HARMONIC INC
Form 10-Q
August 03, 2007

Table of Contents

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

FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended June 29, 2007

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

Commission File No. 0-25826

HARMONIC INC.

(Exact name of Registrant as specified in its charter)

Delaware	77-0201147
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

549 Baltic Way
Sunnyvale, CA 94089
(408) 542-2500
(Address, including zip code, and telephone number, including area code, of Registrant s principal executive offices)

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 shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes þ No o

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

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

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No þ

The number of shares outstanding of the Registrant s Common Stock, $.001 par value, was 79,765,014 on July 27, 2007.

TABLE OF CONTENTS

PART I
- ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
- ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
- Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK
- Item 4. CONTROLS AND PROCEDURES

PART II
- Item 1. LEGAL PROCEEDINGS
- Item 1A. RISK FACTORS
- Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS
- Item 3. DEFAULTS UPON SENIOR SECURITIES
- Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS
- Item 5. OTHER INFORMATION
- Item 6. EXHIBITS

SIGNATURES
EXHIBIT 10.1
EXHIBIT 31.1
EXHIBIT 31.2
EXHIBIT 32.1
EXHIBIT 32.2

Table of Contents

PART I

FINANCIAL INFORMATION

ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

HARMONIC INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(UNAUDITED)

(In thousands, except par value amounts)	June 29, 2007	December 31, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	$ 21,421	$ 33,454
Short-term investments	60,798	58,917
Accounts receivable, net of allowances of $4,791 and $4,471	62,476	64,674
Inventories	42,508	42,116
Prepaid expenses and other current assets	16,387	12,807
Total current assets	203,590	211,968
Property and equipment, net	14,011	14,816
Goodwill	37,204	37,141
Intangibles, net	14,483	16,634
Other assets	1,415	1,403
Total assets	$ 270,703	$ 281,962
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term debt	$	$ 460
Accounts payable	16,716	33,863
Income taxes payable	480	7,098
Deferred revenue	28,844	29,052
Accrued liabilities	37,756	44,097
Total current liabilities	83,796	114,570
Accrued excess facilities costs, long-term	13,403	16,434
Income taxes payable, long-term	8,040	
Other non-current liabilities	7,045	5,824
Total liabilities	112,284	136,828
Commitments and contingencies (Notes 15,16 and 17)		
Stockholders equity:		
Preferred stock, $0.001 par value, 5,000 shares authorized; no shares issued or outstanding		
Common stock, $0.001 par value, 150,000 shares authorized; 79,410 and 78,386 shares issued and outstanding	79	78

Capital in excess of par value	2,086,992	2,078,863
Accumulated deficit	(1,928,442)	(1,933,708)
Accumulated other comprehensive loss	(210)	(99)
Total stockholders equity	158,419	145,134
Total liabilities and stockholders equity	$ 270,703	$ 281,962

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

Table of Contents

HARMONIC INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

(In thousands, except per share amounts)	**Three Months Ended**		**Six Months Ended**	
	June 29, 2007	**June 30, 2006**	**June 29, 2007**	**June 30, 2006**
Product sales	$ 64,066	$ 46,662	$ 130,022	$ 98,446
Service revenue	7,216	6,608	11,497	11,045
Net sales	71,282	53,270	141,519	109,491
Product cost of sales	37,501	29,061	78,417	63,242
Service cost of sales	3,216	2,603	5,385	4,763
Total cost of sales	40,717	31,664	83,802	68,005
Gross profit	30,565	21,606	57,717	41,486
Operating expenses:				
Research and development	9,605	9,585	20,597	19,533
Selling, general and administrative	15,771	15,979	31,446	31,692
Amortization of intangibles	111	43	222	135
Total operating expenses	25,487	25,607	52,265	51,360
Income (loss) from operations	5,078	(4,001)	5,452	(9,874)
Interest income, net	990	1,175	1,986	2,167
Other expense, net	7	128	(16)	36
Income (loss) before income taxes	6,075	(2,698)	7,422	(7,671)
Provision for (benefit from) income taxes	(174)	205	57	380
Net income (loss)	$ 6,249	$ (2,903)	$ 7,365	$ (8,051)
Net income (loss) per share				
Basic	$ 0.08	$ (0.04)	$ 0.09	$ (0.11)
Diluted	$ 0.08	$ (0.04)	$ 0.09	$ (0.11)

Weighted average shares				
Basic	79,361	74,167	79,164	74,134
Diluted	80,480	74,167	80,304	74,134

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

Table of Contents

HARMONIC INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

(In thousands)	Six Months Ended June 29, 2007	Six Months Ended June 30, 2006
Cash flows from operating activities:		
Net income (loss)	$ 7,365	$ (8,051)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Amortization of intangibles	2,151	458
Depreciation	3,347	3,993
Stock-based compensation	2,786	3,130
Net loss (gain) on disposal and impairment of fixed assets	(60)	20
Changes in assets and liabilities, net of effect of acquisition:		
Accounts receivable, net	2,172	7,630
Inventories	(383)	7,564
Prepaid expenses and other assets	(3,706)	(3,731)
Accounts payable	(16,913)	(3,129)
Deferred revenue	1,622	(3,248)
Income taxes payable	(664)	319
Accrued excess facilities costs	(2,646)	(2,335)
Accrued and other liabilities	(5,054)	698
Net cash provided by (used in) operating activities	(9,983)	3,318
Cash flows from investing activities:		
Purchases of investments	(53,843)	(39,431)
Proceeds from sales of investments	51,928	49,024
Acquisition of property and equipment	(2,482)	(2,404)
Acquisition costs related to the merger of Entone Technologies, Inc.	(2,466)	
Net cash provided by (used in) investing activities	(6,863)	7,189
Cash flows from financing activities:		
Proceeds from issuance of common stock, net	5,329	2,145
Repayments under bank line and term loan	(460)	(418)
Repayments of capital lease obligations	(43)	(41)
Net cash provided by financing activities	4,826	1,686
Effect of exchange rate changes on cash and cash equivalents	(13)	(41)
Net increase (decrease) in cash and cash equivalents	(12,033)	12,152
Cash and cash equivalents at beginning of period	33,454	37,818
Cash and cash equivalents at end of period	$ 21,421	$ 49,970

Supplemental disclosure of cash flow information:				
Income tax payments, net	$	768	$	138
Interest paid during the period	$	66	$	59

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

Table of Contents

HARMONIC INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1: Basis of Presentation

Basis of Presentation. The accompanying unaudited condensed consolidated financial statements include all adjustments (consisting only of normal recurring adjustments) which Harmonic Inc. (Harmonic, the Company or we) considers necessary for a fair presentation of the results of operations for the interim periods covered and the consolidated financial condition of the Company at the date of the balance sheets. This Quarterly Report on Form 10-Q should be read in conjunction with the Company s audited consolidated financial statements contained in the Company s Annual Report on Form 10-K, which was filed with the Securities and Exchange Commission on March 15, 2007. The interim results presented herein are not necessarily indicative of the results of operations that may be expected for the full fiscal year ending December 31, 2007, or any other future period. The Company s fiscal quarters end on the Friday nearest the calendar quarter end, except for the fourth quarter which ends on December 31. The condensed consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

Use of Estimates. The preparation of the consolidated financial statements in conformity with generally accepted accounting principles in the United States of America 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 revenue and expenses during the reporting period. Actual results could differ from those estimates.

Note 2: Recent Accounting Pronouncements

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (SFAS No. 157). This statement clarifies the definition of fair value, establishes a framework for measuring fair value, and expands the disclosures on fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. We have not determined the effect, if any, the adoption of this statement in the first quarter of 2008 will have on our results of operations or financial position.

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). SFAS 159 expands the use of fair value accounting but does not affect existing standards which require assets or liabilities to be carried at fair value. Under SFAS 159, a company may elect to use fair value to measure accounts and loans receivable, available-for-sale and held-to-maturity securities, equity method investments, accounts payable, guarantees and issued debt. Other eligible items include firm commitments for financial instruments that otherwise would not be recognized at inception and non-cash warranty obligations where a warrantor is permitted to pay a third party to provide the warranty goods or services. If the use of fair value is elected, any upfront costs and fees related to the item must be recognized in earnings and cannot be deferred, e.g., debt issue costs. The fair value election is irrevocable and generally made on an instrument-by-instrument basis, even if a company has similar instruments that it elects not to measure based on fair value. At the adoption date, unrealized gains and losses on existing items for which fair value has been elected are reported as a cumulative adjustment to beginning retained earnings. Subsequent to the adoption of SFAS 159, changes in fair value are recognized in earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007 and is required to be adopted by Harmonic in the first quarter of fiscal 2008. Harmonic currently is determining whether fair value accounting is appropriate for any of its eligible items and cannot estimate the impact, if any, which SFAS 159 will have on its consolidated results of operations and financial condition.

The Company adopted Financial Standards Accounting Board Interpretation No. 48, Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109 (FIN 48) on January 1, 2007. FIN 48 clarifies the

Table of Contents

accounting and reporting for uncertainties in income tax law. FIN 48 prescribes a comprehensive model for the financial statement recognition, measurement, presentation and disclosure of uncertain tax positions taken or expected to be taken in income tax returns. See Note 10 for additional information, including the effects of adoption on the Company s condensed consolidated financial statements.

Note 3: Entone Acquisition

On December 8, 2006, Harmonic acquired Entone Technologies, Inc., or Entone, pursuant to the terms of an Agreement and Plan of Merger (the Merger Agreement) dated August 21, 2006. Under the terms of the merger agreement, Entone spun off its consumer premise equipment business, or CPE business, to Entone s existing stockholders prior to closing. Entone then merged into Harmonic, and Harmonic acquired Entone s VOD business, which includes the development, sale and support of head-end equipment (software and hardware) and associated services for the creation, distribution and delivery of on-demand television programming to operators who offer such programming to businesses and consumers. Harmonic believes Entone s software solution, which facilitates the provisioning of personalized video services including video-on-demand, network personal video recording, time-shifted television and targeted advertisement insertion, will enable Harmonic to expand the scope of solutions we can offer to cable, satellite and telco/IPTV service providers in order to provide an advanced and uniquely integrated delivery system for the next generation of both broadcast and personalized IP-delivered video services. These opportunities, along with the established Asia-based software development workforce, were significant factors to the establishment of the purchase price, which exceeded the fair value of Entone s net tangible and intangible assets acquired resulting in the amount of goodwill we have recorded with this transaction. Management has made a preliminary allocation of the estimated purchase price to the tangible and intangible assets acquired and liabilities assumed based on various preliminary estimates. The allocation of the estimated purchase price is preliminary pending finalization of various estimates and analyses.

The purchase price of $49.0 million included $26.2 million in cash, $20.1 million of stock issued, consisting of 3,579,715 shares of Harmonic common stock, $0.2 million in stock options assumed, and $2.5 million of transaction costs. Stock options to purchase Harmonic common stock totaling 175,342 shares were issued to reflect the conversion of all outstanding Entone options for continuing employees. The fair value of Harmonic s stock options issued to Entone employees were valued at $925,000 using the Black-Scholes options pricing model of which $697,000 represented unearned stock-based compensation, which is being recorded as compensation expense as services are provided by optionholders, and $228,000 was recorded as purchase consideration. As part of the terms of the Merger Agreement, Harmonic was obligated to purchase a convertible note with a face amount of $2.5 million in the new spun off private company subject to closing of an initial round of equity financing in which at least $4 million is invested by third parties. This note was funded in July 2007.

The Entone acquisition was accounted for under SFAS No. 141 and certain specified provisions of SFAS No. 142. The results of operations of Entone are included in Harmonic s Consolidated Statements of Operations from December 8, 2006, the date of acquisition. The following table summarizes the preliminary allocation of the

Table of Contents

purchase price based on the estimated fair value of the tangible assets acquired and the liabilities assumed at the date of acquisition:

	(in thousands)
Cash acquired	$
Accounts receivable	297
Inventory	184
Fixed assets	313
Other tangible assets acquired	22
Amortizable intangible assets:	
Existing technology	11,600
Core technology	2,800
Customer relationships	1,700
Tradenames/trademarks	800
Goodwill	32,412
Total assets acquired	50,128
Accounts payable	(855)
Deferred revenue	(166)
Other accrued liabilities	(146)
Net assets acquired	$ 48,961

The purchase price was allocated as set forth in the table above. The Income Approach which includes an analysis of the markets, cash flows and risks associated with achieving such cash flows, was the primary method used in valuing the identified intangibles acquired. The Discounted Cash Flow method was used to estimate the fair value of the acquired existing technology and customer relationships. The Royalty Savings Method was used to estimate the fair value of the acquired core technology and trademarks/trade names. In the Royalty Savings Method, the value of an asset is estimated by capitalizing the royalties saved because the Company owns the asset. Expected cash flows were discounted at the Company s weighted average cost of capital of 18%. Identified intangible assets, including existing technology and core technology are being amortized over their useful lives of three to four years; tradename/trademarks are being amortized over their useful lives of five years; and customer relationships are being amortized over its useful life of six years.

The residual purchase price of $32.4 million has been recorded as goodwill. The goodwill as a result of this acquisition is not expected to be deductible for tax purposes. In accordance with SFAS No. 142, Goodwill and Other Intangible Assets, goodwill relating to the acquisition of Entone is not being amortized and will be tested for impairment annually or whenever events indicate that an impairment may have occurred.

The following unaudited pro forma financial information presented below summarizes the combined results of operations as if the merger had been completed as of the beginning of January 1, 2006. The unaudited pro forma financial information for the three and six months ended June 30, 2006 combines the results for Harmonic for the three and six months ended June 30, 2006, and the historical results of Entone s VOD business for the three and six months ended June 30, 2006. The pro forma financial information is presented for informational purposes only and does not purport to be indicative of what would have occurred had the merger actually been completed on such date or of results which may occur in the future.

	Three Months Ended	Six Months Ended

(in thousands, except per share data)	June 30, 2006	June 30, 2006
Net sales	$ 55,019	$111,574
Net loss	$ (4,544)	$ (12,329)
Net loss per share basic	$ (0.06)	$ (0.17)
Net loss per share diluted	$ (0.06)	$ (0.17)

7

Table of Contents

Note 4: Cash, Cash Equivalents and Investments

At June 29, 2007 and December 31, 2006, cash, cash equivalents and short-term investments are summarized as follows (in thousands):

	June 29, 2007	December 31, 2006
Cash and cash equivalents	$ 21,421	$ 33,454
Short-term investments:		
Less than one year	44,380	54,724
Due in 1-2 years	16,418	4,193
Total short-term investments	60,798	58,917
Total cash, cash equivalents and short-term investments	$ 82,219	$ 92,371

The following is a summary of available-for-sale securities (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
June 29, 2007				
U.S. government debt securities	$ 19,257	$ 8	$ (31)	$ 19,234
Corporate debt securities	35,047	8	(41)	35,014
Other debt securities	6,550	¾	¾	6,550
Total	$ 60,854	$ 16	$ (72)	$ 60,798
December 31, 2006				
U.S. government debt securities	$ 17,187	$ ¾	$ (36)	$ 17,151
Corporate debt securities	38,678	38	(25)	38,691
Other debt securities	3,075	¾	¾	3,075
Total	$ 58,940	$ 38	$ (61)	$ 58,917

Impairment of Investments

We monitor our investment portfolio for impairment on a periodic basis. In the event that the carrying value of an investment exceeds its fair value and the decline in value is determined to be other-than-temporary, an impairment charge is recorded and a new cost basis for the investment is established. In order to determine whether a decline in value is other-than-temporary, we evaluate, among other factors: the duration and extent to which the fair value has been less than the carrying value; our financial condition and business outlook, including key operational and cash flow metrics, current market conditions and future trends in our industry; our relative competitive position within the industry; and our intent and ability to retain the investment for a period of time sufficient to allow any anticipated recovery in fair value.

Table of Contents

In accordance with FASB Staff Position Nos. 115-1 and FAS 124-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments (FSP FAS 115-1), the following table summarizes the fair value and gross unrealized losses related to available-for-sale securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, as of June 29, 2007 (in thousands):

	Less than 12 months		Greater than 12 months		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
U.S. Government debt securities	$ 12,583	$ (23)	$ 3,492	$ (8)	$ 16,075	$ (31)
Corporate debt securities	19,414	(41)	749	¾	20,163	(41)
Total	$ 31,997	$ (64)	$ 4,241	$ (8)	$ 36,238	$ (72)

The decline in the estimated fair value of these investments relative to amortized cost is primarily related to changes in interest rates and is considered to be temporary in nature.

Note 5: Inventories

(In thousands)	June 29, 2007	December 31, 2006
Raw materials	$ 11,166	$ 12,845
Work-in-process	4,306	3,759
Finished goods	27,036	25,512
	$ 42,508	$ 42,116

Note 6: Goodwill and Identified Intangibles

The following is a summary of goodwill and intangible assets as of June 29, 2007 and December 31, 2006 (in thousands):

	June 29, 2007			December 31, 2006		
	Gross Carrying Amount *	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Identified intangibles:						
Developed core technology	$ 44,367	$ (32,135)	$ 12,232	$ 44,322	$ (30,160)	$ 14,162
Customer relationships	33,613	(32,072)	1,541	33,611	(31,929)	1,682
Trademark and tradename	5,038	(4,328)	710	5,031	(4,241)	790
Supply agreement	3,544	(3,544)		3,532	(3,532)	

Subtotal of identified intangibles	86,562	(72,079)	14,483	86,496	(69,862)	16,634
Goodwill	37,204		37,204	37,141		37,141
Total goodwill and other intangibles	$ 123,766	$ (72,079)	$ 51,687	$ 123,637	$ (69,862)	$ 53,775

* Cumulative foreign currency translation adjustments, reflecting movement in the functional currencies of the underlying international entities, totaled approximately $0.2 million for intangible assets as of June 29, 2007 and December 31, 2006.

Table of Contents

The changes in the carrying amount of goodwill for the six months ended June 29, 2007 are as follows (in thousands):

	Goodwill
Balance as of January 1, 2007	