

NETLIST INC  
Form 10-Q  
August 12, 2014  
[Table of Contents](#)

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended June 28, 2014

or

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

For the transition period from            to

Commission file number 001-33170

## NETLIST, INC.

(Exact name of registrant as specified in its charter)

**Delaware**

State or other jurisdiction of incorporation or organization

**95-4812784**

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

**175 Technology Drive, Suite 150**

**Irvine, CA 92618**

(Address of principal executive offices) (Zip Code)

**(949) 435-0025**

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer   
(Do not check if a smaller reporting company)

Smaller reporting company

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

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

Common Stock, par value \$0.001 per share

41,479,584 shares outstanding at July 31, 2014

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Table of Contents

NETLIST, INC. AND SUBSIDIARIES  
QUARTERLY REPORT ON FORM 10-Q  
FOR THE THREE AND SIX MONTHS ENDED JUNE 28, 2014

TABLE OF CONTENTS

	<b>Page</b>
<b><u>PART I. FINANCIAL INFORMATION</u></b>	
<b><u>Item 1. Financial Statements</u></b>	3
<u>Condensed Consolidated Balance Sheets at June 28, 2014 (unaudited) and December 28, 2013 (audited)</u>	3
<u>Unaudited Condensed Consolidated Statements of Operations for the Three and Six Months Ended June 28, 2014 and June 29, 2013</u>	4
<u>Unaudited Condensed Consolidated Statements of Cash Flows for the Six Months Ended June 28, 2014 and June 29, 2013</u>	5
<u>Notes to Unaudited Condensed Consolidated Financial Statements</u>	6
<b><u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u></b>	26
<b><u>Item 4. Controls and Procedures</u></b>	40
<b><u>PART II. OTHER INFORMATION</u></b>	40
<b><u>Item 1. Legal Proceedings</u></b>	40
<b><u>Item 1A. Risk Factors</u></b>	40
<b><u>Item 6. Exhibits</u></b>	58

Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****NETLIST, INC. AND SUBSIDIARIES****Condensed Consolidated Balance Sheets****(in thousands, except par value)**

	(unaudited) June 28, 2014	(audited) December 28, 2013
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 16,184	\$ 6,701
Restricted cash	1,100	1,100
Accounts receivable, net	2,981	4,866
Inventories	2,463	2,620
Prepaid expenses and other current assets	715	823
Total current assets	23,443	16,110
Property and equipment, net	678	1,143
Other assets	255	422
Total assets	\$ 24,376	\$ 17,675
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 3,361	\$ 3,795
Accrued payroll and related liabilities	760	635
Accrued expenses and other current liabilities	488	533
Accrued engineering charges	500	500
Current portion of long-term debt, net of debt discount	919	
Total current liabilities	6,028	5,463
Long-term debt, net of current portion and debt discount	4,635	5,099
Other liabilities	98	100
Total liabilities	10,761	10,662
Commitments and contingencies		
Stockholders' equity:		
Common stock, \$0.001 par value - 90,000 shares authorized; 41,480 (2014) and 31,776 (2013) shares issued and outstanding	41	31
Additional paid-in capital	116,572	104,469
Accumulated deficit	(102,998)	(97,487)
Total stockholders' equity	13,615	7,013
Total liabilities and stockholders' equity	\$ 24,376	\$ 17,675

See accompanying notes.



Table of Contents

## NETLIST, INC. AND SUBSIDIARIES

## Unaudited Condensed Consolidated Statements of Operations

(in thousands, except per share amounts)

	Three Months Ended		Six Months Ended	
	June 28, 2014	June 29, 2013	June 28, 2014	June 29, 2013
Net sales	\$ 4,887	\$ 5,065	\$ 11,888	\$ 11,029
Cost of sales(1)	3,908	4,818	8,924	10,216
Gross profit	979	247	2,964	813
Operating expenses:				
Research and development(1)	2,302	1,457	4,277	3,299
Selling, general and administrative(1)	1,781	1,571	3,403	3,327
Total operating expenses	4,083	3,028	7,680	6,626
Operating loss	(3,104)	(2,781)	(4,716)	(5,813)
Other income (expense), net:				
Interest expense, net	(393)	(88)	(788)	(218)
Other expense, net	6	7	(5)	1
Total other expense, net	(387)	(81)	(793)	(217)
Loss before provision for income taxes	(3,491)	(2,862)	(5,509)	(6,030)
Provision for income taxes	2	1	2	3
Net loss	\$ (3,493)	\$ (2,863)	\$ (5,511)	\$ (6,033)
Net loss per common share:				
Basic and diluted	\$ (0.08)	\$ (0.09)	\$ (0.14)	\$ (0.20)
Weighted-average common shares outstanding:				
Basic and diluted	41,472	30,320	39,134	30,263

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

Cost of sales	\$ 14	\$ 11	\$ 29	\$ 23
Research and development	181	118	369	278
Selling, general and administrative	320	240	648	502

See accompanying notes.

Table of Contents

## NETLIST, INC. AND SUBSIDIARIES

## Unaudited Condensed Consolidated Statements of Cash Flows

(in thousands)

	Six Months Ended	
	June 28, 2014	June 29, 2013
Cash flows from operating activities:		
Net loss	\$ (5,511)	\$ (6,033)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	535	813
Amortization of debt discount and debt issuance costs	402	
Realized loss on disposal of property and equipment	6	1
Capitalized payment-in-kind interest	123	
Stock-based compensation	1,046	803
Changes in operating assets and liabilities:		
Accounts receivable	1,885	1,370
Inventories	157	2,075
Prepaid expenses and other current assets	481	491
Other assets	(167)	4
Accounts payable	(434)	71
Accrued payroll and related liabilities	125	(74)
Accrued expenses and other liabilities	(47)	(51)
Net cash used in operating activities	(1,399)	(530)
Cash flows from investing activities:		
Acquisition of property and equipment	(79)	(52)
Proceeds from sale of property and equipment	3	2
Proceeds from maturities and sales of investments in marketable securities		415
Net cash (used in) provided by investing activities	(76)	365
Cash flows from financing activities:		
Payments on debt	(109)	(830)
Proceeds from public offering, net of offering costs of \$116	10,276	28
Proceeds from exercise of equity awards, net of taxes remitted for restricted stock	791	29
Net cash provided by (used in) financing activities	10,958	(773)
Increase (decrease) in cash and cash equivalents	9,483	(938)
Cash and cash equivalents at beginning of period	6,701	7,755
Cash and cash equivalents at end of period	\$ 16,184	\$ 6,817

See accompanying notes.



Table of Contents

**NETLIST, INC. AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**June 28, 2014**

**Note 1 Description of Business**

Netlist, Inc. (the "Company" or "Netlist") designs and manufactures a wide variety of high performance, logic-based memory subsystems for the global datacenter, storage and high-performance computing and communications markets. The Company's memory subsystems consist of combinations of dynamic random access memory integrated circuits ("DRAM ICs" or "DRAM"), NAND flash memory ("NAND"), application-specific integrated circuits ("ASICs") and other components assembled on printed circuit boards ("PCBs"). Netlist primarily markets and sells its products to leading original equipment manufacturer ("OEM") customers, hyperscale datacenter operators and storage vendors. The Company's solutions are targeted at applications where memory plays a key role in meeting system performance requirements. The Company leverages 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, reduced power consumption and low cost per bit. Our NVvault product is the first to offer both DRAM and NAND in a standard form factor memory subsystem as a persistent DIMM in mission critical applications.

Netlist was incorporated in June 2000 and is headquartered in Irvine, California. In 2007, the Company established a manufacturing facility in the People's Republic of China (the "PRC"), which became operational in July 2007 upon the successful qualification of certain key customers.

**Note 2 Summary of Significant Accounting Policies**

*Basis of Presentation*

The interim unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (the "U.S.") for interim financial information and with the instructions to Securities and Exchange Commission ("SEC") Form 10-Q and Article 8 of SEC Regulation S-X. These condensed consolidated financial statements do not include all of the information and footnotes required by accounting principles generally accepted in the U.S. for complete financial statements. Therefore, these 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 28, 2013, included in the Company's Annual Report on Form 10-K filed with the SEC on March 18, 2014.

The condensed consolidated financial statements included herein as of June 28, 2014 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 condensed consolidated financial position of the Company and its wholly-owned subsidiaries as of June 28, 2014 and the condensed consolidated statements of operations for the three and six months ended June 28, 2014 and June 29, 2013 and the condensed consolidated statements of cash flows for the six months ended June 28, 2014 and June 29, 2013. The results of operations for the six months ended June 28, 2014 are not necessarily indicative of the results to

be expected for the full year or any future interim periods.

*Principles of Consolidation*

The condensed consolidated financial statements include the accounts of Netlist, Inc. and its wholly-owned subsidiaries. All intercompany balances and transactions have been eliminated in consolidation.

*Fiscal Year*

The Company operates under a 52/53-week fiscal year ending on the Saturday closest to December 31. For fiscal 2014, the Company's fiscal year is scheduled to end on December 27, 2014 and will consist of 52 weeks. Each of the Company's first three quarters in a fiscal year is comprised of 13 weeks.

Table of Contents

*Use of Estimates*

The preparation of financial statements in conformity with accounting principles generally accepted in the U.S. 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 condensed 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. Significant estimates made by management include, among others, provisions for uncollectible receivables and sales returns, warranty liabilities, valuation of inventories, fair value of financial instruments, recoverability of long-lived assets, stock-based transactions and realization of deferred tax assets. The Company bases its estimates on historical experience, knowledge of current conditions and our beliefs of what could occur in the future considering available information. The Company reviews its estimates on an on-going basis. The actual results experienced by the Company may differ materially and adversely from its estimates. To the extent there are material differences between the estimates and the actual results, future results of operations will be affected.

*Revenue Recognition*

The Company's revenues primarily consist of product sales of high-performance memory subsystems to OEMs, hyperscale datacenter operators and storage vendors.

The Company recognizes revenues in accordance with the Financial Accounting Standards Board ( FASB ) Accounting Standards Codification ( ASC ) Topic 605. Accordingly, the Company recognizes revenues when there is persuasive evidence of an arrangement, product delivery and acceptance have occurred, the sales price is fixed or determinable, and collectibility of the resulting receivable is reasonably assured.

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

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

*Cash and Cash Equivalents*

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Cash and cash equivalents consist of cash and short-term investments with original maturities of three months or less, other than short-term investments in securities that lack an active market.

### *Restricted Cash*

Restricted cash of \$1.1 million, as of June 28, 2014, consists of cash to secure three standby letters of credit.

### *Fair Value of Financial Instruments*

The Company's financial instruments consist principally of cash and cash equivalents, restricted cash, accounts receivable, accounts payable, accrued expenses and debt instruments. The fair value of the Company's cash equivalents is determined based on quoted prices in active markets for identical assets or Level 1 inputs. The Company recognizes transfers between Levels 1 through 3 of the fair value hierarchy at the beginning of the reporting period. The Company believes that the carrying values of all other financial instruments approximate their current fair values due to their nature and respective durations.

Table of Contents

*Allowance for Doubtful Accounts*

The Company evaluates the collectibility of accounts receivable based on a combination of factors. In cases where the Company is aware of circumstances that may impair a specific customer's ability to meet its financial obligations subsequent to the original sale, the Company will record an allowance against amounts due, and thereby reduce the net recognized receivable to the amount the Company reasonably believes will be collected. For all other customers, the Company records allowances for doubtful accounts based primarily on the length of time the receivables are past due based on the terms of the originating transaction, the current business environment and its historical experience. Uncollectible accounts are charged against the allowance for doubtful accounts when all cost effective commercial means of collection have been exhausted.

*Concentration of Credit Risk*

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist principally of cash and cash equivalents, and accounts receivable.

The Company invests its cash equivalents primarily in money market mutual funds. Cash equivalents are maintained with high quality institutions, the composition and maturities of which are regularly monitored by management. At times, deposits held with financial institutions may exceed the amount of insurance provided by the Federal Deposit Insurance Corporation and the Securities Investor Protection Corporation.

The Company's trade accounts receivable are primarily derived from sales to OEMs in the computer industry. The Company performs credit evaluations of its customers' financial condition and limits the amount of credit extended when deemed necessary, but generally requires no collateral. The Company believes that the concentration of credit risk in its trade receivables is moderated by its credit evaluation process, relatively short collection terms, the high level of credit worthiness of its customers (see Note 3), foreign credit insurance and letters of credit issued on the Company's behalf. Reserves are maintained for potential credit losses, and such losses historically have not been significant and have been within management's expectations.

*Inventories*

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

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### *Deferred Financing Costs, Debt Discount and Detachable Debt-Related Warrants*

Costs incurred to issue debt are deferred and included in debt issuance costs in the accompanying consolidated balance sheet. The Company amortizes debt issuance costs over the expected term of the related debt using the effective interest method. Debt discounts relate to the relative fair value of any warrants issued in conjunction with the debt are recorded as a reduction to the debt balance and accreted over the expected term of the debt to interest expense using the effective interest method.

### *Property and Equipment*

Property and equipment are recorded at cost and depreciated on a straight-line basis over their estimated useful lives, which generally range from three to seven years. Leasehold improvements are recorded at cost and amortized on a straight-line basis over the shorter of their estimated useful lives or the remaining lease term.

Table of Contents

*Impairment of Long-Lived Assets*

The Company evaluates the recoverability of the carrying value of long-lived assets held and used by the Company for impairment on at least an annual basis or whenever events or changes in circumstances indicate that their carrying value may not be recoverable. When such factors and circumstances exist, the Company compares the projected undiscounted future net cash flows associated with the related asset or group of assets over their estimated useful lives against their respective carrying amount. 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 value of the asset. The fair value of the asset or asset group is based on market value when available, or when unavailable, on discounted expected cash flows. The Company's management believes there is no impairment of long-lived assets as of June 28, 2014. There can be no assurance, however, that market conditions will not change or demand for the Company's products will continue, which could result in future impairment of long-lived assets.

*Warranty Reserve*

The Company offers product warranties generally ranging from one to three years, depending on the product and negotiated terms of any purchase agreements with customers. 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. Warranties are not offered on sales of excess component inventory. The Company records an estimate for warranty-related costs at the time of sale based on its historical and estimated product return rates and expected repair or replacement costs (see Note 3). While such costs have historically been within management's expectations and the provisions established, unexpected changes in failure rates could have a material adverse impact on the Company, requiring additional warranty reserves, and could adversely affect the Company's gross profit and gross margins.

*Stock-Based Compensation*

The Company accounts for equity issuances to non-employees in accordance with ASC Topic 505. 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 ASC Topic 718, employee and director stock-based compensation expense recognized during the period is based on the value of the portion of stock-based payment awards that is ultimately expected to vest during the period. Given that stock-based compensation expense recognized in the condensed consolidated statements of operations is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. ASC Topic 718 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 Company's estimated average forfeiture rates are based on historical forfeiture experience and estimated future forfeitures.

The fair value of common stock option awards to employees and directors is calculated using the Black-Scholes option pricing model. The Black-Scholes model requires subjective assumptions regarding future stock price volatility and expected time to exercise, along with

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assumptions about the risk-free interest rate and expected dividends, all of which affect the estimated fair values of the Company's common stock option awards. The expected term of options granted is calculated as the average of the weighted vesting period and the contractual expiration date of the option. This calculation is based on the safe harbor method permitted by the SEC in instances where the vesting and exercise terms of options granted meet certain conditions and where limited historical exercise data is available. The expected volatility is based on the historical volatility of the Company's common stock. 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 dividend assumption is based on the Company's history and management's expectation regarding dividend payouts. Compensation expense for common stock option awards with graded vesting schedules is recognized on a straight-line basis over the requisite service period for the last separately vesting portion of the award, provided that the accumulated cost recognized as of any date at least equals the value of the vested portion of the award.

The Company recognizes the fair value of restricted stock awards issued to employees and outside directors as stock-based compensation expense on a straight-line basis over the vesting period for the last separately vesting portion of the awards. Fair value is determined as the difference between the closing price of our common stock on the grant date and the purchase price of the restricted stock award, if any, reduced by expected forfeitures.

If there are any modifications or cancellations of the underlying vested or unvested stock-based awards, the Company may be required to accelerate, increase or cancel any remaining unearned stock-based compensation expense, or record additional expense for vested stock-based awards. Future stock-based compensation expense and unearned stock-based compensation may increase to the extent that the Company grants additional common stock options or other stock-based awards.



Table of Contents

*Income Taxes*

Under ASC Topic 270, the Company is required to adjust its effective tax rate each quarter to be consistent with the estimated annual effective tax rate. The Company is also required to record the tax impact of certain discrete items, unusual or infrequently occurring, including changes in judgment about valuation allowances and effects of changes in tax laws or rates, in the interim period in which they occur. In addition, jurisdictions with a projected loss for the year or a year-to-date loss where no tax benefit can be recognized are excluded from the estimated annual effective tax rate. The impact of such an exclusion could result in a higher or lower effective tax rate during a particular quarter, based upon the mix and timing of actual earnings versus annual projections.