

NETLIST INC  
Form 10-Q  
August 08, 2008  
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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549



## **FORM 10-Q**



(Mark One)

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

For the quarterly period ended June 28, 2008

or

- ☐ **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 001-33170









## **NETLIST, INC.**

(Exact name of registrant as specified in its charter)



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**Delaware**

State or other jurisdiction of  
incorporation or organization

**95-4812784**

(I.R.S. Employer  
Identification No.)

**51 Discovery, Irvine, CA 92618**

(Address of principal executive offices) (Zip Code)

**(949) 435-0025**

(Registrant's telephone number, including area code)

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

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

Large accelerated filer ☐ Accelerated filer ☐ Non-accelerated filer ☐ Smaller reporting company ☒  
(Do not check if a smaller reporting company)

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

The number of shares outstanding of each of the registrant's classes of common stock as of the latest practicable date:

Common Stock, par value \$0.001 per share

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19,855,411 shares outstanding at July 31, 2008

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**NETLIST, INC. AND SUBSIDIARIES**

**QUARTERLY REPORT ON FORM 10-Q**

**FOR THE THREE AND SIX MONTHS ENDED JUNE 28, 2008**



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**PART I. FINANCIAL INFORMATION**



**Item 1. Financial Statements**



**NETLIST, INC. AND SUBSIDIARIES**

**Unaudited Condensed Consolidated Balance Sheets**

(in thousands)





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	June 28, 2008	December 29, 2007
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 11,243	\$ 7,182
Restricted cash	2,000	
Investments in marketable securities	11,595	15,573
Accounts receivable, net	6,441	12,034
Inventories	8,331	3,333
Income taxes receivable	903	708
Deferred taxes	3,899	3,464
Prepaid expenses and other current assets	975	392
Total current assets	45,387	42,686
Property and equipment, net	7,907	8,191
Deferred taxes	1,620	1,065
Long-term investments in marketable securities	974	7,814
Other assets	556	600
Total assets	\$ 56,444	\$ 60,356
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 4,952	\$ 6,697
Revolving line of credit	5,662	4,872
Current portion of long-term debt	547	740
Current portion of deferred gain on sale and leaseback transaction	118	118
Accrued expenses and other current liabilities	2,618	2,872
Total current liabilities	13,897	15,299
Long-term debt, net of current portion	397	638
Deferred gain on sale and leaseback transaction, net of current portion	167	226
Total liabilities	14,461	16,163
Commitments and contingencies		
Stockholders' equity:		
Common stock	20	20
Additional paid-in capital	68,724	68,109
Accumulated deficit	(26,734)	(23,899)
Accumulated other comprehensive loss	(27)	(37)
Total stockholders' equity	41,983	44,193
Total liabilities and stockholders' equity	\$ 56,444	\$ 60,356

See accompanying notes.

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**NETLIST, INC. AND SUBSIDIARIES**

**Unaudited Condensed Consolidated Statements of Operations**

(in thousands, except per share amounts)

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	Three Months Ended		Six Months Ended	
	June 28, 2008	June 30, 2007	June 28, 2008	June 30, 2007
Net sales	\$ 18,429	\$ 12,811	\$ 31,533	\$ 50,349
Cost of sales(1)	15,770	18,734	25,743	50,823
Gross profit (loss)	2,659	(5,923)	5,790	(474)
Operating expenses:				
Research and development(1)	1,716	1,478	3,292	2,545
Selling, general and administrative(1)	3,310	3,845	6,778	7,549
Total operating expenses	5,026	5,323	10,070	10,094
Operating loss	(2,367)	(11,246)	(4,280)	(10,568)
Other income:				
Interest income, net	104	162	343	114
Other income (expense), net	23	4	(68)	5
Total other income, net	127	166	275	119
Loss before provision (benefit) for income taxes	(2,240)	(11,080)	(4,005)	(10,449)
Provision (benefit) for income taxes	11	(3,864)	(1,170)	(3,864)
Net loss	\$ (2,251)	\$ (7,216)	\$ (2,835)	\$ (6,585)
Net loss per common share:				
Basic and diluted	\$ (0.11)	\$ (0.37)	\$ (0.14)	\$ (0.34)
Weighted-average common shares outstanding:				
Basic and diluted	19,855	19,653	19,839	19,638

(1) Amounts include stock-based compensation expense as follows:

Cost of sales	\$ 48	\$ 44	\$ 62	\$ 108
Research and development	62	19	85	65
Selling, general and administrative	265	231	472	449

See accompanying notes.

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**NETLIST, INC. AND SUBSIDIARIES**

**Unaudited Condensed Consolidated Statements of Cash Flows**

(in thousands)





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	Six Months Ended	
	June 28, 2008	June 30, 2007
Cash flows from operating activities:		
Net loss	\$ (2,835)	\$ (6,585)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	1,054	568
Amortization of deferred gain on sale and leaseback transaction	(59)	(59)
Deferred income taxes	(990)	(4,394)
Impairment of long-lived asset		257
Loss on inventory adjustments		6,012
Stock-based compensation	619	622
Changes in operating assets and liabilities:		
Accounts receivable	5,593	16,414
Inventories	(4,998)	7,438
Income taxes receivable	(195)	
Prepaid expenses and other current assets	(583)	303
Other assets	44	(592)
Accounts payable	(1,745)	(7,273)
Income taxes payable		(525)
Accrued expenses and other current liabilities	(254)	(596)
Net cash provided by (used in) operating activities	(4,349)	11,590
Cash flows from investing activities:		
Acquisition of property and equipment	(770)	(4,248)
Repayment of note receivable from stockholder		1
Purchase of investments in marketable securities	(6,672)	(43,481)
Proceeds from maturities and sales of investments in marketable securities	17,500	24,800
Net cash provided by (used in) investing activities	10,058	(22,928)
Cash flows from financing activities:		
Borrowings on lines of credit	49,490	61,880
Payments on lines of credit	(48,700)	(76,311)
Borrowings on debt		290
Payments on debt	(434)	(658)
Increase in restricted cash	(2,000)	
Proceeds from exercise of stock options and warrants		161
Reversal of unrealized excess tax benefit from exercise of warrants	(4)	
Net cash used in financing activities	(1,648)	(14,638)
Increase (decrease) in cash and cash equivalents	4,061	(25,976)
Cash and cash equivalents at beginning of period	7,182	30,975
Cash and cash equivalents at end of period	\$ 11,243	\$ 4,999

See accompanying notes.

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**NETLIST, INC. AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

June 28, 2008

**Note 1 Description of Business**

Netlist designs and manufactures high performance memory subsystems for the server, high performance computing and communications markets. The Company's solutions are targeted at applications where memory plays a key role in meeting system performance requirements.

**Note 2 Summary of Significant Accounting Policies**

*Basis of Presentation*

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The interim unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Securities and Exchange Commission ( SEC ) Form 10-Q and Article 8 of SEC Regulation S-X. These financial statements do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. Therefore, these financial statements should be read in conjunction with the Company's audited consolidated financial statements and notes thereto for the year ended December 29, 2007, included in the Company's Annual Report on Form 10-K filed with the SEC on February 29, 2008.

The condensed consolidated financial statements included herein are unaudited; however, they contain all normal recurring accruals and adjustments that, in the opinion of the Company's management, are necessary to present fairly the consolidated financial position of the Company and its wholly owned subsidiaries as of June 28, 2008 and December 29, 2007, the consolidated results of its operations for the three and six months ended June 28, 2008 and June 30, 2007, and the consolidated cash flows for the six months ended June 28, 2008 and June 30, 2007. All intercompany balances and transactions have been eliminated in consolidation. The results of operations for the three and six months ended June 28, 2008 are not necessarily indicative of the results to be expected for the full year or any future interim periods.

*Fiscal Year*



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The Company operates under a 52/53-week fiscal year ending on the Saturday closest to December 31. For fiscal 2008, the Company's fiscal year end is scheduled to be January 3, 2009 and will consist of 53 weeks. Each of the Company's first three quarters in a fiscal year is comprised of 13 weeks.

### *Use of Estimates*

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of the assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Significant estimates made by management include, among others, provisions for uncollectible receivables and sales returns, warranty liabilities, valuation of inventories, recoverability of long-lived assets, stock-based compensation expense and realization of deferred tax assets. The Company bases its estimates and assumptions on current facts, historical experience and various other factors that it believes to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities and the accrual of costs and expenses that are not readily apparent from other sources. The actual results experienced by the Company may differ materially and adversely from the Company's estimates. To the extent there are material differences between the estimates and the actual results, future results of operations will be affected.

*Revenue Recognition*

The Company's revenues primarily consist of product sales of high performance memory subsystems to original equipment manufacturers ( OEMs ). Revenues also include sales of excess inventories to distributors and other users of memory integrated circuits ( ICs ) totaling approximately \$0.1 million and \$0.2 million, respectively, during the three and six months ended June 28, 2008 and approximately \$0.4 million and \$1.4 million, respectively, for the three and six months ended June 30, 2007.

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The Company recognizes revenues in accordance with the SEC's Staff Accounting Bulletin No. 104, *Revenue Recognition* (SAB 104). Under the provisions of SAB 104, the Company recognizes revenues when there is persuasive evidence of an arrangement, product delivery and acceptance have occurred, the sales price is fixed or determinable, and collectibility of the resulting receivable is reasonably assured.

The Company generally uses customer purchase orders and/or contracts as evidence of an arrangement. Delivery occurs when goods are shipped for customers with FOB Shipping Point terms and upon receipt for customers with FOB Destination terms, at which time title and risk of loss transfer to the customer. Shipping documents are used to verify delivery and customer acceptance. The Company assesses whether the sales price is fixed or determinable based on the payment terms associated with the transaction and whether the sales price is subject to refund. Customers are generally allowed limited rights of return for up to 30 days, except for sales of excess inventories, which contain no right-of-return privileges. Estimated returns are provided for at the time of sale based on historical experience or specific identification of an event necessitating a reserve. The Company offers a standard product warranty to its customers and has no other post-shipment obligations. The Company assesses collectibility based on the creditworthiness of the customer as determined by credit checks and evaluations, as well as the customer's payment history.

A portion of the Company's international shipments are made to third-party inventory warehouses, or hubs, and the Company recognizes revenue when the inventory is pulled from the hub for use in production by the customer. The Company receives a report from the customer on a daily basis indicating the inventories pulled from a hub for use by the customer, and performs a daily reconciliation of inventories shipped to and pulled by the customer to those inventories reflected on the customer's reports to ensure that sales are recognized in the appropriate periods.

All amounts billed to customers related to shipping and handling are classified as revenues, while all costs incurred by the Company for shipping and handling are classified as cost of sales.

*Cash and Cash Equivalents*



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Cash and cash equivalents consist of cash and short-term investments with original maturities of 90 days or less.

*Restricted Cash*





Restricted cash represents amounts pledged as collateral on an outstanding letter of credit.

*Investments in Marketable Securities*



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The Company accounts for its investments in marketable securities in accordance with Statement of Financial Accounting Standards ( SFAS ) No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and Financial Accounting Standards Board ( FASB ) Staff Position SFAS No. 115-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*. The Company determines the appropriate classification of its investments at the time of purchase and reevaluates such designation at each balance sheet date. The Company's investments in marketable securities have been classified and accounted for as available-for-sale based on management's investment intentions relating to these securities. Available-for-sale securities are stated at market value based on market quotes. Unrealized gains and losses, net of deferred taxes, are recorded as a component of other comprehensive income (loss). The Company follows the guidance provided by Emerging Issues Task Force ( EITF ) Issue No. 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*, to assess whether its investments with unrealized loss positions are other than temporarily impaired. Realized gains and losses and declines in value judged to be other than temporary are determined based on the specific identification method and are reported in other income (expense), net in the unaudited condensed consolidated statements of operations.

The Company generally invests its excess cash in money market funds and in highly liquid debt instruments of United States ( U.S. ) municipalities, corporations, the U.S. government and its agencies and auction rate securities. All highly liquid investments with stated maturities of three months or less from the date of purchase are classified as cash equivalents; all investments with stated maturities of greater than three months are classified as investments in marketable securities.

*Fair Value of Financial Instruments*



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The Company's financial instruments consist principally of cash and cash equivalents, investments in marketable securities, accounts receivable, accounts payable, accrued expenses and debt instruments. Effective December 30, 2007, the Company adopted SFAS No. 157, *Fair Value Measurements* (SFAS 157), which defines fair value, establishes a framework for measuring fair value in accordance with accounting principles generally accepted in the United States of America and expands required disclosures about fair value measurements. Pursuant to SFAS 157, other than for certain investments in auction rate securities (see Note 4), the fair value of the Company's cash equivalents and investments in marketable securities is determined based on Level 1 inputs, which consist of quoted prices in active markets for identical assets. The Company believes that the carrying values of all other financial instruments approximate their current fair values due to their nature and respective durations.

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*Inventories*





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Inventories are valued at the lower of cost or net realizable value. Cost is determined on an average cost basis which approximates actual cost on a first-in, first-out basis and includes raw materials, labor and manufacturing overhead. At each balance sheet date, the Company evaluates its ending inventories for excess quantities and obsolescence. Among other factors, the Company considers historical demand and forecasted demand in relation to the inventory on hand, competitiveness of product offerings, market conditions and product life cycles when determining obsolescence and net realizable value. Provisions are made to reduce excess or obsolete inventories to their estimated net realizable values. Once established, write-downs are considered permanent adjustments to the cost basis of the excess or obsolete inventories.

### *Warranties*



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The Company offers warranties generally ranging from one to three years to its customers, other than on sales of excess inventory, depending on the product and negotiated terms of purchase agreements. Such warranties require the Company to repair or replace defective product returned to the Company during the warranty period at no cost to the customer. The Company records an estimate for warranty-related costs at the time of sale based on, among other factors, its historical and estimated product return rates and expected repair or replacement costs. Such costs have historically been consistent between periods and in-line with management's expectations. The Company's warranty liability is included as a component of accrued expenses and other current liabilities in the accompanying unaudited condensed consolidated balance sheets.

### *Stock-Based Compensation*



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The Company accounts for equity issuances to non-employees in accordance with SFAS No. 123, *Accounting for Stock-Based Compensation* ( SFAS 123 ), and EITF Issue No. 96-18, *Accounting for Equity Instruments that are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods and Services*. All transactions in which goods or services are the consideration received for the issuance of equity instruments are accounted for based on the fair value of the consideration received or the fair value of the equity instrument issued, whichever is more reliably measurable. The measurement date used to determine the fair value of the equity instrument issued is the earlier of the date on which the third-party performance is complete or the date on which it is probable that performance will occur.

In accordance with SFAS No. 123(R), *Share-Based Payment* ( SFAS 123R ), employee and director stock-based compensation expense recognized during the period is based on the value of the portion of share-based payment awards that is ultimately expected to vest during the period. Stock-based compensation expense recognized in the accompanying unaudited condensed consolidated statements of operations includes (i) compensation expense for share-based payment awards granted prior to, but not yet vested as of December 31, 2005 based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123 and (ii) compensation expense for the share-based payment awards granted subsequent to December 31, 2005 based on the grant date fair value estimated in accordance with the provisions of SFAS 123R. Given that stock-based compensation expense recognized in the unaudited condensed consolidated statements of operations is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. The estimated average forfeiture rates used by the Company are based on historical forfeiture experience and estimated future forfeitures.

The fair value of stock-based awards to employees and directors is calculated using the Black-Scholes option pricing model. The Black-Scholes model requires subjective assumptions regarding future stock price volatility and expected time to exercise, along with assumptions about the risk-free interest rate and expected dividends, which affect the estimated fair values of the Company's stock-based awards. The expected term of options granted is derived from historical data on employee exercises and post-vesting employment termination behavior. The expected volatility is based on the historical volatilities of the common stock of comparable publicly traded companies based on the Company's belief that it currently has limited historical data regarding the volatility of its stock price on which to base a meaningful estimate of expected volatility. The risk-free rate selected to value any particular grant is based on the U.S. Treasury rate that corresponds to the expected term of the grant effective as of the date of the grant. The expected dividends assumption is based on the Company's history and expectation of dividend payouts. These factors could change in the future, affecting the determination of stock-based compensation expense in future periods.

### *Income Taxes*



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The Company accounts for income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes* ( SFAS 109 ). Under SFAS 109, deferred tax assets and liabilities are recognized to reflect the estimated future tax effects, calculated at currently effective tax rates, of future deductible or taxable amounts attributable to events that have been recognized on a cumulative basis in the consolidated financial statements. A valuation allowance related to a deferred tax asset is recorded when it is more likely than not that some portion of the deferred tax asset will not be realized.



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The Company adopted FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes - An Interpretation of FASB Statement No. 109* ( FIN 48 ) on December 31, 2006, the first day of its fiscal 2007. FIN 48 seeks to reduce the diversity in practice associated with certain aspects of measurement and recognition in accounting for income taxes. FIN 48 prescribes a recognition threshold and measurement requirement for the financial statement recognition of a tax position that has been taken or is expected to be taken on a tax return and also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. Under FIN 48 the Company may only recognize or continue to recognize tax positions that meet a more likely than not threshold.

*Risks and Uncertainties*



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The Company's operations in the People's Republic of China ( PRC ) are subject to various political, geographical and economic risks and uncertainties inherent to conducting business in China. These include, but are not limited to, (i) potential changes in economic conditions in the region, (ii) managing a local workforce that may subject the Company to uncertainties or certain regulatory policies and (iii) changes in other policies of the Chinese governmental and regulatory agencies. Additionally, the Chinese government controls the procedures by which its local currency, the Chinese Renminbi ( RMB ), is converted into other currencies. If changes or restrictions in the conversion of RMB are instituted, the Company's operations and operating results may be negatively impacted.

### *Foreign Currency Remeasurement*



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The functional currency of the Company's foreign subsidiaries is the U.S. dollar. Local currency financial statements are remeasured into U.S. dollars using the current exchange rate for monetary assets and liabilities and the historical exchange rate for nonmonetary assets and liabilities. Expenses are remeasured using the average exchange rate for the period, except items related to nonmonetary assets and liabilities, which are remeasured using historical exchange rates. All remeasurement gains and losses are included in determining net income (loss).

### **Note 3 Supplemental Financial Information**



*Inventories*

Inventories consist of the following (in thousands):

	June 28, 2008		December 29, 2007	
Raw materials	\$	3,579	\$	1,878
Work in process		1,314		425
Finished goods		3,438		1,030
	\$	8,331	\$	3,333

*Warranty Liability*

The following table summarizes the activity related to the warranty liability (in thousands):

	June 28, 2008		Six Months Ended June 30, 2007	
Beginning balance	\$	353	\$	298
Charged to costs and expenses		8		140
Usage		(70)		(93)
Ending balance	\$	291	\$	345

The warranty liability is included as a component of accrued expenses and other current liabilities in the accompanying unaudited condensed consolidated balance sheets.

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*Facility Relocation Costs*

The following table summarizes the activity related to the Company's accrual for facility relocation costs during the six months ended June 28, 2008 (in thousands):

		<b>Six Months Ended June 28, 2008</b>
Beginning balance	\$	103
Charged to costs and expenses		
Net payments		(46)
Ending balance	\$	57

The liability for facility relocation costs is included as a component of accrued expenses and other current liabilities in the accompanying unaudited condensed consolidated balance sheets.

*Comprehensive Loss*





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The components of comprehensive loss, net of taxes, consist of the following (in thousands):

	Three Months Ended		Six Months Ended	
	June 28, 2008	June 30, 2007	June 28, 2008	June 30, 2007
Net loss	\$ (2,251)	\$ (7,216)	\$ (2,835)	\$ (6,585)
Other comprehensive loss:				
Change in net unrealized loss on investments	68	(11)	23	(7)
Reclassification adjustment for net realized gain included in net loss			(13)	
Total comprehensive loss	\$ (2,183)	\$ (7,227)	\$ (2,825)	\$ (6,592)

Accumulated other comprehensive loss reflected on the unaudited condensed consolidated balance sheets at June 28, 2008 and December 29, 2007 represents accumulated net unrealized losses on investments in marketable securities.

### *Computation of Net Loss Per Share*

Basic and diluted net loss per share is calculated by dividing net loss by the weighted-average common shares outstanding during the period. The following table sets forth the computation of net loss per share (in thousands, except per share data):

	Three Months Ended		Six Months Ended	
	June 28, 2008	June 30, 2007	June 28, 2008	June 30, 2007
Numerator: Net loss	\$ (2,251)	\$ (7,216)	\$ (2,835)	\$ (6,585)
Denominator: Weighted-average common shares outstanding	19,855	19,653	19,839	19,638
Net loss per share, basic and diluted	\$ (0.11)	\$ (0.37)	\$ (0.14)	\$ (0.34)

The following table sets forth all potentially dilutive common share equivalents, consisting of shares issuable upon the exercise of outstanding stock options and warrants computed using the treasury stock method, which have been excluded from the diluted net loss per share calculations above as their effect would be anti-dilutive for the periods then ended (in thousands):

	Three Months Ended		Six Months Ended	
	June 28, 2008	June 30, 2007	June 28, 2008	June 30, 2007
Common share equivalents	867	1,414	868	1,660

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*Major Customers*

The Company's product sales have historically been concentrated in a small number of customers. The following table sets forth sales to customers comprising 10% or more of the Company's total revenues for the periods presented:

	Three Months Ended		Six Months Ended	
	June 28, 2008	June 30, 2007	June 28, 2008	June 30, 2007
<b>Customer:</b>				
Dell	60%	48%	66%	41%
Hewlett Packard	26%	19%	22%	28%
IBM	%	12%		