NETGEAR, INC
Form 10-Q
May 09, 2008
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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 March 30, 2008.

¨ **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	**77-0419172**
(State or other jurisdiction of	***(IRS Employer***
incorporation or organization)	**Identification No.)**
4500 Great America Parkway,	
Santa Clara, California	**95054**
(Address of principal executive offices)	***(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 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 ¨ No x

The number of outstanding shares of the registrant s Common Stock, $0.001 par value, was 35,343,187 as of May 2, 2008.

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PART I: FINANCIAL INFORMATION

Item 1. ***Financial Statements***

NETGEAR, INC.

UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands)

	March 30, 2008	December 31, 2007
ASSETS		
Current assets:		
Cash and cash equivalents	$ 179,706	$ 167,495
Short-term investments	21,087	37,848
Accounts receivable, net	155,843	157,765
Inventories	97,604	83,023
Deferred income taxes	13,222	13,091
Prepaid expenses and other current assets	22,391	20,367
Total current assets	489,853	479,589
Property and equipment, net	13,846	11,205
Intangibles, net	15,136	16,319
Goodwill	41,985	41,985
Other non-current assets	1,865	2,011
Total assets	$ 562,685	$ 551,109
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 51,548	$ 55,333
Accrued employee compensation	11,183	16,085
Other accrued liabilities	89,451	89,470
Deferred revenue	7,453	7,619
Income taxes payable	3,322	
Total current liabilities	162,957	168,507
Deferred income tax liability	1,787	2,626
Non-current income taxes payable	9,577	8,272
Other non-current liabilities	1,325	181
Total liabilities	175,646	179,586
Commitments and contingencies (Note 10)		
Stockholders equity:		
Common stock	35	35
Additional paid-in capital	256,883	252,421
Cumulative other comprehensive income	86	101
Retained earnings	130,035	118,966
Total stockholders equity	387,039	371,523

Total liabilities and stockholders equity	$ 562,685	$ 551,109

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 March 30, 2008	Three Months Ended April 1, 2007
Net revenue	$ 198,154	$ 173,572
Cost of revenue (1)	134,291	113,542
Gross profit	63,863	60,030
Operating expenses:		
Research and development (1)	8,738	6,156
Sales and marketing (1)	33,028	27,826
General and administrative (1)	7,313	6,914
Litigation reserves, net	51	
Total operating expenses	49,130	40,896
Income from operations	14,733	19,134
Interest income	1,512	2,371
Other income	2,843	272
Income before income taxes	19,088	21,777
Provision for income taxes	7,862	7,756
Net income	$ 11,226	$ 14,021
Net income per share:		
Basic	$ 0.32	$ 0.41
Diluted	$ 0.31	$ 0.40
Weighted average shares outstanding used to compute net income per share:		
Basic	35,316	34,308
Diluted	35,941	35,362
(1) Stock-based compensation expense was allocated as follows:		
Cost of revenue	$ 222	$ 133
Research and development	801	469
Sales and marketing	847	622
General and administrative	928	623

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)

	Three Months Ended March 30, 2008	Three Months Ended April 1, 2007
Cash flows from operating activities:		
Net income	$ 11,226	$ 14,021
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	2,754	1,298
Accretion of purchase discounts on investments	(14)	(394)
Non-cash stock-based compensation	2,798	1,847
Income tax benefit associated with stock option exercises	147	3,427
Excess tax benefit from stock-based compensation	(133)	(2,651)
Deferred income taxes	(970)	671
Changes in assets and liabilities:		
Accounts receivable	1,922	(3,700)
Inventories	(14,581)	9,564
Prepaid expenses and other assets	(1,878)	(772)
Accounts payable	(3,785)	(7,014)
Accrued employee compensation	(4,902)	(2,893)
Other accrued liabilities	1,135	1,784
Deferred revenue	(166)	(2,458)
Income taxes payable	4,627	462
Net cash provided by (used in) operating activities	(1,820)	13,192
Cash flows from investing activities:		
Purchases of short-term investments		(24,118)
Proceeds from sale of short-term investments	16,750	23,600
Purchase of property and equipment	(4,212)	(1,608)
Net cash provided by (used in) investing activities	12,538	(2,126)
Cash flows from financing activities:		
Purchase and retirement of treasury stock	(157)	
Proceeds from exercise of stock options	784	3,505
Proceeds from issuance of common stock under employee stock purchase plan	733	627
Excess tax benefit from stock-based compensation	133	2,651
Net cash provided by financing activities	1,493	6,783
Net increase in cash and cash equivalents	12,211	17,849
Cash and cash equivalents, at beginning of period	167,495	87,736
Cash and cash equivalents, at end of period	$ 179,706	$ 105,585

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 Summary of Significant Accounting Policies

NETGEAR, Inc. was incorporated in Delaware in January 1996. NETGEAR, Inc. together with its subsidiaries (collectively, NETGEAR or the Company) designs, develops and markets networking products that address the specific needs of small businesses and homes, enabling users to share Internet access, peripherals, files and digital content and applications among multiple networked devices. The Company s products include Ethernet networking products, broadband access products and wireless networking connectivity products that are sold worldwide through distributors, traditional retailers, online retailers, direct market resellers, or DMRs, value added resellers, or 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 at December 31, 2007 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 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, 2007.

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 the reported amounts of 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 reported period. Actual results could differ from those estimates and operating results for the three months ended March 30, 2008 are not necessarily indicative of the results that may be expected for the year ending December 31, 2008.

The Company s significant accounting policies are disclosed in the Company s Annual Report on Form 10-K for the year ended December 31, 2007. The Company s significant accounting policies have not materially changed during the three months ended March 30, 2008.

2. Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (SFAS 157), which defines fair value, establishes a framework for measuring fair value in accordance with U.S. generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 applies under other existing accounting pronouncements that require or permit fair value measurements, as the FASB previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, SFAS 157 does not require any new fair value measurements. Effective January 1, 2008, the Company adopted SFAS 157 as it relates to financial assets and liabilities recognized at fair value on a recurring basis. The new disclosures required by SFAS 157 are included in Note 11.

In February 2008, the FASB issued FASB Staff Position No. 157-2, Effective Date of FASB Statement No. 157 (FSP 157-2), which delays the effective date of SFAS 157 until January 1, 2009 for all non-financial assets and non-financial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis. These nonfinancial items include assets and liabilities such as reporting units measured at fair value in a goodwill impairment test and nonfinancial assets acquired and liabilities assumed in a business combination. The Company is currently evaluating the impact of SFAS 157 for nonfinancial assets and liabilities on the Company s financial position and results of operations.

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In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115, (SFAS 159) which permits entities to elect to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. This election is irrevocable. SFAS 159 was effective in the first quarter of fiscal 2008. The Company has not elected to apply the fair value option to any of its financial instruments.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), Business Combinations (SFAS 141R) and SFAS No. 160, Non-controlling Interests in Consolidated Financial Statements, an amendment of Accounting Research Bulletin No. 51 (SFAS 160). SFAS 141R will change how business acquisitions are accounted for and will impact financial statements both on the acquisition date and in subsequent periods. SFAS 160 will change the accounting and reporting for minority interests, which will be re-characterized as non-controlling interests and classified as a component of equity. SFAS 141R and SFAS 160 are effective for fiscal years beginning after December 15, 2008. The Company is currently evaluating the impact of adopting SFAS 141R and SFAS 160 on the consolidated financial statements.

In March 2008, the FASB issued FASB Statement No. 161, Disclosures about Derivative Instruments and Hedging Activities (SFAS 161). SFAS 161 requires companies with derivative instruments to disclose information that should enable financial-statement users to understand how and why a company uses derivative instruments, how derivative instruments and related hedged items are accounted for under FASB Statement No. 133 Accounting for Derivative Instruments and Hedging Activities and how derivative instruments and related hedged items affect a company s financial position, financial performance and cash flows. SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. The Company is currently evaluating the impact of adopting SFAS 161 on the consolidated financial statements.

3. Stock-based Compensation

The Company grants options and restricted stock units from the 2006 Long-Term Incentive Plan, under which awards may be granted to all employees. In addition, the Company s stock option program includes the 2003 Stock Plan, from which the Company does not currently grant awards, but may choose to do so. Award vesting periods for these plans are generally four years. As of March 30, 2008, 178,337 shares were reserved for future grants under these plans.

Additionally, the Company sponsors an Employee Stock Purchase Plan (the ESPP), pursuant to which eligible employees may contribute up to 10% of base compensation, subject to certain income limits, to purchase shares of the Company s common stock. Employees purchase stock semi-annually at a price equal to 85% of the fair market value on the purchase date.

The fair value of each option award is estimated on the date of grant using the Black-Scholes-Merton option valuation model and the weighted average assumptions in the following table. The expected term of options granted is derived from historical data on employee exercise and post-vesting employment termination behavior. The risk free interest rate is based on the implied yield currently available on U.S. Treasury securities with an equivalent remaining term. Expected volatility is based on a combination of the historical volatility of the Company s stock as well as the historical volatility of certain of the Company s industry peers stock:

	Stock Options Three Months Ended	
	March 30, 2008	**April 1, 2007**
Expected life (in years)	4.3	4.6
Risk-free interest rate	3.08%	4.67%
Expected volatility	49%	55%
Dividend yield		

As of March 30, 2008, $27.6 million of total unrecognized compensation cost related to stock options, adjusted for estimated forfeitures, is expected to be recognized over a weighted-average period of 1.42 years. Additionally, $5.6 million of total unrecognized compensation cost related to non-vested restricted stock awards, adjusted for estimated forfeitures, is expected to be recognized over a weighted-average period of 1.45 years.

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4. Product Warranties

The Company provides for estimated future warranty obligations at the time revenue is recognized. The Company s standard warranty obligation to its direct customers generally provides for a right of return of any product for a full refund in the event that such product is not merchantable or is found to be damaged or defective. At the time revenue is recognized, an estimate of future warranty returns is recorded to reduce revenue in the amount of the expected credit or refund to be provided to its direct customers. At the time the Company records the reduction to revenue related to warranty returns, the Company includes within cost of revenue a write-down to reduce the carrying value of such products to net realizable value. The Company s standard warranty obligation to its end-users provides for repair or replacement of a defective product for one or more years. Factors that affect the warranty obligation include product failure rates, material usage, and service delivery costs incurred in correcting product failures. The estimated cost associated with fulfilling the Company s warranty obligation to end-users is recorded in cost of revenue. Because the Company s products are manufactured by contract manufacturers, in certain cases the Company has recourse to the contract manufacturer for replacement or credit for the defective products. The Company gives consideration to amounts recoverable from its contract manufacturers in determining its warranty liability. The Company assesses the adequacy of its warranty liability every quarter and, as necessary, makes adjustments to the liability. Changes in the Company s warranty liability, which is included as a component of Other accrued liabilities in the condensed consolidated balance sheets, are as follows (in thousands):

	Three Months Ended	
	March 30, 2008	April 1, 2007
Balance as of beginning of the period	$ 27,557	$ 21,299
Provision for warranty liability made during the period	16,859	10,313
Settlements made during the period	(13,287)	(9,726)
Balance at end of period	$ 31,129	$ 21,886

5. Shipping and Handling Fees and Costs

The Company includes shipping and handling fees billed to customers in net revenue. Shipping and handling costs associated with inbound freight are included in cost of revenue. Shipping and handling costs associated with outbound freight are included in sales and marketing expenses and totaled $3.3 million for the three months ended March 30, 2008 and $3.0 million for the three months ended April 1, 2007.

6. Balance Sheet Components

Accounts receivable, net:

	March 30, 2008	December 31, 2007
	(In thousands)	
Gross accounts receivable	$ 168,567	$ 169,986
Less: Allowance for doubtful accounts	(2,164)	(2,307)
Allowance for sales returns	(9,473)	(9,417)
Allowance for price protection	(1,087)	(497)
Total allowances	(12,724)	(12,221)
Accounts receivable, net	$ 155,843	$ 157,765

Inventories:

	March 30, 2008	December 31, 2007
	(In thousands)	
Raw materials	$ 2,863	$ 496
Finished goods	94,741	82,527
Total	$ 97,604	$ 83,023

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Other accrued liabilities:

	March 30, 2008	December 31, 2007