventories	$152,820	$163,724

The Company records provisions for excess and obsolete inventory based on forecasts of future demand. While management believes the estimates and assumptions underlying its current forecasts are reasonable, there is risk that additional charges may be necessary if current forecasts are greater than actual demand.

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Property and equipment, net

	As of July 1, 2012	December 31, 2011
Computer equipment	$6,936	$7,109
Furniture, fixtures and leasehold improvements	12,139	9,757
Software	20,861	19,974
Machinery and equipment	25,191	21,797
Construction in progress	367	662
	65,494	59,299
Less: accumulated depreciation and amortization	(48,212)	(43,415)
Total property and equipment, net	$17,282	$15,884

Depreciation expense was $2.9 million and $5.5 million for the three and six months ended July 1, 2012, respectively, and $2.6 million and $4.9 million for the three and six months ended July 3, 2011, respectively.

Intangibles, net

The following tables present details of the Company's purchased intangible assets:

	Gross	Accumulated Amortization	Net
July 1, 2012			
Customer contracts and relationships	$15,700	$(2,290)	$13,410
Existing technology	18,159	(12,760)	5,399
Core technology	10,800	(7,909)	2,891
Trademarks	2,600	(2,238)	362
Patents	1,270	(244)	1,026
Non-compete	100	(100)	—
Backlog	100	(100)	—
Total intangibles, net	$48,729	$(25,641)	$23,088

	Gross	Accumulated Amortization	Net
December 31, 2011			
Customer contracts and relationships	$15,700	$(1,308)	$14,392
Existing technology	14,000	(12,548)	1,452
Core technology	10,800	(7,357)	3,443
Trademarks	2,600	(2,021)	579
Patents	1,270	(180)	1,090
Non-compete	100	(100)	—
Backlog	100	(100)	—
Total intangibles, net	$44,570	$(23,614)	$20,956

In June 2012, the Company recorded $4.2 million of purchased intangible assets, as a result of its acquisition of certain intellectual property of Firetide. The Company designated the acquired intangible assets as existing technology. For further discussion, see Note 3, Business Acquisitions.

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Amortization of purchased intangible assets was $1.0 million and $2.0 million for the three and six months ended July 1, 2012, respectively, and $1.2 million, and $2.5 million for the three and six months ended July 3, 2011, respectively. No impairment charges were recorded in the three and six months ended July 1, 2012, and July 3, 2011.

Estimated amortization expense related to intangibles for each of the next five years and thereafter is as follows:

Year Ending December 31	Amount
2012 (remaining six months)	$2,373
2013	4,458
2014	4,133
2015	3,517
2016	3,209
Thereafter	5,398
Total expected amortization expense	$23,088

Goodwill

The changes in the carrying amount of goodwill during the six months ended July 1, 2012 are as follows:

Retail