

NETLIST INC
Form 10-Q
May 15, 2007

**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 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 001-33170

NETLIST, INC.

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(Exact name of registrant as specified in its charter)

Delaware

State or other jurisdiction of
incorporation or organization

95-4812784

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

475 Goddard, Irvine, CA 92618

(Address of principal executive offices) (Zip Code)

(949) 435-0025

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

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Title of each class
Common Stock, par value \$0.001 per share

Name of each exchange on which registered
The NASDAQ Global Market

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, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check One):

Large Accelerated Filer

Accelerated Filer

Non-accelerated filer

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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19,644,487 shares outstanding at April 30, 2007

NETLIST, INC. AND SUBSIDIARIES

QUARTERLY REPORT ON FORM 10-Q

FOR THE THREE MONTHS ENDED MARCH 31, 2007

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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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	March 31, 2007	December 30, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 11,694	\$ 30,975
Investments in marketable securities	16,149	5,267
Accounts receivable, net	18,033	23,703
Inventories	13,380	19,473
Deferred taxes	1,100	1,054
Prepaid expenses and other current assets	897	988
Total current assets	61,253	81,460
Property and equipment, net	3,894	3,830
Deferred taxes	932	576
Long-term investments in marketable securities	6,842	1,502
Other assets	636	326
Total assets	\$ 73,557	\$ 87,694
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 5,491	\$ 11,680
Revolving line of credit	12,026	19,238
Current portion of long-term debt	865	1,033
Current portion of deferred gain on sale and leaseback transaction	118	118
Income taxes payable	108	552
Accrued expenses and other current liabilities	2,459	3,255
Total current liabilities	21,067	35,876
Long-term debt, net of current portion	1,010	1,230
Deferred gain on sale and leaseback transaction, net of current portion	314	344
Total liabilities	22,391	37,450
Commitments and contingencies		
Stockholders' equity:		
Common stock	20	20
Additional paid-in capital	66,998	66,557
Note receivable from stockholder	(1) (1
Accumulated deficit	(15,855) (16,332
Accumulated other comprehensive income	4)
Total stockholders' equity	51,166	50,244
Total liabilities and stockholders' equity	\$ 73,557	\$ 87,694

See accompanying notes.

NETLIST, INC. AND SUBSIDIARIES

Unaudited Condensed Consolidated Statements of Operations
(in thousands, except per share amounts)

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	Three Months Ended	
	March 31, 2007	April 1, 2006
Net sales	\$ 37,538	\$ 26,020
Cost of sales(1)	32,089	23,466
Gross profit	5,449	2,554
Operating expenses:		
Research and development(1)	1,067	666
Selling, general and administrative(1)	3,704	1,803
Total operating expenses	4,771	2,469
Operating income	678	85
Other expense:		
Interest expense, net of interest income	(48)	(400)
Other income (expense), net	1	(10)
Total other expense, net	(47)	(410)
Income (loss) before provision (benefit) for income taxes	631	(325)
Provision (benefit) for income taxes		(83)
Net income (loss)	\$ 631	\$ (242)
Net income (loss) per common share:		
Basic	\$ 0.03	\$ (0.02)
Diluted	\$ 0.03	\$ (0.02)
Weighted-average common shares outstanding:		
Basic	19,624	10,753
Diluted	21,425	10,753

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

Cost of sales	\$ 64	\$ 7
Research and development	46	11
Selling, general and administrative	218	55

See accompanying notes.

NETLIST, INC. AND SUBSIDIARIES

Unaudited Condensed Consolidated Statements of Cash Flows
(in thousands)

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	Three Months Ended	
	March 31, 2007	April 1, 2006
Cash flows from operating activities:		
Net income (loss)	\$ 631	\$ (242)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	254	249
Amortization of deferred gain on sale and leaseback transaction	(30)	(30)
Deferred income taxes	(402)	
Impairment of long-lived asset	114	
Loss on disposal of assets		15
Stock-based compensation	328	73
Changes in operating assets and liabilities:		
Accounts receivable	5,670	137
Inventories	6,093	315
Income taxes receivable		(83)
Prepaid expenses and other current assets	91	166
Other assets	(310)	3
Accounts payable	(6,172)	1,987
Income taxes payable	(598)	
Accrued expenses and other current liabilities	(796)	(12)
Net cash provided by operating activities	4,873	2,578
Cash flows from investing activities:		
Acquisition of property and equipment	(449)	(67)
Proceeds from sale of equipment		45
Purchases of investments in marketable securities	(30,618)	
Proceeds from maturities of investments in marketable securities	14,400	
Net cash used in investing activities	(16,667)	(22)
Cash flows from financing activities:		
Borrowings on lines of credit	40,174	22,542
Payments on lines of credit	(47,386)	(25,933)
Payments on debt	(388)	(200)
Proceeds from exercise of stock options and warrants	113	104
Net cash used in financing activities	(7,487)	(3,487)
Net decrease in cash and cash equivalents	(19,281)	(931)
Cash and cash equivalents, beginning of period	30,975	953
Cash and cash equivalents, end of period	\$ 11,694	\$ 22

See accompanying notes.

NETLIST, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2007

NOTE 1 DESCRIPTION OF BUSINESS

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Netlist, Inc. (the Company or Netlist) was incorporated on June 12, 2000 in Delaware. 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.

In December 2006, the Company sold 6,250,000 of its common shares in its initial public offering at an offering price of \$7.00 per share, resulting in proceeds of \$39.5 million, net of underwriters' discounts and offering expenses of approximately \$4.2 million.

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 10 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 interim unaudited condensed consolidated financial statements should be read in conjunction with the Company s audited consolidated financial statements and notes thereto for the year ended December 30, 2006, included in the Company s Annual Report on Form 10-K filed with the SEC on February 28, 2007.

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 March 31, 2007 and December 30, 2006, and the consolidated results of its operations and cash flows for the three months ended March 31, 2007 and April 1, 2006. All intercompany balances and transactions have been eliminated in consolidation. The results of operations for the three months ended March 31, 2007 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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Effective January 1, 2003, the Company changed its fiscal year from a calendar year to a 52/53-week fiscal year ending on the Saturday closest to December 31. Each of the Company's first three quarters in a fiscal year end on the Saturday closest to March 31, June 30 and September 30, respectively.

Use of Estimates

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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, valuation of inventories, recoverability of long-lived assets and realization of deferred tax assets. Actual results could differ from these estimates.

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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 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. This evaluation includes an analysis of sales levels by product type. 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.

Revenue Recognition

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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 \$1.0 million and \$5.1 million, during the three months ended March 31, 2007 and April 1, 2006, respectively.

The Company recognizes revenues in accordance with the SEC's Staff Accounting Bulletin (SAB) No. 104, *Revenue Recognition* (SAB No. 104). In accordance with the provisions of SAB No. 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.

For all sales, the Company uses a binding purchase order 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. 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. Returns from customers have not been material in any period as the Company's principal customers have adopted build-to-order manufacturing models or just-in-time management processes. 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.

Most 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.

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.

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 such warranty period at no cost to the customer. An estimate by the Company for warranty related costs is recorded by the Company at the time of sale based on its historical and estimated product return rates and expected repair or replacement costs. Such costs have historically been consistent between periods and insignificant. The Company's estimated warranty liability at March 31, 2007 was approximately \$0.3 million, and is included as a component of accrued expenses and other current liabilities in the accompanying unaudited condensed consolidated balance sheet.

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Stock-Based Compensation

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The Company accounts for equity issuances to non-employees in accordance with Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-Based Compensation* (SFAS No. 123), and Emerging Issues Task Force (EITF) 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 No. 123(R)), 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 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 No. 123 and 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 No. 123(R). 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 No. 123(R) 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 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, which greatly affect the calculated 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 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 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. These factors could change in the future, affecting the determination of stock-based compensation expense in future periods.

Net Income (Loss) Per Share

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Basic net income (loss) per share is calculated by dividing net income (loss) by the weighted-average common shares outstanding during the period. Diluted net income (loss) per share is calculated by dividing the net income (loss) by the weighted-average common shares and dilutive potential common shares outstanding during the period. Dilutive potential common shares consist of dilutive shares issuable upon the exercise of outstanding stock options and warrants computed using the treasury stock method. During fiscal 2006 and prior years, in addition to outstanding stock options and warrants, dilutive potential common shares also consisted of shares issuable upon the conversion of notes payable and convertible preferred stock using the if converted method.

New Accounting Pronouncements

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In February 2007, the Financial Accounting Standards Board (FASB) issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115* (SFAS No. 159). SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. SFAS No. 159 also establishes presentation and disclosure requirements designed to facilitate comparison between entities that choose different measurement attributes for similar types of assets and liabilities. The Company will adopt SFAS No. 159 in the first quarter of 2008, is still evaluating the effect, if any, on its consolidated financial position and consolidated results of operations and has not yet determined its impact.

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NOTE 3 SUPPLEMENTAL FINANCIAL INFORMATION

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Inventories

Inventories consist of the following (in thousands):

	March 31, 2007	December 30, 2006
Raw materials	\$ 4,279	\$ 10,513
Work in process	1,984	3,343
Finished goods	7,117	5,617
	\$ 13,380	\$ 19,473

Comprehensive Income (Loss)

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

	Three Months Ended March 31, 2007	April 1, 2006
Net income (loss)	\$ 631	\$ (242)
Other comprehensive income (loss):		
Change in net unrealized gain on investments	4	
Comprehensive income (loss)	\$ 635	\$ (242)

Computation of Net Income (Loss) Per Share

The following table sets forth the computation of basic and diluted net income (loss) per share, including the reconciliation of the numerator and denominator used in the calculation of basic and diluted net income (loss) per share (in thousands, except per share data):

	Three Months Ended March 31, 2007	April 1, 2006
Basic net income (loss) per share:		
Numerator: Net income (loss)	\$ 631	\$ (242)
Denominator: Weighted-average common shares outstanding, basic	19,624	10,753
Basic net income (loss) per share	\$ 0.03	\$ (0.02)
Diluted net income (loss) per share:		
Numerator: Net income (loss)	\$ 631	\$ (242)
Weighted-average common shares outstanding, basic	19,624	10,753
Effect of dilutive securities:		
Stock options and warrants	1,801	
Denominator: Weighted-average common shares outstanding, diluted	21,425	10,753
Diluted net income (loss) per share	\$ 0.03	\$ (0.02)

All potentially dilutive common share equivalents of approximately 3.6 million shares have been excluded from the diluted net loss per share calculation for the three months ended April 1, 2006 as their effect would be anti-dilutive for the period then ended.

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:

	Three Months Ended March 31, 2007		April 1, 2006	
Customer:				
A	38	%	16	%
B	11	%	33	%
C	31	%		

The Company's accounts receivable are concentrated with four customers at March 31, 2007, representing 38%, 21%, 11% and 11% of aggregate gross receivables. At December 30, 2006, accounts receivable are concentrated with four customers representing 32%, 19%, 14% and 13% of aggregate gross receivables. A significant reduction in sales to, or the ability to collect receivables from, a significant customer could have a material adverse impact on the Company.

NOTE 4 CREDIT AGREEMENT

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In April 2007, the Company executed the Seventh Amendment to the Amended and Restated Credit and Security Agreement (the Seventh Amendment). The Seventh Amendment, which is effective as of March 21, 2007, allows the Company to, at its election, increase its line of credit from \$25 million, in \$2.5 million increments, up to a total of \$40 million at the prime rate of interest, which was 8.25% at March 31, 2007 and December 30, 2006. In addition, the amendment (i) extends the maturity date of the line of credit to July 31, 2009, (ii) establishes an equipment advance line of \$3 million, (iii) increases the sublimit for letters of credit to \$5 million, (iv) sets an inventory sublimit of \$7 million, with the ability to increase to \$10 million if certain financial targets are met, (v) provides for the reduction in interest rates on borrowings if certain borrowing amounts and financial performance targets are met, (vi) resets the minimum book net worth, capital expenditures, and minimum debt service coverage ratio financial covenants and (vii) eliminates the minimum net income and stop loss financial covenants. As of March 31, 2007, the Company was in compliance with all financial covenants.

The \$40 million credit facility was preceded by a line of credit facility up to \$25 million (\$3 million of which was in the form of letters of credit), limited to 85% of eligible accounts receivable, plus the least of (i) a percentage of eligible inventory determined from time to time by the Company's bank, (ii) 80% of the orderly liquidation value, as defined, of eligible inventories, and (iii) \$7 million. Interest is payable monthly, at the Company's option, either at prime rate plus 0.50% or LIBOR plus 3%. The interest rate was reduced to the prime rate or LIBOR plus 2.50% in December 2006 concurrent with the Company's raise of capital through an initial public offering.

Interest on the equipment advances is payable monthly, at the Company's option, either at the prime rate or LIBOR plus 2.50%. Interest only payments were required on the equipment advances through January 31, 2007. Commencing February 1, 2007, the Company was required to repay the equipment advances in 42 equal monthly installments. The outstanding balance on this loan was approximately \$1.0 million and \$1.1 million at March 31, 2007 and December 30, 2006, respectively. (see Note 5).

Interest expense related to borrowings on the line of credit was approximately \$0.4 million and \$0.3 million for the three months ended March 31, 2007 and April 1, 2006, respectively. Outstanding borrowings on the line of credit were approximately \$12.0 million and \$19.2 million at March 31, 2007 and December 30, 2006, respectively. Borrowing availability under the line of credit was approximately \$2.9 million at March 31, 2007.

NOTE 5 LONG-TERM DEBT

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Long-term debt consists of the following (in thousands):

	March 31, 2007		December 30, 2006	
Obligations under capital leases	\$ 696		\$ 802	
Equipment note payable to bank (see Note 4)	996		1,072	
Notes payable to others	183		389	
	1,875		2,263	
Less current portion	(865)	(1,033)
	\$ 1,010		\$ 1,230	

Notes Payable to Others

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In November 2002, the Company entered into a \$100,000 unsecured loan agreement with an individual, bearing interest at 7% payable annually, principal due, as amended, in June 2006. In January 2004, \$4,000 of the principal amount was used to exercise certain stock options. The balance of this note was \$96,000 at December 30, 2006, which, along with accrued interest, was repaid in full in January 2007.

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In January 2003, the Company entered into a \$300,000 loan agreement with a financing company, collateralized by assets owned by an employee related to the majority stockholder. This note bears interest at 14% per annum and matures in January 2009. Principal and interest payments of approximately \$6,000 are due and payable monthly. The balance of this note was approximately \$119,000 and \$133,000 at March 31, 2007 and December 30, 2006, respectively.

In August 2005, the Company entered into an agreement with a financing company in connection with financing certain insurance policies. The financing agreement required monthly principal and interest payments of approximately \$25,000 through maturity on June 30, 2006. Interest was payable at 8.55% per annum. The outstanding principal balance on this financing was \$142,000 at December 31, 2005. During the year ended December 30, 2006, the balance was repaid in full. In August 2006, the Company entered into a new agreement with the financing company to finance its insurance policies. The financing agreement requires monthly principal and interest payments of approximately \$32,000 through maturity on June 30, 2007. Interest is payable at 9.45% per annum. The outstanding principal balance on this financing was approximately \$64,000 and \$160,000 at March 31, 2007 and December 30, 2006, respectively.

Capital Leases

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The Company has purchased manufacturing and computer equipment through the use of various capital leases. These leases require aggregate monthly payments of approximately \$34,000 and mature at various dates through May 2011. The interest rates on these leases vary between 4.3% and 9.4%.

Interest expense related to long-term debt was approximately \$57,000, and \$46,000 for the three months ended March 31, 2007 and April 1, 2006, respectively.

NOTE 6 INCOME TAXES

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The Company recorded a tax provision of \$0 and \$83,000 for the three months ended March 31, 2007 and April 1, 2006, respectively. The effective tax rates for the Company were 0% and 26% for the three months ended March 31, 2007 and April 1, 2006, respectively.

The Company adopted FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48), on December 31, 2006, the first day of fiscal 2007. As a result of the implementation of FIN 48, the Company recorded an increase in the net liability for unrecognized tax positions of approximately \$0.2 million, which was recorded as an adjustment to the beginning balance of accumulated deficit as of December 31, 2006. Including the increase in the net liability, at December 31, 2006 the Company had approximately \$0.5 million of total unrecognized tax benefits. Included in this balance were \$0.5 million of tax positions that, if recognized, would affect the effective tax rate.

The Company's continuing practice is to recognize accrued interest and penalties related to unrecognized tax benefits as a component of tax expense. This policy did not change as a result of the adoption of FIN 48. The Company had approximately \$30,000 accrued for interest and \$0 accrued for penalties at December 31, 2006.

The Company files tax returns with federal and state jurisdictions. The Company is no longer subject to IRS or state examinations prior to fiscal 2003, although certain carryforward attributes that were generated prior to fiscal 2003 may still be adjusted by the IRS if they either have been or will be used in a future period.

NOTE 7 COMMITMENTS AND CONTINGENCIES

Litigation

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From time to time, the Company may be involved in litigation relating to claims arising out of its operations in the normal course of business.

In May 2007, the Company and certain of its officers and directors were named as defendants in a securities class action filed in federal court in New York (*Tran v. Netlist, et al.*, No. 07 CV 3754). The complaint is filed on behalf of purchasers of the Company's common stock in or traceable to the Company's initial public offering and asserts claims under Sections 11 and 15 of the Securities Act of 1933. The Company has not been served with the complaint.

Other Obligations

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In March 2007, the Company entered into a five year lease commitment agreement on a facility in Suzhou in the People's Republic of China for which the total base rent for the term of the lease is expected to approximate \$800,000. In March 2007, the Company began its occupation of the facility and commenced recording monthly rent expense of approximately \$13,000.

In April 2007, the Company entered into a four year facility lease agreement of approximately 28,700 rentable square feet in Irvine, California. The Company plans to occupy the new facility in July 2007, which will allow for the consolidation of its headquarters and manufacturing operations into a single location. The total base rent for the term of the lease will be approximately \$1.7 million, with monthly rent payments ranging from approximately \$33,000 to \$37,000 during the term of the lease.

NOTE 8 RELATED PARTY TRANSACTIONS

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In February 2003, the Company loaned an employee \$19,900 to exercise a portion of his then-vested common stock options. This full recourse note bears interest at a rate of 7% payable annually, and is due on February 17, 2008. In December 2006, the employee repaid \$23,000 of the note. As of March 31, 2007 and December 30, 2006, the remaining amount outstanding was approximately \$1,000 and has been recorded as a reduction of stockholders' equity in the consolidated balance sheets.

NOTE 9 IMPAIRMENT OF LONG-LIVED ASSET

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During fiscal 2006, the Company acquired certain laser soldering equipment (the Equipment) primarily intended for use in connection with a new product technology to be developed for a customer. In the first quarter of 2007, management determined that certain alternative equipment and related design processes were a more appropriate complement to the development of this technology. As a result, the Company determined the extent to which it expects to utilize the Equipment in the future had decreased from its original estimates. Accordingly, the Company concluded that the carrying value of the Equipment of approximately \$0.3 million was no longer recoverable and was in fact impaired. In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, the Company estimated the current fair value of the Equipment primarily using market prices for comparable machinery and equipment. As a result of its analysis, the Company recorded an impairment charge of approximately \$0.1 million to write down the carrying value of the Equipment to its estimated fair value. This charge is included as a component of research and development expense for the three months ended March 31, 2007 in the accompanying unaudited condensed consolidated statement of operations.

The Company is still evaluating the extent of possible alternative uses for the Equipment, which may include ultimately disposing of the Equipment through a sale.

NOTE 10 STOCK OPTIONS AND WARRANTS

Common Stock Options

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In November 2000, the Company adopted the 2000 Equity Incentive Plan (the 2000 Plan) and in October 2006, the Company adopted the 2006 Equity Incentive Plan (the 2006 Plan), under which direct stock awards or options to acquire shares of the Company s common stock may be granted to employees and nonemployees of the Company. The 2000 Plan is administered by the Board of Directors or a committee thereof, and the 2006 Plan is administered by the Compensation Committee of the Board of Directors. The 2000 Plan permitted the issuance of up to 5,750,000 shares of the Company s common stock. Effective as of the Company s initial public offering on December 5, 2006, no further grants may be

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made under the 2000 Plan. The 2006 Plan permits the issuance of a maximum of 500,000 shares of common stock, automatically increasing on the first day of each calendar year beginning on or after January 1, 2007 by the lesser of (i) 500,000 shares and (ii) such smaller number of shares as may be determined by our Board of Directors prior to that date. Options granted under the 2000 Plan and 2006 Plan primarily vest over a rate of 25% per year over four years and expire 10 years from the date of grant.

In March 2007, the Company granted options to purchase 3,000 shares of the Company's common stock to a non-employee consultant, which were immediately vested as of the grant date and carry an exercise price of \$2.55 per share. The total grant date fair value of these options was approximately \$20,000, which was recorded as stock-based compensation expense for the three months ended March 31, 2007.

A summary of common stock option activity as of and for the three months ended March 31, 2007 is presented below (shares in thousands):

	Shares	Weighted- Average Exercise Price per Share
Options outstanding at December 31, 2006	3,318	\$ 3.34
Options granted	91	8.56
Options exercised	(101)) 1.12
Options cancelled	(27)) 2.55
Options outstanding at March 31, 2007	3,281	\$ 3.56

The weighted-average grant date fair value per share of stock options granted during the three months ended March 31, 2007 and April 1, 2006 was \$6.07 and \$0.52, respectively. These values were estimated using the following assumptions:

	Three Months Ended March 31, 2007	Three Months Ended April 1, 2006
Expected term (in years)	5.4	6
Expected volatility	80	% 40
Risk-free interest rate	4.65	% 4.55
Expected dividends		

At March 31, 2007, the amount of unearned stock-based compensation currently estimated to be expensed from fiscal 2007 through fiscal 2011 related to unvested common stock options is approximately \$3.5 million. The weighted-average period over which the unearned stock-based compensation is expected to be recognized is approximately 3.2 years. If there are any modifications or cancellations of the underlying unvested common stock options, the Company may be required to accelerate, increase or cancel any remaining unearned stock-based compensation expense. Future stock-based compensation expense and unearned stock-based compensation will increase to the extent that the Company grants additional equity awards.

Warrants

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From time to time, the Company issues warrants to non-employees for services rendered or to be rendered in the future. Such warrants are issued outside of the 2000 Plan and 2006 Plan. As of March 31, 2007 and December 30, 2006, there were warrants outstanding to purchase 397,500 shares of common stock. As of March 31, 2007, approximately 368,000 warrants to purchase shares of common stock were fully vested and exercisable, while the remaining warrants to purchase 29,500 shares of common stock vest over approximately the next 3.5 years. The weighted-average exercise price of the warrants outstanding at March 31, 2007 was \$1.35 per share.

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NOTE 11 SEGMENT AND GEOGRAPHIC INFORMATION

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The Company operates in one reportable segment: the design and manufacture of high-performance memory subsystems for the server, high-performance computing and communications markets. The Company evaluates financial performance on a Company-wide basis. All the Company's international sales relate to shipments of products to its U.S. customers' international manufacturing sites or third-party hubs and are denominated in U.S. dollars.

NOTE 12 SUBSEQUENT EVENT

In May 2007, the Company and certain of its officers and directors were named as defendants in a securities class action filed in federal court in New York (*Tran v. Netlist, et al.*, No. 07 CV 3754). The complaint is filed on behalf of purchasers of the Company's common stock in or traceable to the Company's initial public offering and asserts claims under Sections 11 and 15 of the Securities Act of 1933. The Company has not been served with the complaint.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Cautionary Statement

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The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our Unaudited Condensed Consolidated Financial Statements and the related notes thereto contained in Part I, Item 1 of this Report. The information contained in this Quarterly Report on Form 10-Q is not a complete description of our business or the risks associated with an investment in our common stock. We urge you to carefully review and consider the various disclosures made by us in this Report and in our other reports filed with the Securities and Exchange Commission (SEC), including our Annual Report on Form 10-K for the fiscal year ended December 30, 2006 and subsequent reports on Form 8-K, which discuss our business in greater detail.

The section entitled Risk Factors set forth in Part II, Item 1A, and similar discussions in our other SEC filings, describe some of the important risk factors that may affect our business, results of operations and financial condition. You should carefully consider those risks, in addition to the other information in this Quarterly Report on Form 10-Q and in our other filings with the SEC, before deciding to purchase, hold or sell our common stock.

This report contains forward-looking statements that involve risks, uncertainties, estimates and assumptions. These statements are not guarantees of future performance and are subject to certain risks, uncertainties and assumptions that are difficult to predict. Therefore, our actual results could differ materially and adversely from those expressed in any forward-looking statements as a result of various factors, including but not limited to those identified under the heading Risk Factors set forth in Part II, Item 1A. We undertake no obligation to revise or update publicly any forward-looking statements for any reason.

Overview

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We design, manufacture and sell high performance memory subsystems for the server, high performance computing and communications markets. Our memory subsystems consist of dynamic random access memory integrated circuits, or DRAM ICs, and other components assembled on a printed circuit board, or PCB. We engage with our original equipment manufacturer, or OEM, customers from the earliest stages of new product definition, which provides us unique insight into their full range of system architecture and performance requirements. This close collaboration has also allowed us to develop a significant level of systems expertise. We leverage a portfolio of proprietary technologies and design techniques, including efficient planar design, alternative packaging techniques and custom semiconductor logic, to deliver memory subsystems with high memory density, small form factor, high signal integrity, attractive thermal characteristics and low cost per bit.

Due to their importance to overall system architecture and performance, our products must undergo lengthy qualification reviews by our OEM customers, which may last up to six months. In addition, in order to penetrate large OEMs, we have typically been required to demonstrate our ability to meet strict standards for quality, customer service and turnaround time by first supplying less complex products into a limited range of high volume applications. For example, the initial products we sold to IBM were used in mobile computing applications. The majority of our sales of subsequent products to IBM have been for high-end server applications, our primary market focus. Consistent with the concentrated nature of the

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OEM customer base in our target markets, a small number of large customers have historically accounted for a significant portion of our net sales. Dell and IBM represented 38% and 11%, respectively, of our net sales in the three months ended March 31, 2007, and 16% and 33%, respectively, of our net sales in the three months ended April 1, 2006. Additionally, Hewlett Packard represented 31% of our net sales in the three months ended March 31, 2007. We expect that Dell, IBM and Hewlett Packard will continue to represent a significant percentage of our net sales for at least the next 12 months.

During the three months ended March 31, 2007, the market price of DRAM ICs decreased over 50%. This decline has adversely affected the selling prices of many of our products and resulted in lower revenues, lower gross margin and reduced inventory value during this period. Should the decline in the DRAM IC market continue, it would result in lower net sales, lower gross margin and reduced inventory value in subsequent periods. We expect that the continued softness in the DRAM market will have a significant impact on our overall results of operations in subsequent periods.

Key Business Metrics

The following describes certain line items in our statements of operations that are important to management's assessment of our financial performance:

Net Sales. Net sales consist primarily of sales of our high performance memory subsystems, net of a provision for estimated returns under our right of return policies, which range up to 30 days. We generally do not have long-term sales agreements with our customers. Although OEM customers typically provide us with non-binding forecasts of future product demand over specific periods of time, they generally place purchase orders with us approximately two weeks in advance of scheduled delivery. Selling prices are typically negotiated monthly, based on competitive market conditions and the current price of DRAM ICs. Purchase orders generally have no cancellation or rescheduling penalty provisions. We often ship our products to our customers' international manufacturing sites. All of our sales to date, however, are denominated in U.S. dollars. We also sell excess component inventory of DRAM ICs to distributors and other users of memory ICs. These sales accounted for approximately 3% and 19% of our net sales in the three months ended March 31, 2007 and April 1, 2006, respectively. We expect that component inventory sales will continue to decrease as a percentage of net sales in future periods as we diversify our customer base and therefore are able to use components in a wider range of memory subsystems.

Cost of Sales. Our cost of sales includes the cost of materials, manufacturing costs, depreciation and amortization of equipment, inventory valuation provisions, stock-based compensation and occupancy costs and other allocated fixed costs. The DRAM ICs incorporated into our products constitute a significant portion of our cost of sales, and thus our cost of sales will fluctuate based on the current price of DRAM ICs. We attempt to pass through such DRAM IC cost fluctuations to our customers by frequently renegotiating pricing prior to the placement of their purchase orders. To the extent we are successful, a large majority of our product cost is variable, and thus our cost of sales and gross margin percentages may not be significantly impacted by changes in sales volume. However, the sales prices of our memory subsystems can also fluctuate due to competitive situations unrelated to the pricing of DRAM ICs, which will affect gross margins. The gross margin on our sales of excess component DRAM IC inventory is much lower than the gross margin on our sales of our memory subsystems. As a result, a decrease in DRAM IC inventory sales as a percentage of our overall sales would result in an improved overall gross margin. We assess the valuation of our inventories on a monthly basis and record a provision to cost of sales as necessary to reduce inventories to the lower of cost or market value.

Research and Development. Research and development expense consists primarily of employee and independent contractor compensation and related costs, stock-based compensation, computer-aided design software licenses, reference design development costs, patent-related fees, depreciation or rental of evaluation equipment, and occupancy and other allocated overhead costs. Also included in research and development expense are the costs of material and overhead related to the production of engineering samples of new products under development or products used solely in the research and development process. Our customers typically do not separately compensate us for design and engineering work involved in developing application-specific products for them. All research and development costs are expensed as incurred. As we continue to develop additional proprietary technologies, we anticipate that research and development expenditures will increase.

Selling, General and Administrative. Selling, general and administrative expenses consist primarily of employee salaries and related costs, stock-based compensation, independent sales representative commissions, professional services, promotional and other selling and marketing expenses, and occupancy and other allocated overhead costs. A significant portion of our selling efforts is directed at building relationships with OEMs and working through the product approval and qualification process with them. Therefore, the cost of material and overhead related to products manufactured for qualification is included in selling expenses. As we continue to service existing and penetrate new OEM customers, we anticipate that our sales and marketing expenses will increase. We also anticipate that our general and administrative expenses will increase as a percentage of net sales as we incur accounting and legal expenses associated with our ongoing public reporting obligations and compliance with the requirements of the Sarbanes-Oxley Act of 2002.

Provision (Benefit) for Income Taxes. Our income tax provision (benefit) is based on the statutory federal tax rate of 35% and is typically impacted by state taxes and permanent book-tax differences.

Critical Accounting Policies

The preparation of financial statements in conformity with accounting principles generally accepted in the U.S. requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of net sales and expenses during the reporting period. By their nature, these estimates and assumptions are subject to an inherent degree of uncertainty. We base our estimates on our historical experience, knowledge of current conditions and our beliefs of what could occur in the future considering available information. We review our estimates on an on-going basis. Actual results may differ from these estimates, which may result in material adverse effects on our operating results and financial position. We believe the following critical accounting policies involve our more significant assumptions and estimates used in the preparation of our consolidated financial statements:

Revenue Recognition. We recognize revenues in accordance with the Securities and Exchange Commission's Staff Accounting Bulletin No. 104, *Revenue Recognition*, or SAB No. 104. Under the provisions of SAB No. 104, we recognize 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.

For all sales, we use a binding purchase order 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. We assess 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. Returns from customers have not been material in any period as our principal customers have adopted build-to-order manufacturing models or just-in-time management processes. We offer a standard product warranty to our customers and have no other post-shipment obligations. We assess collectibility based on the creditworthiness of the customer as determined by credit checks and evaluations, as well as the customer's payment history. Most of our international shipments are made to third-party inventory warehouses, or hubs, and we recognize revenue when the inventory is pulled from the hub for use in production by the customer. We receive a report from the customer on a daily basis indicating the inventories pulled from a hub for use by the customer, and perform 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.

Customers are generally allowed limited rights of return for up to 30 days. Estimated returns are provided for at the time of sale based on historical experience or specific identification of an event necessitating a reserve. While these returns have historically been within our expectations and the provisions established, we cannot guarantee that we will continue to experience similar return rates in the future. Any significant increase in product failure rates and the resulting product returns could have a material adverse effect on our operating results for the period or periods in which such returns materialize.

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

Warranty Reserve. We offer warranties on our memory subsystems generally ranging from one to three years, depending on the product and negotiated terms of purchase agreements with our customers. Such warranties require us to repair or replace defective product returned to us during such warranty period at no cost to the customer. Our estimates for warranty related costs are recorded at the time of sale based on historical and estimated future product return rates and expected repair or replacement costs. While such costs have historically been insignificant, unexpected changes in failure rates could have a material adverse impact on us.

Accounts Receivable. We perform credit evaluations of our customers' financial condition and limit the amount of credit extended to our customers as deemed necessary, but generally require no collateral. We continuously monitor collections and payments from our customers and maintain a provision for estimated credit losses based upon our historical experience and any specific customer collection issues that we have identified. Generally, these credit losses have been within our expectations and the provisions established. However, we cannot guarantee that we will continue to experience credit loss rates similar to those we have experienced in the past.

Our accounts receivable are highly concentrated among a small number of customers, and a significant change in the liquidity or financial position of one of these customers could have a material adverse effect on the collectibility of our accounts receivable, our liquidity and our future operating results.

Inventories. We value our inventories at the lower of the actual cost to purchase or manufacture the inventory or the net realizable value of the inventory. Cost is determined on a first-in, first-out basis and includes raw materials, labor and manufacturing overhead. We regularly review inventory quantities on hand and on order and record a provision for excess and obsolete inventories based primarily on our estimated forecast of product demand and production requirements for the next three to six months. In addition, we consider changes in the market value of DRAM ICs in determining the realizable value of our raw material inventory. Once established, any write-downs are considered permanent adjustments to the cost basis of our inventories. A significant decrease in demand for our products could result in an increase in the amount of excess inventory quantities on hand. In addition, our estimates of future product demand may prove to be inaccurate, in which case we may have understated or overstated the provision required for excess and obsolete inventory. In the future, if our inventories are determined to be overvalued, we would be required to recognize additional expense in our cost of sales at the time of such determination. Likewise, if our inventories are determined to be undervalued, we may have over-reported our costs of sales in previous periods and would be required to recognize additional gross profit at the time such inventories are sold. In addition, should the market value of DRAM ICs decrease significantly, we may be required to lower our selling prices to reflect the lower cost of our raw materials. If such price decreases reduce the realizable value of our inventories to less than our cost, we would be required to recognize additional expense in our cost of sales in the same period. Although we make every reasonable effort to ensure the accuracy of our forecasts of future product demand, any significant unanticipated changes in demand, technological developments or the market value of DRAM ICs could have a material effect on the value of our inventories and our reported operating results.

Long-Lived Assets. We review the recoverability of the carrying value of long-lived assets on an annual basis or whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of these assets is determined based upon the forecasted undiscounted future net cash flows from the operations to which the assets relate, utilizing our best estimates, appropriate assumptions and projections at the time. These projected future cash flows may vary significantly over time as a result of increased competition, changes in technology, fluctuations in demand, consolidation of our customers and reductions in average selling prices. If the carrying value is determined not to be recoverable from future operating cash flows, the asset is deemed impaired and an impairment loss is recognized to the extent the carrying value exceeds the estimated fair market value of the asset.

Stock-Based Compensation. We account for equity issuances to non-employees in accordance with Statement of Financial Accounting Standards, or SFAS, No. 123, *Accounting for Stock Based Compensation*, and Emerging Issues Task Force, or 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.

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Prior to January 1, 2006, we accounted for stock-based compensation issued to employees using the intrinsic value method of accounting prescribed by Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* and related pronouncements. Under this method, compensation expense was recognized over the respective vesting period based on the excess, on the date of grant, of the fair value of our common stock over the grant price, net of forfeitures. Deferred stock-based compensation was amortized on a straight-line basis over the vesting period of each grant.

On January 1, 2006, we adopted SFAS No. 123(R), *Share-Based Payment*, or SFAS No. 123(R), which requires the measurement and recognition of compensation expense for all share-based payment awards made to our employees and directors related to our Amended and Restated 2000 Equity Incentive Plan based on estimated fair values. We adopted SFAS No. 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006, the first day of our fiscal year 2006. Our consolidated financial statements as of and for the year ended December 30, 2006 reflect the impact of adopting SFAS No. 123(R). In accordance with the modified prospective transition method, our consolidated financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS No. 123(R). The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in our consolidated statement of operations. As stock-based compensation expense recognized in the consolidated statement of operations is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS No. 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

Income Taxes. We recognize deferred tax assets and liabilities based on the differences between the financial statement carrying values and the tax bases of assets and liabilities. We regularly review our deferred tax assets for recoverability and establish a valuation allowance based on historical taxable income, projected future taxable income, and the expected timing of the reversals of existing temporary differences. If we operate at a loss for an extended period of time or are unable to generate sufficient future taxable income, or if there is a material change in the actual effective tax rates or time period within which the underlying temporary differences become taxable or deductible, we could be required to record a valuation allowance against all or a significant portion of our deferred tax assets which could substantially increase our effective tax rate for such period. Any significant changes in statutory tax rates or the amount of our valuation allowance could have a material effect on the value of our deferred tax assets and liabilities, and our reported financial results. Additionally, the Company adopted Financial Accounting Standards Board, or FASB, Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, or FIN 48, on December 31, 2006, the first day of fiscal 2007. FIN 48 is an interpretation of SFAS No. 109, *Accounting for Income Taxes*, and 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. FIN 48 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. Refer to Note. 6, *Income Taxes*, for additional information.

Results of Operations

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The following table sets forth certain consolidated statements of operations data as a percentage of net sales for the periods indicated:

	Three Months Ended		April 1,	
	March 31,		2006	
	2007			
Net sales	100.0	%	100.0	%
Cost of sales	85.5		90.2	
Gross profit	14.5		9.8	
Operating expenses:				
Research and development	2.8		2.6	
Selling, general and administrative	9.9		6.9	
Total operating expenses	12.7		9.5	
Operating income	1.8		0.3	
Interest expense, net	(0.1)	(1.6)
Other income (expense), net				
Income (loss) before provision (benefit) for income taxes	1.7		(1.2)
Provision (benefit) for income taxes			(0.3)
Net income (loss)	1.7	%	(0.9)%

Three Months Ended March 31, 2007 Compared to Three Months Ended April 1, 2006

Net Sales. Net sales for the three months ended March 31, 2007 were \$37.5 million, a net increase of \$11.5 million, or 44%, over the three months ended April 1, 2006. Sales of laptop personal computer, or PC, memory subsystems increased approximately \$11.0 million over the three months ended April 1, 2006 primarily as a result of certain opportunities that arose in the market to sell such additional units during the current period. This was offset by a decrease in sales of our very low profile memory subsystems of approximately \$8.3 million. In addition, DDR2 server memory subsystem sales increased by approximately \$2.8 million while DDR subsystem sales decreased by approximately \$0.3 million as customers continue transitioning to DDR2 architectures. Finally, sales of memory subsystems used to control redundant arrays of independent disks (RAIDs), which commenced late in the second quarter of fiscal 2006, contributed to approximately \$11.3 of our revenues for the three months ended March 31, 2007.

Although sales of laptop PC memory increased significantly during the three months ended March 31, 2007 compared to the comparable quarter of 2006, such sales were adversely impacted by the significant decrease in DRAM IC market prices during the quarter. Such market price decreases cause us to decrease pricing on many of our products, including laptop PC memory subsystems. Should such market price declines continue, our overall revenues could be adversely impacted as we lower prices on some products to meet market conditions.

Sales of our component inventory to distributors and other users of memory ICs represented 3% and 19% of net sales for the three months ended March 31, 2007 and April 1, 2006, respectively. We expect that component inventory sales will continue to represent a relatively small percentage of net sales in future periods as we diversify our customer base and therefore are able to use components in a wider range of memory subsystems.

Gross Profit and Gross Margin. Gross profit for the three months ended March 31, 2007 was \$5.5 million, an increase of \$2.9 million, or 113%, over the three months ended April 1, 2006. Gross margin increased to 14.5% from 9.8% for the same period. The increase in both gross profit and gross margin is primarily attributable to increased sales of DDR2 server memory subsystems and memory subsystems to control RAIDs, which generate higher margins due to their innovative design. These increases were

partially offset by the comparatively low gross margins realized on sales of laptop memory to one OEM customer during the three months ended March 31, 2007. The gross margin on sales of laptop PC memory was adversely impacted by the significant decrease in the market price of DRAM ICs during the first quarter of fiscal 2007. To the extent that such market price declines continue and should our product sales mix shift more toward lower margin products such as laptop memory, our gross profit, gross margin and overall operating results could be adversely affected.

Research and Development. Research and development expenses for the three months ended March 31, 2007 were \$1.1 million, an increase of \$0.4 million compared to the three months ended April 1, 2006. The increase was primarily attributable to (i) an increase of \$0.1 million related to additional personnel engaged in research and development activities since April 1, 2006, (ii) \$0.1 million related to the impairment write-down of certain long-lived assets used in the product development process and (iii) an increase of \$0.1 million related to equipment, testing and certain other professional services incurred.

Selling, General and Administrative. Selling, general and administrative expenses for the three months ended March 31, 2007 were \$3.7 million, an increase of \$1.9 million compared to the three months ended April 1, 2006. The increase was primarily attributable to (i) an increase of \$0.6 million related to additional personnel engaged in selling, general and administrative activities since April 1, 2006, (ii) an increase of \$0.7 million in legal and professional services, primarily related to reporting and other obligations as a result of becoming a publicly traded company, along with costs incurred to set up our operation in China, (iii) an increase of \$0.4 million related to certain selling and promotional expenses and (iv) an increase of \$0.2 million in stock-based compensation.

Other Expense, Net. Other expense, net, for the three months ended March 31, 2007 was \$47,000, a decrease of \$0.4 million compared to the three months ended April 1, 2006. The decrease was due primarily to interest income of approximately \$0.4 million earned during the current period on our investments in marketable securities, which significantly offset our interest expense of approximately \$0.5 million for the three months ended March 31, 2007.

Provision (Benefit) for Income Taxes. We did not record a provision for income taxes for the three months ended March 31, 2007 which is compared to an income tax benefit of \$83,000 recorded for the three months ended April 1, 2006. As of March 31, 2007, we have estimated our annual effective tax rate to be zero for fiscal 2007, which is based on our projected annualized income and the effect of research and development credits.

New Accounting Pronouncements

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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*, or SFAS No. 159. SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. SFAS No. 159 also establishes presentation and disclosure requirements designed to facilitate comparison between entities that choose different measurement attributes for similar types of assets and liabilities. We will adopt SFAS No. 159 in the first quarter of 2008 and are still evaluating the effect, if any, on our consolidated financial position and consolidated results of operations and have not yet determined its impact.

Liquidity and Capital Resources

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Since our inception, we have financed our operations primarily through issuances of equity and debt securities and cash generated from operations. We have also funded our operations with a revolving line of credit under our bank credit facility, from capitalized lease obligations, financing of receivables and from the sale and leaseback of our manufacturing facility.

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Working Capital and Cash and Marketable Securities. The following table presents working capital, cash and cash equivalents and investments in marketable securities (in thousands):