

PIXELWORKS, INC
Form 10-Q
November 07, 2008

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q**

(Mark One)

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

For the quarterly period ended September 30, 2008.

or

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

For the transition period from _____ to _____.

Commission File Number: 000-30269

PIXELWORKS, INC.

(Exact name of registrant as specified in its charter)

OREGON

(State or other jurisdiction of incorporation)

91-1761992

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

**8100 SW Nyberg Road
Tualatin, Oregon 97062
(503) 454-1750**

(Address of principal executive offices, including zip code,
and 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 last 90 days. Yes No

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

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

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

Yes No

Number of shares of Common Stock outstanding as of October 31, 2008: 13,729,127

PIXELWORKS, INC.
FORM 10-Q
FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2008
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PIXELWORKS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands)
(Unaudited)

	September 30, 2008	December 31, 2007
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 42,780	\$ 74,572
Short-term marketable securities	18,560	34,581
Accounts receivable, net	5,948	6,223
Inventories, net	5,257	11,265
Prepaid expenses and other current assets	3,771	3,791
 Total current assets	 76,316	 130,432
 Long-term marketable securities	 1,490	 9,804
Property and equipment, net	4,839	6,148
Other assets, net	5,387	6,902
Debt issuance costs, net	764	2,260
Acquired intangible assets, net	4,091	6,370
 Total assets	 \$ 92,887	 \$ 161,916
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 4,541	\$ 3,992
Accrued liabilities and current portion of long-term liabilities	7,396	13,848
Current portion of income taxes payable		232
 Total current liabilities	 11,937	 18,072
 Long-term liabilities, net of current portion	 1,501	 1,236
Income taxes payable, net of current portion	10,866	10,635
Long-term debt	60,634	140,000
 Total liabilities	 84,938	 169,943
 Commitments and contingencies		
 Shareholders' equity (deficit):		
Preferred stock		

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Common stock	334,127	333,934
Shares exchangeable into common stock		113
Accumulated other comprehensive loss	(1,984)	(4,778)
Accumulated deficit	(324,194)	(337,296)
Total shareholders' equity (deficit)	7,949	(8,027)
Total liabilities and shareholders' equity	\$ 92,887	\$ 161,916

See accompanying notes to condensed consolidated financial statements.

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PIXELWORKS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share data)
(Unaudited)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2008	2007	2008	2007
Revenue, net	\$ 21,479	\$ 28,133	\$ 66,248	\$ 79,010
Cost of revenue (1)	10,028	16,025	32,628	45,447
Gross profit	11,451	12,108	33,620	33,563
Operating expenses:				
Research and development (2)	6,476	8,962	20,391	30,612
Selling, general and administrative (3)	4,413	5,697	13,590	20,235
Restructuring	121	1,645	971	7,048
Amortization of acquired intangible assets		89	164	269
Total operating expenses	11,010	16,393	35,116	58,164
Income (loss) from operations	441	(4,285)	(1,496)	(24,601)
Gain on repurchase of long-term debt, net	8,113		19,670	
Interest income	405	1,454	1,941	4,425
Interest expense	(343)	(658)	(1,335)	(2,003)
Amortization of debt issuance costs	(83)	(165)	(354)	(496)
Other income			218	
Other-than-temporary impairment of marketable security			(6,490)	
Interest and other income, net	8,092	631	13,650	1,926
Income (loss) before income taxes	8,533	(3,654)	12,154	(22,675)
Provision (benefit) for income taxes	314	775	(948)	1,796
Net income (loss)	\$ 8,219	\$ (4,429)	\$ 13,102	\$ (24,471)
Net income (loss) per share:				
Basic	\$ 0.57	\$ (0.27)	\$ 0.90	\$ (1.50)
Diluted	\$ 0.56	\$ (0.27)	\$ 0.89	\$ (1.50)
Weighted average shares outstanding:				
Basic	14,383	16,307	14,629	16,284

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Diluted	15,399	16,307	14,640	16,284
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(1) Includes:

Amortization of acquired developed technology	\$705	\$705	\$2,115	\$2,115
Stock-based compensation	8	22	46	70
Restructuring		11		147
(2) Includes stock-based compensation	177	538	1,075	1,718
(3) Includes stock-based compensation	227	684	965	2,633

See accompanying notes to condensed consolidated financial statements.

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PIXELWORKS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Nine Months Ended	
	September 30,	
	2008	2007
Cash flows from operating activities:		
Net income (loss)	\$ 13,102	\$ (24,471)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Gain on repurchase of long-term debt, net	(19,670)	
Other-than-temporary impairment of marketable security	6,490	
Depreciation and amortization	5,007	10,982
Amortization of acquired intangible assets	2,279	2,384
Stock-based compensation	2,086	4,421
Deferred income tax expense (benefit)	(476)	420
Amortization of debt issuance costs	354	496
Accretion on short- and long-term marketable securities	(325)	(320)
Loss on asset disposals	93	210
Write-off of certain assets related to restructuring	14	679
Other	40	41
Changes in operating assets and liabilities:		
Accounts receivable, net	275	646
Inventories, net	6,008	(1,703)
Prepaid expenses and other current and long-term assets, net	759	3,326
Accounts payable	(390)	(934)
Accrued current and long-term liabilities	(2,459)	(1,822)
Income taxes payable	(1)	(412)
Net cash provided by (used in) operating activities	13,186	(6,057)
Cash flows from investing activities:		
Proceeds from sales and maturities of marketable securities	43,964	52,221
Purchases of marketable securities	(22,999)	(27,837)
Purchases of property and equipment	(1,478)	(2,027)
Proceeds from sales of property and equipment	20	26
Net cash provided by investing activities	19,507	22,383
Cash flows from financing activities:		
Repurchase of long-term debt	(58,554)	
Payments on asset financings	(3,925)	(6,130)
Repurchase of common stock	(2,053)	
Proceeds from issuances of common stock	47	352

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Net cash used in financing activities	(64,485)	(5,778)
Net change in cash and cash equivalents	(31,792)	10,548
Cash and cash equivalents, beginning of period	74,572	63,095
Cash and cash equivalents, end of period	\$ 42,780	\$ 73,643

See accompanying notes to condensed consolidated financial statements.

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PIXELWORKS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(In thousands, except share and per share data)
(Unaudited)

NOTE 1: BASIS OF PRESENTATION

Nature of Business

We are an innovative designer, developer and marketer of video and pixel processing technology semiconductors and software for high-end digital video applications. Our solutions enable manufacturers of digital display and projection devices, such as multimedia projectors and large-screen liquid crystal display (LCD) televisions to differentiate their products with a consistently high level of video quality.

Condensed Consolidated Financial Statements

These condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles (GAAP) have been condensed or omitted pursuant to such regulations, although we believe that the disclosures provided are adequate to prevent the information presented from being misleading.

The financial information included herein for the three and nine month periods ended September 30, 2008 and 2007 is unaudited; however, such information reflects all adjustments, consisting only of normal recurring adjustments, that are, in the opinion of management, necessary for a fair presentation of the financial position, results of operations and cash flows of the Company for these interim periods. The financial information as of December 31, 2007 is derived from our audited consolidated financial statements and notes thereto for the fiscal year ended December 31, 2007, included in Item 8 of our Annual Report on Form 10-K, filed with the SEC on March 12, 2008, and should be read in conjunction with such consolidated financial statements.

The results of operations for the three and nine month periods ended September 30, 2008 are not necessarily indicative of the results expected for the entire fiscal year ending December 31, 2008.

Use of Estimates

The preparation of consolidated financial statements in conformity with GAAP requires us to make estimates and judgments that affect amounts reported in the financial statements and accompanying notes. Our significant estimates and judgments include those related to valuation of short- and long-term marketable securities, product returns, warranty obligations, bad debts, inventories, property and equipment, intangible assets, valuation of share-based payments, income taxes, litigation and other contingencies. The actual results experienced could differ materially from our estimates.

Reclassifications

Certain reclassifications have been made to the 2007 condensed consolidated financial statements to conform with the 2008 presentation, including the reclassification of payments on asset financing as financing activities on the condensed consolidated statements of cash flow. Similar amounts will be reclassified in future filings for prior periods.

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As of September 30, 2008 and December 31, 2007, all of our short- and long-term marketable securities are available-for-sale.

Unrealized holding gains (losses) on short- and long-term available-for-sale securities, net of tax, were \$78 and \$(2,019), respectively, as of September 30, 2008 and \$(22) and \$(4,713), respectively, as of December 31, 2007. These unrealized holding gains and losses are recorded in accumulated other comprehensive loss, a component of shareholders' equity (deficit), in the condensed consolidated balance sheets. We determined that as of September 30, 2008, gross unrealized losses on our marketable securities were temporary based on our intent and ability to hold the investments until recovery.

Accounts Receivable, Net

Accounts receivable are recorded at invoiced amount and do not bear interest when recorded or accrue interest when past due. We do not have any off balance sheet exposure risk related to customers. Accounts receivable are stated net of an allowance for doubtful accounts, which is maintained for estimated losses that may result from the inability of our customers to make required payments. Accounts receivable, net consists of the following:

	September 30, 2008	December 31, 2007
Accounts receivable, gross	\$ 6,490	\$ 6,765
Less: allowance for doubtful accounts	(542)	(542)
Accounts receivable, net	\$ 5,948	\$ 6,223

The following is the change in our allowance for doubtful accounts:

	Nine Months Ended September 30,	
	2008	2007
Balance at beginning of period	\$ 542	\$ 200
Provision		483
Recoveries		(96)
Balance at end of period	\$ 542	\$ 587

Inventories, Net

Inventories consist of finished goods and work-in-process, and are stated at the lower of standard cost (which approximates actual cost on a first-in, first-out basis) or market (net realizable value), net of a reserve for slow-moving and obsolete items.

Inventories, net consists of the following:

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	September 30, 2008	December 31, 2007
Finished goods	\$ 4,928	\$ 12,733
Work-in-process	5,412	4,482
	10,340	17,215
Less: reserve for slow-moving and obsolete items	(5,083)	(5,950)
Inventories, net	\$ 5,257	\$ 11,265

The following is the change in our reserve for slow-moving and obsolete items:

	Nine Months Ended September 30,	
	2008	2007
Balance at beginning of period	\$ 5,950	\$ 5,950
Provision	1,361	3,834
Usage:		
Sales	(836)	(1,408)
Scrap	(1,392)	(1,551)
Total usage	(2,228)	(2,959)
Balance at end of period	\$ 5,083	\$ 6,825

Based upon our forecast and backlog, we do not currently expect to be able to sell or otherwise use the reserved inventory we have on hand at September 30, 2008. However, it is possible that a customer will decide in the future to purchase a portion of the reserved inventory. It is not possible for us to predict if or when this may happen, or how much we may sell. If such sales occur, we do not expect that they will have a material effect on gross profit margin.

Prepaid Expenses and Other Current Assets

Prepaid expenses and other current assets consist of current prepaid expenses, deposits, income taxes receivable, other receivables and deferred tax assets. In the third quarter of 2008 we increased the estimated amortization rate of a certain prepaid royalty due to a change in future product design. The revision will be made prospectively and had no impact on our condensed statements of operations, balance sheets or cash flows as of September 30, 2008.

Property and Equipment, Net

Property and equipment, net consists of the following:

	September 30, 2008	December 31, 2007
Gross carrying amount	\$ 18,685	\$ 17,109
Less: accumulated depreciation and amortization	(13,846)	(10,961)
Property and equipment, net	\$ 4,839	\$ 6,148

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Acquired intangible assets, net consists of the following:

	September 30, 2008	December 31, 2007
Gross carrying amount:		
Developed technology	\$ 19,170	\$ 19,170
Customer relationships	1,689	1,689
	20,859	20,859
Less accumulated amortization:		
Developed technology	(15,079)	(12,964)
Customer relationships	(1,689)	(1,525)
	(16,768)	(14,489)
Acquired intangible assets, net	\$ 4,091	\$ 6,370

Estimated future amortization of acquired developed technology is as follows:

Three Months Ending December 31:	
2008	\$ 705
Year Ending December 31:	
2009	2,336
2010	1,050
	\$ 4,091

Accrued Liabilities and Current Portion of Long-Term Liabilities

Accrued liabilities and current portion of long-term liabilities consists of the following:

	September 30, 2008	December 31, 2007
Accrued payroll and related liabilities	\$ 3,535	\$ 3,366
Reserve for warranty returns	678	932
Accrued costs related to restructuring	487	2,918
Current portion of accrued liabilities for asset financings	428	4,150
Accrued interest payable	416	405
Accrued commissions and royalties	249	381
Reserve for sales returns and allowances	175	175
Other	1,428	1,521
	\$ 7,396	\$ 13,848

The following is the change in our reserves for warranty returns and sales returns and allowances:

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	Nine Months Ended September 30,	
	2008	2007
Reserve for warranty returns:		
Balance at beginning of period	\$ 932	\$ 662
Provision	(73)	1,203
Charge offs	(181)	(959)
Balance at end of period	\$ 678	\$ 906
Reserve for sales returns and allowances:		
Balance at beginning of period	\$ 175	\$ 479
Provision	74	111
Charge offs	(74)	(415)
Balance at end of period	\$ 175	\$ 175

Long-Term Debt

In 2004, we issued \$150,000 of 1.75% convertible subordinated debentures (the debentures) due 2024. In February 2006, we repurchased and retired \$10,000 of the debentures. In February 2008, we repurchased and retired \$50,248 of the debentures in a modified dutch auction tender offer for \$37,939 in cash. We recognized a net gain of \$11,557 on the repurchase, which included a \$13,064 discount, offset by legal and professional fees of \$755 and a write-off of debt issuance costs of \$752. In August 2008, we repurchased and retired \$29,118 of the debentures for \$20,615 in a combination of open market and private transactions. We recognized a net gain of \$8,113 on the repurchases, which included an \$8,503 discount, offset by a write-off of debt issuance costs of \$390. The remaining \$60,634 of debentures are convertible, under certain circumstances, into our common stock at a conversion rate of 13.6876 shares of common stock per \$1 principal amount of debentures for a total of 829,934 shares. This is equivalent to a conversion price of approximately \$73.06 per share. The debentures are convertible if (a) our stock trades above 130% of the conversion price for 20 out of 30 consecutive trading days during any calendar quarter, (b) the debentures trade at an amount less than or