

PIXELWORKS, INC
Form 10-Q
August 11, 2008

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 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.

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 July 31, 2008: 14,526,127

PIXELWORKS, INC.
FORM 10-Q
FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2008
TABLE OF CONTENTS

PART I FINANCIAL INFORMATION

Item 1. Financial Statements

Condensed Consolidated Balance Sheets
Condensed Consolidated Statements of Operations
Condensed Consolidated Statements of Cash Flows
Notes to Condensed Consolidated Financial Statements

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 OTHER INFORMATION

Item 1A. Risk Factors

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Item 4. Submission of Matters to a Vote of Security Holders

Item 6. Exhibits

SIGNATURE

EXHIBIT 3.1
EXHIBIT 10.1
EXHIBIT 10.2
EXHIBIT 31.1
EXHIBIT 31.2
EXHIBIT 32.1
EXHIBIT 32.2

Table of Contents**PART I FINANCIAL INFORMATION****Item 1. Financial Statements.**

PIXELWORKS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands)
(Unaudited)

	June 30, 2008	December 31, 2007
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 59,394	\$ 74,572
Short-term marketable securities	14,804	34,581
Accounts receivable, net	6,738	6,223
Inventories, net	6,271	11,265
Prepaid expenses and other current assets	3,862	3,791
Total current assets	91,069	130,432
Long-term marketable securities	7,495	9,804
Property and equipment, net	5,747	6,148
Other assets, net	7,036	6,902
Debt issuance costs, net	1,237	2,260
Acquired intangible assets, net	4,796	6,370
Total assets	\$ 117,380	\$ 161,916
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 3,658	\$ 3,992
Accrued liabilities and current portion of long-term liabilities	9,988	13,848
Current portion of income taxes payable	281	232
Total current liabilities	13,927	18,072
Long-term liabilities, net of current portion	1,719	1,236
Income taxes payable, net of current portion	10,524	10,635
Long-term debt	89,752	140,000
Total liabilities	115,922	169,943
Commitments and contingencies		
Shareholders' equity (deficit):		
Preferred stock		
Common stock	334,386	333,934

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Shares exchangeable into common stock		113
Accumulated other comprehensive loss	(515)	(4,778)
Accumulated deficit	(332,413)	(337,296)
Total shareholders' equity (deficit)	1,458	(8,027)
Total liabilities and shareholders' equity	\$ 117,380	\$ 161,916

See accompanying notes to condensed consolidated financial statements.

3

Table of Contents

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

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2008	2007	2008	2007
Revenue, net	\$ 20,793	\$ 26,896	\$ 44,769	\$ 50,877
Cost of revenue (1)	10,295	15,294	22,600	29,422
Gross profit	10,498	11,602	22,169	21,455
Operating expenses:				
Research and development (2)	7,193	9,675	13,915	21,650
Selling, general and administrative (3)	4,491	7,013	9,177	14,538
Restructuring	(158)	2,635	850	5,403
Amortization of acquired intangible assets	74	90	164	180
Total operating expenses	11,600	19,413	24,106	41,771
Loss from operations	(1,102)	(7,811)	(1,937)	(20,316)
Interest income	553	1,444	1,536	2,971
Other income	218		218	
Interest expense	(419)	(688)	(992)	(1,345)
Amortization of debt issuance costs	(125)	(166)	(271)	(331)
Gain on repurchase of long-term debt, net			11,557	
Other-than-temporary impairment of marketable security			(6,490)	
Interest and other income, net	227	590	5,558	1,295
Income (loss) before income taxes	(875)	(7,221)	3,621	(19,021)
Provision (benefit) for income taxes	375	399	(1,262)	1,021
Net income (loss)	\$ (1,250)	\$ (7,620)	\$ 4,883	\$ (20,042)
Net income (loss) per share basic and diluted	\$ (0.09)	\$ (0.47)	\$ 0.33	\$ (1.23)
Weighted averages shares outstanding:				
Basic	14,577	16,286	14,753	16,273
Diluted	14,577	16,286	14,766	16,273

(1) Includes:

Amortization of acquired developed technology	\$ 705	\$ 705	\$ 1,410	\$ 1,410
Stock-based compensation	20	28	38	48
Restructuring		35		136
(2) Includes stock-based compensation	449	510	898	1,180
(3) Includes stock-based compensation	313	916	738	1,949

See accompanying notes to condensed consolidated financial statements.

4

Table of Contents

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

	Six Months Ended	
	June 30,	
	2008	2007
Cash flows from operating activities:		
Net income (loss)	\$ 4,883	\$ (20,042)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Gain on repurchase of long-term debt, net	(11,557)	
Other-than-temporary impairment of marketable security	6,490	
Depreciation and amortization	3,375	7,742
Stock-based compensation	1,674	3,177
Amortization of acquired intangible assets	1,574	1,590
Deferred income tax benefit	(473)	
Accretion on short- and long-term marketable securities	(295)	(147)
Amortization of debt issuance costs	271	331
Loss on asset disposals	80	206
Write off of certain assets related to restructuring		572
Unrealized foreign currency gain on investments		(201)
Other	27	26
Changes in operating assets and liabilities:		
Accounts receivable, net	(515)	293
Inventories, net	4,994	(3,060)
Prepaid expenses and other current and long-term assets, net	(535)	974
Accounts payable	(334)	4,891
Accrued current and long-term liabilities	(1,667)	(1,202)
Income taxes payable	(62)	(463)
Net cash provided by (used in) operating activities	7,930	(5,313)
Cash flows from investing activities:		
Proceeds from sales and maturities of marketable securities	36,814	30,118
Purchases of marketable securities	(16,659)	(15,556)
Payments on asset financings	(2,764)	(3,609)
Purchases of property and equipment	(1,245)	(1,496)
Proceeds from sales of property and equipment	20	
Net cash provided by investing activities	16,166	9,457
Cash flows from financing activities:		
Repurchase of long-term debt	(37,939)	
Repurchase of common stock	(1,371)	
Proceeds from issuances of common stock	36	250

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Net cash provided by (used in) financing activities	(39,274)	250
Net change in cash and cash equivalents	(15,178)	4,394
Cash and cash equivalents, beginning of period	74,572	63,095
Cash and cash equivalents, end of period	\$ 59,394	\$ 67,489

See accompanying notes to condensed consolidated financial statements.

5

Table of Contents

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 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 six month periods ended June 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 six month periods ended June 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.

Table of Contents**Reclassifications**

Certain reclassifications have been made to the 2007 condensed consolidated financial statements to conform with the 2008 presentation.

NOTE 2: BALANCE SHEET COMPONENTS**Marketable Securities**

As of June 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 \$25 and \$(497), respectively, as of June 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 have determined that as of June 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:

	June 30, 2008	December 31, 2007
Accounts receivable, gross	\$ 7,280	\$ 6,765
Less: allowance for doubtful accounts	(542)	(542)
Accounts receivable, net	\$ 6,738	\$ 6,223

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

	Six Months Ended June 30,	
	2008	2007
Balance at beginning of period	\$ 542	\$ 200
Provision		483
Recoveries		(41)
Balance at end of period	\$ 542	\$ 642

Table of Contents**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:

	June 30, 2008	December 31, 2007
Finished goods	\$ 6,559	\$ 12,733
Work-in-process	5,238	4,482
	11,797	17,215
Less: reserve for slow-moving and obsolete items	(5,526)	(5,950)
Inventory, net	\$ 6,271	\$ 11,265

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

	Six Months Ended June 30,	
	2008	2007
Balance at beginning of period	\$ 5,950	\$ 5,950
Provision	1,315	2,008
Usage:		
Sales	(655)	(586)
Scrap	(1,084)	(1,545)
Total usage	(1,739)	(2,131)
Balance at end of period	\$ 5,526	\$ 5,827

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 June 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.

Property and Equipment, Net

Property and equipment, net consists of the following:

	June 30, 2008	December 31, 2007
Gross carrying amount	\$ 19,056	\$ 17,109
Less: accumulated depreciation and amortization	(13,309)	(10,961)
Property and equipment, net	\$ 5,747	\$ 6,148

Table of Contents**Acquired Intangible Assets, Net**

Acquired intangible assets, net consists of the following:

	June 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	(14,374)	(12,964)
Customer relationships	(1,689)	(1,525)
	(16,063)	(14,489)
Acquired intangible assets, net	\$ 4,796	\$ 6,370

Estimated future amortization of acquired developed technology is as follows:

Six Months Ending December 31:		
2008		\$ 1,410
Year Ending December 31:		
2009		2,336
2010		1,050
		\$ 4,796

Accrued Liabilities and Current Portion of Long-Term Liabilities

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

	June 30, 2008	December 31, 2007
Accrued payroll and related liabilities	\$ 3,416	\$ 3,366
Current portion of accrued liabilities for asset financings	2,290	4,150
Accrued costs related to restructuring	1,014	2,918
Reserve for warranty returns	726	932
Accrued interest payable	295	405
Accrued commissions and royalties	235	381
Reserve for sales returns and allowances	175	175
Other	1,837	1,521
	\$ 9,988	\$ 13,848

Table of Contents

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

	Six Months Ended June 30,	
	2008	2007
Reserve for warranty returns:		
Balance at beginning of period	\$ 932	\$ 662
Provision	(54)	682
Charge offs	(152)	(502)
Balance at end of period	\$ 726	\$ 842
Reserve for sales returns and allowances:		
Balance at beginning of period	\$ 175	\$ 479
Provision	14	18
Charge offs	(14)	(322)
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 January 2008, we commenced a modified dutch auction tender offer under which we offered to purchase, for cash, up to \$50,000 aggregate principal amount of the debentures at a price not greater than \$0.75 nor less than \$0.68 per \$1 principal amount. The tender offer expired on February 28, 2008 and we repurchased \$50,248 principal amount of the debentures, which included \$248 that we purchased without extending the tender offer in accordance with applicable securities laws. The purchase price was \$0.74 per \$1. We recognized a net gain of \$11,557 on the repurchase, which included the \$13,064 discount, offset by legal and professional fees of \$755 and a write-off of debt issuance costs of \$752.

The remaining \$89,752 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 1,228,489 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 equal to 98% of the if-converted value of the debentures for five consecutive trading days, (c) a call for redemption occurs, or (d) in the event of certain other specified corporate transactions.

We may redeem some or all of the debentures for cash on or after May 15, 2011 at a price equal to 100% of the principal amount of the debentures plus accrued and unpaid interest. The holders of the debentures have the right to require us to purchase all or a portion of the \$89,752 debentures outstanding at each of the following dates: May 15, 2011, May 15, 2014, and May 15, 2019, at a purchase price equal to 100% of the principal amount plus accrued and unpaid interest. The debentures are unsecured obligations and are subordinated in right of payment to all our existing and future senior debt.

Table of Contents

Shareholders Equity (Deficit)

Reverse Stock Split

On June 4, 2008, we effected a one-for-three reverse split of our common stock. The exercise price and number of shares of common stock issuable under our stock incentive plans, as well as the conversion price and number of shares issuable upon conversion of our long-term debt were proportionately adjusted to reflect the reverse stock split. Basic and diluted weighted average shares outstanding and earnings per share have been calculated to reflect the reverse stock split in all periods presented.

Share Repurchase Program

On September 25, 2007, we announced a share repurchase program under which the Board of Directors authorized the repurchase of up to \$10,000 of our common stock over the next twelve months. The program does not obligate us to acquire any particular amount of common stock and may be modified or suspended at any time at our discretion.

Share repurchases under the program may be made through open market and privately negotiated transactions at our discretion, subject to market conditions and other factors. During 2007, we repurchased 1,260,833 common shares at a cost of \$4,269. During the first half of 2008, we repurchased 607,737 shares for \$1,371. As of June 30, 2008, \$4,360 remained available for repurchase under the plan. The above numbers reflect the June 4, 2008 one-for-three reverse stock split of our common stock.

NOTE 3: FAIR VALUE MEASUREMENT

On January 1, 2008, we adopted FASB Statement of Financial Accounting Standard No. (SFAS) 157, *Fair Value Measurement* (SFAS 157) for our financial assets and liabilities. SFAS 157 defines fair value and describes three levels of inputs that may be used to measure fair value: