REALNETWORKS INC
Form 10-Q
May 09, 2007

Table of Contents

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

FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended March 31, 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 0-23137
RealNetworks, Inc.
(Exact name of registrant as specified in its charter)

Washington	**91-1628146**
(State of incorporation)	*(I.R.S. Employer Identification Number)*
2601 Elliott Avenue, Suite 1000	
Seattle, Washington	**98121**
(Address of principal executive offices)	*(Zip Code)*

(206) 674-2700
(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 þ No o

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

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

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

The number of shares of the registrant s Common Stock outstanding as of April 30, 2007 was 154,253,428.

TABLE OF CONTENTS

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

REALNETWORKS, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except per share data)

	March 31, 2007	December 31, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	$ 511,212	$ 525,232
Short-term investments	152,199	153,688
Trade accounts receivable, net of allowances for doubtful accounts and sales returns	56,038	65,751
Deferred costs, current portion	3,298	1,643
Deferred tax assets, net, current portion	891	891
Prepaid expenses and other current assets	22,373	21,990
Total current assets	746,011	769,195
Equipment, software, and leasehold improvements:		
Equipment and software	84,456	83,587
Leasehold improvements	30,271	29,665
Total equipment, software, and leasehold improvements, at cost	114,727	113,252
Less accumulated depreciation and amortization	67,833	65,509
Net equipment, software, and leasehold improvements	46,894	47,743
Restricted cash equivalents	15,500	17,300
Equity investments	17,835	22,649
Other assets	5,983	5,148
Deferred tax assets, net, non-current portion	27,150	27,150
Other intangible assets, net	100,507	105,109
Goodwill	310,735	309,122
Total assets	$ 1,270,615	$ 1,303,416
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 40,795	$ 52,097
Accrued and other liabilities	116,379	104,328
Deferred revenue, current portion	26,793	24,137
Accrued loss on excess office facilities, current portion	4,522	4,508
Total current liabilities	188,489	185,070
Deferred revenue, non-current portion	3,468	3,440
Accrued loss on excess office facilities, non-current portion	9,036	9,993

Deferred rent	4,388	4,331
Deferred tax liabilities, net, non-current portion	23,132	27,076
Convertible debt	100,000	100,000
Other long-term liabilities	7,425	3,740
Total liabilities	335,938	333,650
Shareholders equity:		
Preferred stock, $0.001 par value, no shares issued and outstanding		
Series A: authorized 200 shares		
Undesignated series: authorized 59,800 shares		
Common stock, $0.001 par value authorized 1,000,000 shares; issued and outstanding		
154,108 shares in 2007 and 163,278 shares in 2006	154	162
Additional paid-in capital	722,049	791,108
Accumulated other comprehensive income	17,502	23,485
Retained earnings	194,972	155,011
Total shareholders equity	934,677	969,766
Total liabilities and shareholders equity	$ 1,270,615	$ 1,303,416

See accompanying notes to unaudited condensed consolidated financial statements.

3

Table of Contents

REALNETWORKS, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
AND COMPREHENSIVE INCOME
(In thousands, except per share data)

	Three Months ended March 31,	
	2007	**2006**
Net revenue (A)	$ 129,472	$ 86,602
Cost of revenue (B)	45,943	26,753
Gross profit	83,529	59,849
Operating expenses:		
Research and development	23,479	18,099
Sales and marketing	49,700	36,083
General and administrative	17,354	13,226
Loss on excess office facilities		738
Subtotal operating expenses	90,533	68,146
Antitrust litigation benefit, net	(60,747)	(39,835)
Total operating expenses, net	29,786	28,311
Operating income	53,743	31,538
Other income (expenses):		
Interest income, net	9,102	7,979
Equity in net loss of investments	(132)	
Other income, net	467	117
Other income, net	9,437	8,096
Income before income taxes	63,180	39,634
Income taxes	(23,219)	(14,751)
Net income	$ 39,961	$ 24,883
Basic net income per share	$ 0.25	$ 0.15
Diluted net income per share	$ 0.22	$ 0.14
Shares used to compute basic net income per share	161,350	160,887
Shares used to compute diluted net income per share	178,053	176,923
Comprehensive income:		
Net income	$ 39,961	$ 24,883
Unrealized holding losses on short-term and equity investments, net of income taxes	(3,056)	(7,821)
Foreign currency translation gains (losses)	(2,927)	367

Comprehensive income	$ 33,978	$ 17,429
(A) Components of net revenue:		
License fees	$ 21,837	$ 22,636
Service revenue	107,635	63,966
	$ 129,472	$ 86,602
(B) Components of cost of revenue:		
License fees	$ 8,292	$ 9,861
Service revenue	37,651	16,892
	$ 45,943	$ 26,753

See accompanying notes to unaudited condensed consolidated financial statements.

Table of Contents

REALNETWORKS, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Three Months Ended March 31,	
	2007	**2006**
Cash flows from operating activities:		
Net income	$ 39,961	$ 24,883
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	9,933	4,252
Stock-based compensation	5,685	3,638
Equity in net loss of investments	132	
Loss on disposal of equipment, software, and leasehold improvements	41	77
Excess tax benefit from stock option exercises	(294)	
Accrued loss on excess office facilities	(943)	(702)
Deferred income taxes	(3,944)	12,882
Other	26	29
Net change in certain operating assets and liabilities, net of acquisitions	11,492	(47,088)
Net cash provided by (used in) operating activities	62,089	(2,029)
Cash flows from investing activities:		
Purchases of equipment, software, and leasehold improvements	(3,839)	(2,568)
Purchases of short-term investments	(55,432)	(58,884)
Proceeds from sales and maturities of short-term investments	57,124	55,180
Purchases of other intangibles assets	(2,038)	
Decrease in restricted cash equivalents	1,800	
Cash used in acquisitions, net of cash acquired		(6,799)
Net cash used in investing activities	(2,385)	(13,071)
Cash flows from financing activities:		
Net proceeds from sale of common stock under employee stock purchase plan and exercise of stock options	3,776	7,614
Excess tax benefit from stock options exercises	294	
Repurchase of common stock	(78,481)	(76,988)
Net cash used in financing activities	(74,411)	(69,374)
Effect of exchange rate changes on cash and cash equivalents	687	669
Net decrease in cash and cash equivalents	(14,020)	(83,805)
Cash and cash equivalents, beginning of period	525,232	651,971
Cash and cash equivalents, end of period	$ 511,212	$ 568,166

Supplemental disclosure of cash flow information:				
Cash paid for income taxes	$	4,526	$	8,921
Supplemental disclosure of non-cash investing and financing activities:				
Accrued acquisition consideration	$	4,364	$	2,000
Accrued acquisition costs	$		$	287

See accompanying notes to unaudited condensed consolidated financial statements.

Table of Contents

REALNETWORKS, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Three Months Ended March 31, 2007 and 2006

Note 1. Summary of Significant Accounting Policies

Description of Business. RealNetworks, Inc. and subsidiaries (RealNetworks or Company) is a leading global provider of network-delivered digital media products and services. The Company also develops and markets software products and services that enable the creation, distribution and consumption of digital media, including audio and video.

Inherent in the Company s business are various risks and uncertainties, including limited history of certain of its product and service offerings and its limited history of offering premium subscription services on the Internet. The Company s success will depend on the acceptance of the Company s technology, products, and services and the ability to generate related revenue.

Basis of Presentation. The unaudited condensed consolidated financial statements include the accounts of the Company and its wholly-owned and majority-owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation. The Company acquired 99.7% of WiderThan Co., Ltd. (WiderThan) during the quarter ended December 31, 2006. The accompanying unaudited condensed consolidated financial statements include 100% of the financial results of WiderThan from the date of acquisition. The minority interest in the earnings of WiderThan for the quarter ended March 31, 2007 was nominal.

The unaudited condensed consolidated financial statements reflect all adjustments, consisting only of normal, recurring adjustments that, in the opinion of the Company s management, are necessary for a fair presentation of the results of operations for the periods presented. Operating results for the quarter ended March 31, 2007 are not necessarily indicative of the results that may be expected for any subsequent quarter or for the year ending December 31, 2007. Certain information and disclosures normally included in financial statements prepared in conformity with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission (SEC).

These unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and related notes included in the Company s Annual Report on Form 10-K for the year ended December 31, 2006.

Revenue Recognition. The Company recognizes revenue in accordance with the following authoritative literature: AICPA Statement of Position (SOP) No. 97-2, *Software Revenue Recognition;* SOP No. 98-9, *Software Revenue Recognition with Respect to Certain Arrangements*; SOP No. 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*; SEC Staff Accounting Bulletin (SAB) No. 104, *Revenue Recognition in Financial Statements*; Financial Accounting Standards Board s (FASB) Emerging Issues Task Force (EITF) Issue No. 99-19, *Reporting Revenue Gross as a Principal versus Net as an Agent;* and EITF Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*. Generally the Company recognizes revenue when there is persuasive evidence of an arrangement, the fee is fixed or determinable, the product or services have been delivered and collectibility of the resulting receivable is reasonably assured.

Consumer subscription products are paid in advance, typically for monthly, quarterly or annual periods. Subscription revenue is recognized ratably over the related subscription period. Revenue from sales of downloaded individual tracks, albums and games are recognized at the time the music or game is made available, digitally, to the end user.

The Company recognizes revenue for its software products pursuant to the requirements of SOP No. 97-2, as amended by SOP No. 98-9. If the Company provides consulting services that are considered essential to the functionality of the software products, both the software product revenue and services revenue are recognized under contract accounting in accordance with the provisions of SOP No. 81-1. Revenue from these arrangements is either recognized under the percentage of completion method based on the ratio of direct labor hours incurred to total projected labor hours, or on the completed contract method based on customer specific arrangement. Revenue from software license agreements with original equipment manufacturers (OEM) is recognized when the OEM delivers its product incorporating the Company s software to the end user.

The Company has arrangements whereby customers pay one price for multiple products and services and in some cases, involve a combination of products and services. For arrangements with multiple deliverables, revenue is recognized upon the delivery of the individual deliverables in accordance with EITF Issue No. 00-21. In the event that there is no objective and reliable evidence of fair value of the delivered items, the revenue recognized upon delivery is the total arrangement consideration less the fair value of the

REALNETWORKS, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

undelivered items. The Company applies significant judgment in establishing the fair value of multiple elements within revenue arrangements.

The Company recognizes revenue on a gross or net basis in accordance with EITF Issue No. 99-19. In most arrangements, the Company contracts directly with end user customers, is the primary obligor and carries all collectibility risk. In such arrangements the Company reports revenue on a gross basis. In some cases, the Company utilizes third-party distributors to sell products or services directly to end user customers and carries no collectibility risk. In such instances the Company reports revenue on a net basis.

Revenue generated from advertising on the Company s websites and from advertising included in its products is recognized as revenue as the delivery of the advertising occurs.

Accounting for Taxes Collected From Customers. The Company collects various types of taxes from its customers, assessed by governmental authorities, that is imposed on and concurrent with revenue-producing transactions. Such taxes are not included in net revenue of the Company.

Note 2. Recently Adopted Accounting Pronouncement

In June 2006, the FASB issued Financial Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109.* FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS No. 109, *Accounting for Income Taxes*, and prescribes a recognition threshold and measurement process for financial statement recognition and measurement of tax positions taken or expected to be taken in tax returns. FIN No. 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. On January 1, 2007, date of adoption of FIN No. 48, the Company had $7.5 million of unrecognized tax benefits, of which $7.2 million would affect the effective tax rate if recognized. Although the implementation of FIN No. 48 did not impact the amount of liability for unrecognized tax benefits, the Company reclassified $5.3 million of liability for unrecognized tax benefits from current income taxes payable to other long-term liabilities to conform with the balance sheet presentation requirements of FIN No. 48.

In accordance with FIN No. 48, the Company recognizes potential accrued interest and penalties related to unrecognized tax benefits as a component of income tax expense. As of January 1, 2007, the Company had approximately $300,000 of accrued interest and penalties related to uncertain tax positions, which is included as a component of the $5.3 million of unrecognized tax benefit noted above. To the extent interest and penalties are not assessed with respect to uncertain tax positions, amounts accrued will be reduced and reflected as a reduction of the overall income tax provision. The Company does not anticipate that total unrecognized tax benefits will significantly change within the next twelve months.

The Company files numerous consolidated and separate income tax returns in the United States Federal, state, local, and foreign jurisdictions. With few exceptions, the Company is no longer subject to United States Federal, state, local, or foreign income tax examinations for years before 1993.

Note 3. Stock-Based Compensation

The Company accounts for stock-based compensation in accordance with SFAS No. 123R revised 2004, *Share-Based Payment*. Under the fair value provisions of the statement, stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense over the requisite service period, which is the vesting period. The Company uses the Black-Scholes option-pricing model to determine the fair-value of stock-based awards under SFAS No. 123R. The Company recognizes compensation cost related to stock options granted prior to the adoption of SFAS No. 123R on an accelerated basis over the applicable vesting period using the methodology described in FIN No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans*. The Company recognizes compensation cost related to options granted subsequent to the adoption of SFAS No. 123R on a straight-line basis over the applicable vesting period.

The expected term of the options represents the estimated period of time until exercise and is based on historical experience of similar awards, including the contractual terms, vesting schedules, and expectations of future employee behavior. Expected stock price volatility is based on a combination of historical volatility of the Company s stock for the related expected term and the implied volatility of its traded options. The risk-free interest rate is based on the implied yield available on U.S. Treasury zero-coupon issues with a term equivalent to the expected term of the stock options. The Company has not paid dividends in the past.

REALNETWORKS, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The fair value of options granted was determined using the Black-Scholes model and the following weighted average assumptions:

	Three Months Ended March 31,	
	2007	**2006**
Expected dividend yield	0%	0%
Risk-free interest rate	4.7%	4.65%
Expected life (years)	4.1	4.3
Volatility	42%	48%

Stock-based compensation expense recognized is as follows (in thousands):

	Three Months Ended March 31,	
	2007	**2006**
Cost of service revenue	$ 159	$ 50
Research and development	1,772	1,369
Sales and marketing	2,387	1,359
General and administrative	1,367	860
Total stock-based compensation expense	$ 5,685	$ 3,638

No stock-based compensation was capitalized as part of the cost of an asset during the quarters ended March 31, 2007 and 2006. As of March 31, 2007, $41.0 million of total unrecognized compensation cost, net of estimated forfeitures, related to stock options is expected to be recognized over a weighted-average period of 2.6 years.

Note 4. Business Combinations

There were no business combinations during the quarter ended March 31, 2007.

The Company acquired 99.7% of the outstanding common shares and American Depository Shares of WiderThan Co. Ltd. (WiderThan) during the quarter ended December 31, 2006 for a total purchase price of $342.7 million. The results of WiderThan operations are included in the Company s unaudited condensed consolidated financial statements starting from the closing date of October 31, 2006.

Business Combination During the Quarter Ended March 31, 2006.

Zylom Media Group B.V.

On January 31, 2006, the Company acquired all of the outstanding securities of Zylom Media Group B.V. (Zylom) in exchange for $7.9 million in cash payments, including $293,000 in direct acquisition related costs consisting primarily of professional fees. The Company is also obligated to pay an additional $2.0 million, through individual payments of $1.0 million on the first and second anniversaries of the acquisition date. No such payments have been made as of March 31, 2007.

Additionally, the Company may be obligated to pay up to $10.9 million over a three-year period, dependent on whether certain performance criteria are achieved. Such amounts are not included in the initial aggregate purchase price and, to the extent earned, will be recorded as goodwill when the performance criteria are achieved. During the three months ended March 31, 2007 the Company accrued $4.4 million towards such payments based on achievement of certain performance criteria.

Zylom is located in Eindhoven, The Netherlands and is a distributor, developer, and publisher of PC-based games in Europe. The Company believes that combining Zylom s assets and distribution network with the Company s downloadable, PC-based games assets and distribution platform will enhance the Company s presence in the European games market. The results of Zylom s operations are included in the Company s condensed consolidated financial statements starting from the date of acquisition.

Table of Contents

REALNETWORKS, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

A summary of the purchase price of the acquisition is as follows (in thousands):

Cash paid at acquisition	$ 7,922
Additional future payments related to initial purchase price	2,000
Additional payments for achievement of performance criteria	4,364
Estimated direct acquisition costs	293
Total	$ 14,579

The aggregate purchase consideration has been allocated to the assets and liabilities acquired, including identifiable intangible assets, based on their respective estimated fair values as summarized below. The respective estimated fair values were determined by a third-party appraisal at the acquisition date and resulted in excess purchase consideration over the net tangible and identifiable intangible assets acquired of $8.2 million. Goodwill in the amount of $8.2 million is not deductible for tax purposes.

A summary of the allocation of the purchase price is as follows (in thousands):

Current assets	$ 1,830
Property and equipment	166
Other intangible assets subject to amortization:	
Distributor and customer relationships	1,290
Technology and games	570
Tradenames and trademarks	560
Non-compete agreements	180
Goodwill	12,532
Total assets acquired	17,128
Current liabilities	(1,781)
Net deferred tax liabilities	(768)
Total liabilities acquired	(2,549)
Net assets acquired	$ 14,579

Distributor and customer relationships have weighted average estimated useful lives of five years. Technology, games, tradenames, and trademarks have weighted average estimated useful lives of three years. Non-compete agreements have a weighted average estimated useful life of four years. All of the other intangible assets are being amortized over their estimated useful lives on a straight line basis.

Pro forma results are not presented as they are not material to the Company s overall unaudited condensed consolidated financial statements.

Note 5. Allowance for Doubtful Accounts Receivable and Sales Returns

Activity in the allowance for doubtful accounts receivable and sales returns is as follows (in thousands):

	Allowance For Doubtful Accounts Receivable	Sales Returns

Balances, December 31, 2006	$ 1,101	$ 1,389
Additions charged to expenses/revenue	30	1,273
Amounts written off	(31)	(1,460)
Balances, March 31, 2007	$ 1,100	$ 1,202

As of March 31, 2007 and December 31, 2006 one international customer accounted for 26% and 25%, respectively, of trade accounts receivable. The same international customer accounted for 12% of total revenue during the three months ended March 31, 2007. No one customer accounted for more than 10% of total revenue during the quarter ended March 31, 2006.

Table of Contents

REALNETWORKS, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 6. Equity Investments

As of March 31, 2007 and December 31, 2006, the carrying value of equity investments in publicly traded companies consists primarily of approximately 10.6% of outstanding shares of J-Stream Inc. (J-Stream), a Japanese media services company. These equity investments are accounted for as available-for-sale and the increase over the cost basis, net of income taxes, is reflected as a component of accumulated other comprehensive income.

Summary of equity investments is as follows (in thousands):

	March 31, 2007		December 31, 2006	
	Cost	Carrying Value	Cost	Carrying Value
Publicly traded investments	$ 913	$ 15,553	$ 913	$ 20,235
Privately held investments	1,879	2,282	1,879	2,414
Total equity investments	$ 2,792	$ 17,835	$ 2,792	$ 22,649

Note 7. Other Intangible Assets

Other intangible assets at March 31, 2007 consist of the following (in thousands):

	Gross Amount	Accumulated Amortization	Net
Customer relationships	$ 72,426	$ 6,454	$ 65,972
Developed technology	36,681	11,407	25,274
Patents, trademarks and tradenames	7,077	3,086	3,991
Service contracts and other	6,707	1,437	5,270
Total other intangible assets, March 31, 2007	$ 122,891	$ 22,384	$ 100,507

Other intangible assets at December 31, 2006 consist of the following (in thousands):

	Gross Amount	Accumulated Amortization	Net
Customer relationships	$ 73,061	$ 3,386	$ 69,675
Developed technology	36,891	9,981	26,910
Patents, trademarks and tradenames	7,114	2,226	4,888
Service contracts and other	4,680	1,044	3,636
Total other intangible assets, December 31, 2006	$ 121,746	$ 16,637	$ 105,109

Amortization expense related to other intangible assets during the quarters ended March 31, 2007 and 2006, was $5.7 million and $996,000, respectively.

As of March 31, 2007, estimated future amortization of other intangible assets is as follows (in thousands):