

SOUTHWALL TECHNOLOGIES INC /DE/
Form 10-Q
August 12, 2011

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, 2011
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: 0-15930

SOUTHWALL TECHNOLOGIES INC.
(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of incorporation or organization)

94-2551470
(I.R.S. Employer Identification Number)

3788 Fabian Way, Palo Alto, California
(Address of principal executive offices)

94303
(Zip Code)

Registrant's telephone number, including area code: (650) 798-1200

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 (§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, or a non-accelerated filer. 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 | Smaller reporting company |
| <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | <input checked="" type="checkbox"/> |

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

As of July 29, 2011, there were 5,811,868 shares of the registrant's Common Stock outstanding.

SOUTHWALL TECHNOLOGIES INC.

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PART I. FINANCIAL INFORMATION

Item 1--Financial Statements:

SOUTHWALL TECHNOLOGIES INC.
 UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS
 (in thousands, except per share data)

| | June 30, 2011 | December 31, 2010 |
|--|------------------|----------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$13,400 | \$ 13,776 |
| Accounts receivable, net of allowances for sales returns and doubtful accounts of \$1,356 at June 30, 2011 and \$1,316 at December 31, 2010 | 7,450 | 5,902 |
| Inventories | 6,904 | 5,536 |
| Prepaid income taxes | - | 2,017 |
| Other current assets | 4,454 | 1,901 |
| Total current assets | 32,208 | 29,132 |
| Property, plant and equipment, net | | |
| Goodwill | 15,279 | 15,235 |
| Intangibles assets | 366 | 1,854 |
| Deferred tax and other assets | 357 | 901 |
| Total assets | 3,545 | 3,468 |
| | \$51,755 | \$ 50,590 |
| LIABILITIES, PREFERRED STOCK AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Current portion of long-term debt and capital lease obligations | \$1,048 | \$ 1,024 |
| Accounts payable | 2,414 | 2,628 |
| Accrued compensation | 1,337 | 1,742 |
| Other accrued liabilities | 4,795 | 4,764 |
| Total current liabilities | 9,594 | 10,158 |
| Term debt and capital lease obligations | 3,213 | 3,511 |
| Other long-term liabilities | 122 | 112 |
| Total liabilities | 12,929 | 13,781 |
| Commitments and contingencies (Note 7) | | |
| Series A 10% cumulative convertible preferred stock, \$0.001 par value; \$1.00 stated value; 5,000 shares authorized, 4,893 shares outstanding at June 30, 2011 and December 31, 2010 (liquidation preference: \$7,989 and \$7,745 at June 30, 2011 and December 31, 2010, respectively) | 4,810 | 4,810 |
| Southwall stockholders' equity: | | |
| Common stock, \$0.001 par value per share; 10,000 shares authorized, 5,811 shares outstanding at June 30, 2011 and 5,799 shares outstanding at December 31, 2010 | 29 | 29 |

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| | | |
|---|-----------|-----------|
| Capital in excess of par value | 78,791 | 78,759 |
| Accumulated other comprehensive income | 4,440 | 3,466 |
| Accumulated deficit | (49,244) | (50,228) |
| Total Southwall stockholders' equity | 34,016 | 32,026 |
| Noncontrolling interest | - | (27) |
| Total stockholders' equity | 34,016 | 31,999 |
| Total liabilities, preferred stock and stockholders' equity | \$51,755 | \$ 50,590 |

See accompanying notes to unaudited condensed consolidated financial statements.

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SOUTHWALL TECHNOLOGIES INC.
 UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
 (in thousands, except per share data)

| | Three Months Ended | | Six Months Ended | |
|--|--------------------|------------------|------------------|------------------|
| | June 30, 2011 | June 30, 2010 | June 30, 2011 | June 30, 2010 |
| Net revenues | \$13,534 | \$11,790 | \$28,065 | \$22,271 |
| Cost of revenues | 7,763 | 5,891 | 16,167 | 11,659 |
| Gross profit | 5,771 | 5,899 | 11,898 | 10,612 |
| Operating expenses: | | | | |
| Research and development | 1,113 | 792 | 2,147 | 1,584 |
| Selling, general and administrative | 2,938 | 2,266 | 5,877 | 4,266 |
| Goodwill and intangible assets impairment | 1,833 | - | 1,833 | - |
| Total operating expenses | 5,884 | 3,058 | 9,857 | 5,850 |
| Income (loss) from operations | (113) | 2,841 | 2,041 | 4,762 |
| Interest expense, net | (65) | (64) | (131) | (159) |
| Other income (expense), net | 64 | 123 | 336 | (358) |
| Income (loss) before provision for (benefit from) income taxes | (114) | 2,900 | 2,246 | 4,245 |
| Provision for (benefit from) income taxes | 531 | (107) | 1,481 | (99) |
| Net income (loss) | (645) | 3,007 | 765 | 4,344 |
| Net loss attributable to noncontrolling interest | 58 | 30 | 219 | 30 |
| Net income (loss) attributable to Southwall | (587) | 3,037 | 984 | 4,374 |
| Deemed dividend on preferred stock | 122 | 122 | 244 | 244 |
| Net income attributable to common stockholders | \$(709) | \$2,915 | \$740 | \$4,130 |
| Net income (loss) per common share (1): | | | | |
| Basic | \$(0.12) | \$0.51 | \$0.13 | \$0.72 |
| Diluted | \$(0.12) | \$0.42 | \$0.14 | \$0.61 |
| Weighted average shares used in computing per share amounts (1): | | | | |
| Basic | 5,811 | 5,766 | 5,809 | 5,762 |
| Diluted | 5,811 | 7,215 | 7,204 | 7,198 |

(1) All share and per share amounts have been retroactively restated for the three and six months ended June 30, 2010 to reflect the Company's 1-for-5 reverse stock split described in Note 1 to these condensed consolidated financial statements.

See accompanying notes to unaudited condensed consolidated financial statements.

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SOUTHWALL TECHNOLOGIES INC.
 UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
 (in thousands)

| | Six Months Ended | |
|---|------------------|------------------|
| | June 30, 2011 | June 30, 2010 |
| Cash flows from operating activities: | | |
| Net income | \$765 | \$4,344 |
| Adjustments to reconcile net income to net cash (used in) provided by operating activities: | | |
| Gain on acquisition of controlling interest in SIG | - | (706) |
| Deferred income tax | (11) | (12) |
| Loss on disposal of property, plant and equipment | 38 | 2 |
| Depreciation and amortization | 1,749 | 1,227 |
| Goodwill and intangible assets impairment | 1,833 | - |
| Stock-based compensation | 452 | 265 |
| (Provision for) inventory reserves | (88) | (279) |
| Recovery of returns and allowance resesrve | 40 | 206 |
| Non-cash effect of acquisition of controlling interest in SIG | - | (232) |
| Changes in operating assets and liabilities: | | |
| Accounts receivable, net | (1,307) | (1,244) |
| Inventories, net | (1,000) | 891 |
| Other current and non-current assets | (504) | (451) |
| Accounts payable and accrued liabilities | (864) | (2,416) |
| Net cash provided by operating activities | 1,103 | 1,595 |
| Cash flows from investing activities: | | |
| Acquisition of controlling interest in SIG, net of cash acquired | - | (195) |
| Expenditures for property, plant and equipment | (866) | (455) |
| Net cash used in investing activities | (866) | (650) |
| Cash flows from financing activities: | | |
| Proceeds from stock option exercises | 71 | 39 |
| Repayments of term debt and capital lease obligations | (521) | (448) |
| Proceeds from investment credit | 9 | - |
| Net cash used in financing activities | (441) | (409) |
| Effect of foreign exchange rate changes on cash and cash equivalents | (172) | 140 |
| Net increase (decrease) in cash and cash equivalents | (376) | 676 |
| Cash and cash equivalents, beginning of period | 13,776 | 12,454 |
| Cash and cash equivalents, end of period | \$13,400 | \$13,130 |
| Supplemental cash flow disclosures: | | |
| Interest paid | \$156 | \$154 |
| Income taxes paid | \$564 | \$230 |

Supplemental schedule of non-cash investing and financing activities:

| | | |
|--|-------|-------|
| Dividends accrued | \$244 | \$244 |
| Deposits applied to acquisition of property, plant and equipment | \$86 | \$- |
| Acquisition of interest in SIG (Note 12) | \$246 | \$232 |

See accompanying notes to unaudited condensed consolidated financial statements.

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SOUTHWALL TECHNOLOGIES INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(dollar and share amounts in thousands, except per share data)

Note 1 – Basis of Presentation

Southwall Technologies Inc., including its wholly owned subsidiaries, Southwall Europe GmbH, Southwall IG Holdings, Inc., Southwall Insulating Glass, LLC (“SIG”) and Crown Operations International, LLC, are hereafter referred to as the “Company,” “Southwall,” “Registrant,” “We,” “Our” or “Us.”

The accompanying interim condensed consolidated financial statements of Southwall are unaudited and have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, certain information and footnote disclosure normally included in financial statements prepared in accordance with GAAP have been condensed or omitted. In the opinion of management, the unaudited condensed consolidated financial statements reflect all adjustments considered necessary to present fairly the financial position, results of operations and cash flows of Southwall for all periods presented. The year-end consolidated balance sheet data was derived from audited financial statements, but does not include all disclosures required by GAAP. The Company suggests that these condensed consolidated financial statements be read in conjunction with the consolidated financial statements and notes thereto contained in the Company's Form 10-K for the year ended December 31, 2010 filed with the Securities and Exchange Commission on March 29, 2011. The results of operations for the interim periods presented are not necessarily indicative of the operating results to be expected for any future periods.

The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions, based on all known facts and circumstances that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the periods. Management makes these estimates using the best information available at the time of the estimates. The estimates included in preparing our financial statements include: allowance for doubtful accounts and sales returns, quarterly income taxes, inventory valuations (including reserves for excess and obsolete and impaired inventories), reserves for decommissioning costs associated with leasehold asset retirement obligations, impairment of goodwill and other long-lived assets and the valuation of stock-based compensation. Actual results could differ from those estimates.

Reverse Stock Split

On March 17, 2011, the Company completed a 1-for-5 reverse stock split of its common stock, pursuant to previously obtained stockholder approval on May 12, 2010. The reverse stock split reduced the number of shares of the Company's common stock issued and outstanding from approximately 28.8 million to approximately 5.8 million. In connection with the reverse stock split, the Company also reduced the number of our authorized shares of common stock from 50 million to 10 million to reflect the reverse stock split ratio. All share and per share amounts for the three and six months ended June 30, 2010 herein are presented on a post-reverse stock split basis.

Reclassifications

Certain reclassifications have been made to the prior year's condensed consolidated balance sheet and condensed consolidated statement of cash flows to conform to the current year presentation.

Note 2 – Recent Accounting Pronouncements:

Since December 31, 2010, there are no recently issued accounting standards that are expected to have a material effect on our financial condition, results of operations or cash flows.

Note 3 – Fair Value Measurements

The Company has estimated the fair value amounts of its financial instruments, including cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities using available market information and valuation methodologies considered to be appropriate and has determined that the book value of those instruments at June 30, 2011 approximates fair value.

Based on borrowing rates currently available to the Company for debt and capital lease obligations with similar terms, the carrying value of our term debt and capital lease obligations approximates fair value.

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Southwall invests its cash primarily in money market funds. The Company utilizes the market approach to measure fair value of its financial assets.

Cash and cash equivalents are summarized as follows:

| | June 30, 2011 | | |
|---------------------------------|---------------|------------|----------------------|
| | Fair Value | Book Value | Unrealized Gain, net |
| Money market funds, Level I | \$8,672 | \$8,672 | \$- |
| Certificates of deposit | 1,703 | 1,703 | - |
| Total cash equivalents | 10,375 | 10,375 | - |
| Cash | 3,025 | 3,025 | - |
| Total cash and cash equivalents | \$13,400 | \$13,400 | \$- |

| | December 31, 2010 | | |
|---------------------------------|-------------------|------------|----------------------|
| | Fair Value | Book Value | Unrealized Gain, net |
| Money Market Funds, Level I | \$8,990 | \$8,990 | \$- |
| Certificates of deposit | 2,000 | 2,000 | - |
| Total cash equivalents | 10,990 | 10,990 | - |
| Cash | 2,786 | 2,786 | - |
| Total cash and cash equivalents | \$13,776 | \$13,776 | \$- |

The Company's financial assets and liabilities are valued using market prices on active markets (Level 1). Level 1 instrument valuations are obtained from real-time quotes for transactions in active exchange markets involving identical assets. As of June 30, 2011, the Company did not have any Level 2 instrument valuations which were obtained from readily available pricing sources for comparable instruments or any Level 3 instruments without observable market values that would require a high level of judgment to determine fair value.

Note 4 – Balance Sheet Detail

| | June 30, 2011 | December 31, 2010 |
|---|------------------|----------------------|
| Inventories, net | | |
| Raw materials | \$4,009 | \$ 3,072 |
| Work-in-process | 1,472 | 817 |
| Finished goods | 1,423 | 1,647 |
| | \$6,904 | \$ 5,536 |
| Property, plant and equipment | | |
| Land, buildings and leasehold improvements | \$10,165 | \$ 9,453 |
| Machinery and equipment | 35,749 | 33,099 |
| Furniture and fixtures | 2,979 | 2,769 |
| | 48,893 | 45,321 |
| Less: accumulated depreciation and amortization | (33,614) | (30,086) |
| | \$15,279 | \$ 15,235 |

Note 5 – Net Income (Loss) Per Common Share

Basic net income (loss) per common share is computed by dividing net income (loss) attributable to common stockholders (numerator) by the weighted average number of common shares outstanding (denominator) for the period. Diluted net income (loss) per common share gives effect to all dilutive common shares potentially outstanding during the period, including stock options and convertible preferred stock. The Company excludes options from the computation of diluted weighted average shares outstanding if the exercise price of the options is greater than the average market price of the shares because the inclusion of these options would be anti-dilutive to net income (loss) per share. The Company also excludes preferred shares convertible into common stock from the computation of diluted weighted average shares outstanding when the effect would be anti-dilutive.

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At June 30, 2011 and 2010, 3 and 156 outstanding options, respectively, were excluded from the dilutive net income per common share calculation, as they were anti-dilutive because the option prices were higher than the average market price during each of the six-month periods.

The Company has accrued a deemed dividend on preferred stock of \$122 for each of the three-month periods ended June 30, 2011 and 2010. The dilutive effect of convertible securities shall be reflected in diluted net income (loss) per share by application of the if-converted method. Under this method, if an entity has convertible preferred stock outstanding, the preferred dividends applicable to convertible preferred stock shall be added back to the numerator unless their effect is anti-dilutive.

Tables summarizing net income attributable to common stockholders, basic and diluted net income (loss) per common share, and weighted shares outstanding are shown below:

| | Three Months Ended | | Six Months Ended | |
|---|--------------------|------------------|------------------|------------------|
| | June 30, 2011 | June 30, 2010 | June 30, 2011 | June 30, 2010 |
| Net income (loss) attributable to common stockholders - basic | \$(709) | \$2,915 | \$740 | \$4,130 |
| Add: Deemed dividend on preferred stock | - | 122 | 244 | 244 |
| Net income (loss) attributable to common stockholders - diluted | \$(709) | \$3,037 | \$984 | \$4,374 |
| Weighted average common shares outstanding - basic (1) | 5,811 | 5,766 | 5,809 | 5,762 |
| Dilutive effect of Series A preferred shares | - | 978 | 978 | 978 |
| Dilutive effect of stock options | - | 471 | 417 | 458 |
| Weighted average common shares outstanding - diluted (1) | 5,811 | 7,215 | 7,204 | 7,198 |
| Basic net income (loss) per common share | \$(0.12) | \$0.51 | \$0.13 | \$0.72 |
| Diluted net income (loss) per common share | \$(0.12) | \$0.42 | \$0.14 | \$0.61 |

(1) All share and per share amounts have been retroactively restated for the three and six months ended June 30, 2010 to reflect the Company's 1-for-5 reverse stock split described in Note 1 to these condensed consolidated financial statements.

Note 6 – Segment Reporting

The Company is a developer and manufacturer of high performance films and glass products that improve energy efficiency in architectural and automotive glass applications. Prior to the year ended December 31, 2010, the Company operated only one segment. With the acquisition of the controlling interest in SIG, the Company operates in two segments: film, which is a manufacturer of thin film coatings on flexible substrates, and glass, which is a manufacturer of insulated glass units.

The Chief Operating Decision Maker (CODM) is the Company's President and Chief Executive Officer. The CODM allocates resources to and assesses the performance of each operating segment using information about its revenue and operating income (loss).

The Company does not allocate gains and losses from interest and other income, or taxes to operating segments. Although the CODM uses operating income (loss) to evaluate the segments, operating costs included in one segment may benefit the other segment.

Segment information is summarized as follows:

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| | Three Months Ended | | Six Months Ended | |
|---|--------------------|------------------|------------------|----------------------|
| | June 30, 2011 | June 30, 2010 | June 30, 2011 | June 30, 2010 |
| Net revenues: | | | | |
| Film: | | | | |
| Automotive | \$6,085 | \$5,426 | \$12,239 | \$9,886 |
| Window | 5,460 | 4,614 | 11,630 | 9,310 |
| Architectual | 1,374 | 1,273 | 3,225 | 2,571 |
| Other | 179 | 44 | 352 | 71 |
| Subtotal | 13,098 | 11,357 | 27,446 | 21,838 |
| Glass | 436 | 433 | 619 | 433 |
| Total net revenues | \$13,534 | \$11,790 | \$28,065 | \$22,271 |
| Segment income (loss) from operations: | | | | |
| Film | \$2,552 | \$3,044 | \$5,955 | \$4,965 |
| Glass | (2,665) | (203) | (3,914) | (203) |
| Total segment income (loss) from operations | \$(113) | \$2,841 | \$2,041 | \$4,762 |
| Depreciation and amortization: | | | | |
| Film | \$734 | \$523 | \$1,409 | \$1,124 |
| Glass | 170 | 103 | 340 | 103 |
| Total depreciation and amortization | \$904 | \$626 | \$1,749 | \$1,227 |
| Long-lived assets: | | | | |
| Film | | | June 30, 2011 | December 31, 2010 |
| | | | \$13,680 | \$ 13,896 |
| Glass | | | 1,599 | 1,339 |
| Total long-lived assets | | | \$15,279 | \$ 15,235 |

The following is a summary of net revenues by geographic area (based on the location of the Company's customers) for the three and six months ended June 30, 2011 and 2010:

| | Three Months Ended | | Six Months Ended | |
|----------------------------------|--------------------|------------------|------------------|------------------|
| | June 30, 2011 | June 30, 2010 | June 30, 2011 | June 30, 2010 |
| United States | \$2,120 | \$1,830 | \$3,966 | \$2,723 |
| Europe: France, Germany | 6,279 | 5,252 | 12,501 | 9,610 |
| Asia Pacific: Japan, Pacific Rim | 4,765 | 4,298 | 10,793 | 8,890 |
| Rest of the world | 370 | 410 | 805 | 1,048 |
| Total net revenues | \$13,534 | \$11,790 | \$28,065 | \$22,271 |

The Company operates from facilities located in the United States and Germany. Long-lived assets were as follows:

| | June 30, 2011 | December 31, 2010 |
|---------------|------------------|----------------------|
| United States | \$4,809 | \$ 4,724 |
| Germany | 10,470 | 10,511 |
| Consolidated | \$15,279 | \$ 15,235 |

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Note 7 – Commitments and Contingencies

Commitments

The Company leases certain property and equipment as well as its facilities under noncancellable operating leases. These leases expire at various dates through 2016.

In January 2006, the Company renewed a lease agreement for its research and development facility in Palo Alto, California. The lease was renewed in January 2011 for an additional twelve months. Under this lease agreement, the Company had accrued \$480 for leasehold retirement obligations, which is included in other accrued liabilities in the accompanying condensed consolidated balance sheets. The method and timing of payments are not yet finalized, and therefore, this estimate of the Company's liability could differ from the actual future settlement amount.

As of June 30, 2011, the Company had unconditional purchase obligations to procure manufacturing raw material of \$2,258 and equipment of \$2,986.

Credit Agreement with Wells Fargo Bank

In June 2011, the Company renewed its Credit Agreement with Wells Fargo Bank ("Bank"). The Credit Agreement provides for a \$3,000 revolving line of credit. Advances under the line exceeding \$1,500 will be limited to 80% of eligible accounts receivable. The Company will not be eligible for additional borrowings if the Company's consolidated cash balance falls below \$3,500. Amounts borrowed under the line of credit bear interest at either prime plus 0.75% or LIBOR plus 3.5%, determined at the discretion of the Company, and is annualized on the average daily financed amount outstanding. All borrowings under the line of credit facility are collateralized by the Company's assets in the United States and are subject to certain covenants including minimum quarterly net income and minimum liquid asset requirements. The line of credit facility matures in June 2012.

In August 2010, the Company's Credit Agreement with the Bank was amended to provide for a \$1,250 term loan, which was funded on September 2, 2010. Amounts borrowed under the term loan are payable over 36 months in equal installments and bear interest at a fixed rate of 4.05%. The Credit Agreement was further amended to provide covenants for tangible net worth and fixed charge coverage ratio.

The Company has classified \$481 and \$695 outstanding under the Bank term loan and capital lease as a short-term liability and long-term liability, respectively, at June 30, 2011. The Company is obligated to pay an aggregate of \$417 in principal under its Wells Fargo term loan in 2011.

On December 27, 2010, the Company entered into a lease agreement with the Bank to finance research and development equipment. The lease term is 48 months and requires monthly payments. As of June 30, 2011, the principal balance of this lease was \$238.

We were not in compliance with the minimum net income covenant under the Credit Agreement and capital lease with the Bank as of June 30, 2011. On August 4, 2011, the Company obtained a waiver of noncompliance from the Bank as of June 30, 2011.

Term Debt and Capital Lease Obligations

As of June 30, 2011, the Company's term debt and capital lease obligations consisted of the following:

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| Description | Rate | | Term Debt Balance at June 30, 2011 | Capital Lease Balance at June 30, 2011 | Total Debt Balance at June 30, 2011 | Due In Next 12 Months | Balance at December 31, 2010 |
|---|-------|------|---|--|--|-----------------------------|---------------------------------------|
| German bank loan dated May 28, 1999 (20 year) | 5.73 | %(1) | \$ 2,878 | \$ - | \$ 2,878 | \$ 360 | \$ 2,816 |
| Wells Fargo Bank dated September 2, 2010 (3 year) | 4.05 | %(2) | 938 | - | 938 | 417 | 1,146 |
| Total term debt | | | 3,816 | - | 3,816 | 777 | 3,962 |
| German bank financed lease dated June 1, 2008 | 7.518 | %(3) | - | 78 | 78 | 78 | 115 |
| U.S. financing agreement dated May 20, 2008 | 19.80 | %(4) | - | 147 | 147 | 147 | 224 |
| Wells Fargo Bank financing agreement dated December 27, 2010 | 4.47 | %(4) | - | 257 | 257 | 73 | 296 |
| Total capital leases | | | - | 482 | 482 | 298 | 635 |
| Less interest on capital leases | | | - | 37 | 37 | 27 | 62 |
| Total term debt and capital lease obligations | | | 3,816 | 445 | 4,261 | 1,048 | 4,535 |
| Less current portion | | | 777 | 271 | 1,048 | - | 1,024 |
| Total term debt and capital lease obligations, non-current | | | \$ 3,039 | \$ 174 | \$ 3,213 | \$ 1,048 | \$ 3,511 |

(1) Interest rate was reset on September 16, 2009 to 5.73%.

(2) Interest rate is fixed at 4.05%.

(3) Interest rate is fixed at 7.518% until payoff.

(4) Implied interest rate based on a lease rate factor.

Contingencies

The Company is involved in certain other legal actions arising in the ordinary course of business. The Company believes, however, that none of these actions, either individually or in the aggregate, will have a material adverse effect on its business, its consolidated financial position, results of operations or cash flows.

Note 8 – Stock-Based Compensation

The Company has a stock-based compensation program that provides its Board of Directors broad discretion in creating employee equity incentives. The Company has granted stock options under various option plans and agreements in the past and currently grants stock options under the 2007 Long Term Incentive Plan (“2007 Plan”), which authorizes the granting of up to 10,000 shares of common stock. Under the terms of the 2007 Plan, the Company can grant both Incentive Stock Options and Nonstatutory Stock Options. Grants issued under the 2007 Plan vest and become exercisable at a rate of 25% on each anniversary of the date of grant and become fully vested on the fourth anniversary of the date of grant provided that the participant remains an employee or service provider of the Company or a related company. Each option granted under the 2007 Plan is non-transferable and expires over terms not exceeding ten years from the date of grant or 30 days after an option holder’s voluntary termination from the Company. If an option holder’s employment is terminated involuntarily for misconduct, the option will terminate immediately and may no longer be exercised. Involuntary termination not for misconduct allows for the option holder to exercise options within a period of three months after such termination of service occurs. The 2007 Plan provides for longer expiration periods for employees who terminate, but who were employed with the Company in excess of five years. Pursuant to the provisions set forth in the 2007 Plan, the option expiration will be extended anywhere from three months to one year, dependent upon the employee’s years of service. These provisions apply to options that expire as the result of involuntary termination not for misconduct. As of June 30, 2011, there were 1,066 shares of common stock available for grant under the 2007 Plan.

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The following table sets forth the total stock-based compensation for the periods indicated:

| | Three Months Ended | | Six Months Ended | |
|--|--------------------|------------------|------------------|------------------|
| | June 30, 2011 | June 30, 2010 | June 30, 2011 | June 30, 2010 |
| Cost of revenues | \$6 | \$4 | \$10 | \$6 |
| Research and development | 45 | 26 | 78 | 45 |
| Selling, general and administrative | 200 | 123 | 363 | 214 |
| Stock-based compensation expense before income taxes | 251 | 153 | 451 | 265 |
| Income tax benefit | - | - | - | - |
| Total | \$251 | \$153 | \$451 | \$265 |

There were \$0 and \$20 of cash proceeds from the exercise of stock options for the three months ended June 30, 2011 and 2010, respectively. The Company presents excess tax benefits from the exercise of stock options, if any, as financing cash flows.

The fair value of stock-based awards was estimated using the Black-Scholes model with the following weighted-average assumptions for stock options granted during the three and six months ended June 30, 2011 and 2010:

| | Three Months Ended | | Six Months Ended | |
|---|--------------------|------------------|------------------|------------------|
| | June 30, 2011 | June 30, 2010 | June 30, 2011 | June 30, 2010 |
| Expected life (in years) | 5.0 | - | 5.0 | 5.0 |
| Risk-free interest rate | 1.67 % | - % | 2.16 % | 2.62 % |
| Volatility | 121 % | - % | 122 % | 104 % |
| Dividend | - | - | - | - |
| Per share weighted average fair value at grant date (1) | \$10.19 | \$- | \$9.28 | \$6.11 |

(1)The amount for the three and six months ended June 30, 2010 has been restated to reflect the Company's 1-for-5 reverse stock split described in Note 1 to these condensed consolidated financial statements.

The Company's computation of expected volatility was based on historical volatility. The Company's computation of expected life was based on historical exercise patterns. The interest rate for periods within the expected life of the award is based on the U.S. Treasury yield in effect at the time of grant.

The Company has not in the past and does not plan to issue dividends in the future.

Stock option activity for the six months ended June 30, 2011 was as follows:

| | Number of Options | Weighted Average Exercise Price | Remaining Contractual Weighted Average Term (in years) | Aggregate Intrinsic Value |
|----------------------------------|----------------------|--|---|---------------------------------|
| Outstanding at December 31, 2010 | 1,287 | \$4.49 | | |
| Granted | 252 | \$11.07 | | |
| Exercised | (13) | \$5.24 | | |

| | | | | | |
|--|-------|---|--------|------|----------|
| Cancelled or expired | (24 |) | \$8.88 | | |
| Outstanding at June 30, 2011 | 1,502 | | \$5.52 | 6.78 | \$10,593 |
| Vested and expected to vest at June 30, 2011 | 1,342 | | \$5.17 | 6.52 | \$9,929 |
| Exercisable at June 30, 2011 | 910 | | \$3.85 | 5.47 | \$7,931 |

The aggregate intrinsic value in the table above represents the total pretax intrinsic value (the difference between Southwall's closing stock price on the last trading day of its second quarter of fiscal 2011 and the exercise price, times the number of shares) that would have been received by the option holders had all option holders exercised their options on June 30, 2011. This amount changes based on the fair market value of Southwall's stock. Total intrinsic value of options exercised was \$86 for the six months ended June 30, 2011. There were no options exercised during the three months ended June 30, 2011.

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As of June 30, 2011, \$2,299 of total unrecognized compensation cost, net of forfeitures, related to stock options was expected to be recognized over a weighted-average period of approximately 3.16 years.

Note 9 – Allowance for Sales Returns

The Company establishes an allowance for sales returns for specifically identified, as well as anticipated sales returns, based on experience. The activity in the allowance for sales returns account during the six months ended June 30, 2011 and 2010 was as follows:

| | Balance at December 31, 2010 | Provision | Utilized | Balance at June 30, 2011 |
|-----------------------------|------------------------------------|-----------|----------|--------------------------------|
| Allowance for Sales Returns | \$ 1,187 | \$351 | \$(252) | \$1,286 |

| | Balance at December 31, 2009 | Provision | Utilized | Balance at June 30, 2010 |
|-----------------------------|------------------------------------|-----------|----------|--------------------------------|
| Allowance for Sales Returns | \$ 607 | \$656 | \$(349) | \$914 |

These amounts are included in accounts receivable, net, in the condensed consolidated balance sheets.

Note 10 – Comprehensive Income (Loss)

The components of comprehensive income (loss) for the three and six months ended June 30, 2011 and 2010, respectively, were as follows:

| | Three Months Ended | | Six Months Ended | |
|---|--------------------|------------------|------------------|------------------|
| | June 30, 2011 | June 30, 2010 | June 30, 2011 | June 30, 2010 |
| Net income (loss) | \$(645) | \$3,007 | \$765 | \$4,344 |
| Foreign currency translation adjustment | 266 | (982) | 974 | (1,707) |
| Other comprehensive income (loss) | \$(379) | \$2,025 | \$1,739 | \$2,637 |

Note 11 – Income Tax

The Company recorded an income tax provision of \$531 and \$1,481 for the three and six months ended June 30, 2011, respectively, and a benefit from income taxes of \$107 and \$99 for the three and six months ended June 30, 2010, respectively. The effective tax rate was 65.9 % for six months ended June 30, 2011 and (2.3) % for the six months ended June 30, 2010. The primary reason for the change in the effective tax rates for the three and six months ended June 30, 2011, compared to the three and six months ended June 30, 2010, is due to an impairment charge for goodwill and the impact of the valuation allowance during 2010. The Company's effective tax rate differs from the statutory rate due to various factors, such as tax legislation, the mix of domestic and international pre-tax income, research and development credits, foreign tax credits, share-based compensations and change in valuation allowance.

The impact of an uncertain income tax position on the income tax return must be recognized at the largest amount that is more likely than not to be sustained upon audit by the relevant tax authority. An uncertain income tax position will not be recognized if it has less than a 50% likelihood of being sustained. As of June 30, 2011, the Company identified and recorded unrecognized tax benefits in the amount of approximately \$394, but no interest and penalties have been recorded due to the immaterial impact to the financial statements. Management does not expect material changes in

the balance of unrecognized tax benefits will occur within the next twelve months.

Note 12 – Acquisitions

Controlling Interest in Joint Venture

In 2008, Southwall IG Holdings, Inc., a wholly owned subsidiary of Southwall Technologies Inc., entered into a Joint Venture Agreement with Sound Solutions Window & Doors, LLC (“Sound Solutions”), creating SIG, which manufactures insulated glass units for the domestic market, to further expand the market for the Company’s Heat Mirror product. As of December 31, 2009, Southwall IG Holdings, Inc. had a 50% investment in SIG. In 2009, Southwall IG Holdings, Inc. advanced a total of \$300 in the form of a promissory note to Sound Solutions. Pursuant to the terms of the promissory note dated May 11, 2009, the principal and accrued interest was due and payable to Southwall IG Holdings, Inc. by January 1, 2010. Under terms of the note, in the event of default, the outstanding principal was to be paid in the form of a credit to the Southwall IG Holdings, Inc. capital account.

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Effective January 1, 2010, Sound Solutions had not paid the principal balance of \$300 and was in default of the promissory note. The \$300, for which Sound Solutions had received equity consideration in SIG, was credited to Southwall IG Holdings, Inc.'s capital account in SIG, thereby increasing the Company's equity ownership to 66.3%. This change in equity did not result in Southwall IG Holdings, Inc. acquiring a controlling interest in SIG, as governance did not change as a result of the equity event. For the three months and six months ended June 30, 2010, SIG was accounted for under the equity method of accounting and the Company's share of SIG's net losses of \$108 and \$333, respectively, were included in "other income (expense), net" in the condensed consolidated statements of operations.

On May 20, 2010, the Joint Venture Agreement was amended allowing Southwall IG Holding, Inc. to make additional cash contributions to the joint venture. In order to acquire an additional 8.7% to obtain 75% equity ownership, the Company relinquished \$256 of value allowing Sound Solutions to maintain a 25% equity interest in SIG. This transaction triggered a business combination event, which resulted in the consolidation of total assets and liabilities of SIG. Subsequently in 2010, the Company increased its equity ownership in SIG to 80%. During the six months ended June 30, 2011, the Company increased its equity ownership in SIG to 100%.

The unaudited pro forma net revenues for the three months and six months ended June 30, 2010 were \$12,194 and \$23,288, respectively, and net income attributable to Southwall for the three and six months ended June 30, 2010 were \$2,148 and \$3,448, respectively.

Crown Operations International

On August 30, 2010, Crown International Acquisition Company, LLC, a wholly owned subsidiary of Southwall Technologies Inc., acquired the operating assets of Crown Operations International, Ltd. ("Crown Operations"), for \$3,302 in cash. Subsequent to the acquisition of Crown Operations, Crown International Acquisition Company, LLC changed its name to Crown Operations International, LLC ("COI"). Crown Operations is an interlayer converting and laminating facility. The unaudited pro forma net revenues for the three and six months ended June 30, 2010 were \$12,003 and \$22,682, respectively, and net income for the three and six months ended June 30, 2010 were \$3,238 and \$4,835, respectively.

Note 13 – Goodwill and Intangible Assets

Goodwill

The Company reviews goodwill for impairment annually as of December 31 and whenever events or changes in circumstances indicate the carrying value of an asset may not be recoverable in accordance with authoritative guidance. The circumstances that could trigger a goodwill impairment could include, but are not limited to, the following items to the extent that management believes the occurrence of one or more would make it more likely than not that we would fail the first step of the goodwill impairment test: significant adverse change in legal factors or in the business climate, an adverse action or assessment by a regulator, unanticipated competition, a loss of key personnel, a more-likely-than-not expectation that a reporting unit or a significant portion will be sold or otherwise disposed of, a portion of a reporting unit's goodwill has been included in the carrying amounts of a business that will be disposed or if our market capitalization is below our net book value.

During the three month period ending June 30, 2011, the Company altered its business strategy to no longer support the Glass Segment's standard IGU product and reevaluated its ability to gain market share during the technology development stage. As a result, the Company determined that the goodwill related to the Glass Segment was impaired and recorded a one-time impairment charge of \$1,488, which represents one hundred percent of the goodwill related to the Glass Segment.

Goodwill impairment testing is a two-step process. Step 1 involves comparing the fair value of the Company's reporting units to their carrying amount. If the fair value of the reporting unit is greater than the carrying amount, there is no impairment. If the reporting unit's carrying amount is greater than the fair value, the second step must be completed to measure the amount of the impairment, if any. Step 2 calculates the implied fair value of goodwill by deducting the fair value of all tangible and intangible assets, excluding goodwill, of the reporting unit from the fair value of the reporting unit as determined in Step 1. The implied fair value of goodwill determined in this step is compared to the carrying value of goodwill. If the implied fair value of goodwill is less than the carrying value of goodwill, an impairment loss is recognized equal to the difference. The result of the Company's analysis indicated that there would be no remaining implied value attributable to the goodwill in the Glass Segment.

The Company's carrying value of goodwill at June 30, 2011 was \$366 as a result of the Company's acquisition of Crown International Operations.

Intangible Assets

Intangible assets are reviewed for impairment whenever events or circumstances indicate that the carrying amount of an asset or asset group may not be recoverable. During the three month period ending June 30, 2011, the Company determined that the goodwill of the Glass Segment was impaired. In conjunction with the valuation study for Step 2 of goodwill impairment testing, a valuation analysis of the Glass Segment's long-lived assets was also performed. Based on this analysis, the Company determined that the intangible assets of the Glass Segment were impaired and recorded an impairment charge of \$344.

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Intangible assets as of June 30, 2011 and December 31, 2010 consisted of the following:

| | Range of Lives | Gross Assets | June 30, 2011 | | December 31, 2010 | | |
|------------------------|----------------|--------------|--------------------------|-------|-------------------|--------------------------|-------|
| | | | Accumulated Amortization | Net | Gross Assets | Accumulated Amortization | Net |
| Trade name | 5 | \$15 | \$ (2) | \$13 | \$315 | \$ (38) | \$277 |
| Customer relationships | 2 - 10 | 170 | (14) | 156 | 420 | (82) | 338 |
| Trade secrets | 15 | 190 | (11) | 179 | 190 | (4) | 186 |
| Non-compete agreement | 2 | 15 | (6) | 9 | 15 | (3) | 12 |
| Other | 2- 5 | - | - | - | 100 | (12) | 88 |
| | | \$390 | \$ (33) | \$357 | \$1,040 | \$ (139) | \$901 |

Amortization expense for the three months ended June 30, 2011 and 2010 for intangible assets was \$61 and \$18, respectively. Amortization expense for the six months ended June 30, 2011 and 2010 for intangible assets was \$122 and \$18, respectively.

The following table represents the estimated future amortization expense of intangible assets as of June 30, 2011:

| Fiscal year | Amount |
|---------------------------|--------|
| 2011 (6 months remaining) | \$20 |
| 2012 | 38 |
| 2013 | 33 |
| 2014 | 33 |
| 2015 | 32 |
| Thereafter | 201 |
| Total | \$357 |

Note 14 – Total Equity

A summary of the changes in equity for the three and six months ended June 30, 2011 is as follows:

| | Six Months Ended June 30, 2011 | | |
|--|--------------------------------|-------------------------|--------------|
| | Southwall Stockholders' Equity | Noncontrolling Interest | Total Equity |
| Balance at December 31, 2010 | \$32,026 | \$ (27) | \$31,999 |
| Fair market value NCI of SIG | (246) | 246 | - |
| Stock-based compensation expense | 451 | - | 451 |
| Stock option exercises | 71 | - | 71 |
| Dividend accrual on Series A preferred stock | | | |
| preferred stock | (244) | - | (244) |
| Total comprehensive income (loss) | 1,958 | (219) | 1,739 |
| Balance at June 30, 2011 | \$34,016 | \$ - | \$34,016 |

Note 15 – Related Party

As discussed in Note 12, Southwall IG Holdings, Inc., a wholly-owned subsidiary of Southwall Technologies Inc., obtained a 75% equity ownership in the joint venture with Sound Solutions in 2010, which resulted in the consolidation by the Company of assets and liabilities of SIG in May 2010. The Company's accounts receivable balance due from Sound Solutions was \$552 and \$650 at June 30, 2011 and December 31, 2010, respectively. The amount owed by the Company to Sound Solutions was \$3 at June 30, 2011 and December 31, 2010. Net revenues from Sound Solutions were \$0 and \$280 for the three and six months ended June 30, 2011, respectively.

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Item 2 – Management's Discussion and Analysis of Financial Condition and Results of Operations (in thousands):

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 notes thereto appearing elsewhere in this report. This discussion and analysis contains forward-looking statements that involve risks and uncertainties, including those discussed below under "Forward-Looking Statements" and "Risk Factors", set forth in Part I, Item 1A, of our Annual Report on Form 10-K for the year ended December 31, 2010 and in Part II, Item 1A of our Quarterly Report on Form 10-Q for the quarter ended June 30, 2011. You should not place undue reliance on these forward-looking statements. Actual results may differ materially from those anticipated in the forward-looking statements. These forward-looking statements represent our judgment as of the date of the filing of this Form 10-Q.

Forward Looking Statements

Cautionary Statement For the Purpose of the "Safe Harbor" Provisions of the Private Securities Litigation Reform Act of 1995

As used in this report, the terms "we," "us," "our," "Southwall" and the "Company" mean Southwall Technologies Inc. and its subsidiaries, unless the context indicates another meaning. This report contains forward-looking statements as that term is defined in the Private Securities Litigation Reform Act of 1995 that are subject to a number of risks and uncertainties. All statements other than statements of historical facts are forward-looking statements. These statements are identified by terminology such as "may," "will," "could," "should," "expects," "plans," "intends," "seeks," "anticipates," "believes," "estimates," "potential," or "continue," or the negative of such terms or other comparable terminology, or similar terminology, although not all forward-looking statements contain these identifying words. Forward-looking statements are only predictions and include, without limitation, statements relating to:

- our strategy, expected future operations and financial plans;
- our revenue expectations and potential financial results;
- the revenue expectations and potential financial results of Southwall Insulating Glass, LLC;
 - impact of current economic conditions on our business;
- the continued listing of our common stock on the NASDAQ Capital Market;
 - future applications of thin film coating technologies;
- our development of new technologies and products and integration;
 - the properties and functionality of our products;
- our projected need for additional borrowings and future liquidity;
- our ability to implement and maintain effective internal controls and procedures;
- the size of and the markets into which we sell or intend to sell our products;
- our intentions to pursue strategic alliances, acquisitions and business transactions;
 - the possibility of patent and other intellectual property infringement;
- our opinions regarding energy consumption and the loss of energy through inefficient glass;
 - pending and threatened litigation and its outcome;
- our competition and our ability to compete in the markets we serve; and
 - our projected capital expenditures.

You should not place undue reliance on our forward-looking statements. Actual events or results may differ materially. In evaluating these statements, you should specifically consider various factors, including the risks outlined under "Risk Factors" below. These and other factors may cause our actual results to differ materially from any forward-looking statement. Although we believe the expectations reflected in our forward-looking statements are reasonable as of the date they are being made, we cannot guarantee our future results, levels of activity, performance or achievements. Moreover, we do not assume any responsibility for the future accuracy and completeness of these

forward-looking statements.

XIR®, XUV®, Triangle Design®, Superglass®, Heat Mirror®, California Series®, Solis®, ETCH-A-FLEX®, and Southwall® are registered trademarks of Southwall. V-KOOL® is a registered trademark of Solutia, Inc. All other trade names and trademarks referred to in this Quarterly Report on Form 10-Q are the property of their respective owners.

Overview

Southwall is a developer and manufacturer of high performance films and, beginning in 2008, glass products that improve energy efficiency in architectural and automotive glass applications. Founded in response to the oil embargo of 1973, Southwall has approximately 35 years of experience and commercial adoption of its products worldwide. Our products are designed to assist our green building construction and transportation customers in their efforts to decrease carbon emissions which may reduce the use of oil and electricity in the heating and cooling of buildings and vehicles.

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Our customers were not immune to the global economic downturn of 2009. We believe both the architectural and automotive industries experienced material sales declines, which negatively impacted our financial results in the early part of 2010.

In 2010, we acquired a controlling interest in Southwall Insulating Glass, LLC (“Southwall Insulating Glass” or “SIG”), a joint venture between our wholly-owned subsidiary Southwall IG Holdings Inc. and Sound Solutions Windows & Doors, LLC (“Sound Solutions”). During the six months ended June 30, 2011, the Company increased its equity ownership in SIG to 100%.

As a result of our acquisition of a controlling interest in SIG, we operate in two segments: film, which includes our development and manufacture of thin film coatings on flexible substrates, and glass, which includes the production and sale of glass units through Southwall Insulating Glass.

In August 2010, we purchased substantially all of the assets of Crown Operations International, LTD (“Crown Operations”). Crown Operations is a Wisconsin-based processor of high performance, heat reflective interlayers that improve the energy efficiency of laminated glass in buildings, homes and cars. We expect the acquisition of these assets to provide additional integration and improvement of our production processes enabling us to bring new, energy-saving interlayer products to the market. We also believe that the Crown Operations’ laminating and converting capabilities simplify material logistics and facilitate the adoption of high performance interlayers for volume production. We believe we are now positioned to provide a complete interlayer solution from encapsulation through converting in furtherance of our goal of making it easier for manufacturers to integrate the performance of Southwall's XIR heat-reflective film into their architectural and automotive laminated glass products.

Recent Events

On March 17, 2011, we completed a 1-for-5 reverse stock split of our common stock, pursuant to previously obtained stockholder approval on May 12, 2010. The reverse stock split reduced the number of shares of our common stock issued and outstanding from approximately 28.8 million to approximately 5.8 million. In connection with the reverse stock split, we also reduced the number of our authorized shares of common stock from 50 million to 10 million to reflect the reverse stock split ratio. All share and per share amounts herein are presented on a post-reverse stock split basis.

In 2010, we were awarded a three-year grant of \$1,445 from the U.S. Department of Energy to develop advanced technologies aimed at making homes and buildings more energy efficient. We have used and will continue to use the funding to accelerate development of higher performance and lower cost Heat Mirror low-emissivity and solar-reflective films and multi-cavity, suspended-film insulating glass technology to enable the broad commercialization of "super-insulating" R-10 windows.

During the three month period ending June 30, 2011, the Company altered its business strategy to no longer support the Glass Segment’s standard IGU product and reevaluated its ability to gain market share during the technology development stage. As a result, the Company determined that the goodwill and intangible assets related to the Glass Segment was impaired. As a result, the Company recorded a one-time impairment charge of \$1,833, which represents all of the goodwill and intangible assets related to the Glass Segment.

Demand for our customers' products. We derive significant benefits from our relationships with a few large customers and suppliers. Our revenues and gross profit can increase or decrease rapidly, reflecting underlying demand for the products of one or a small number of our customers. We may also be unable to replace a customer when a relationship ends or demand for our product declines as a result of evolution of our customers' products.

Our three largest customers in the automotive glass and window film market, and architectural glass markets include: Saint Gobain Sekurit, Pilkington PLC, and Solutia Inc., formerly GlobaMatrix Holdings Pte. Ltd., which collectively accounted for approximately 70% and 72% of our total revenues during the six months ended June 30, 2011 and 2010, respectively.

Under our agreement with Solutia Inc., as amended, Solutia Inc. agreed to a 2004 minimum purchase commitment of \$9,000 of product. For each year after 2004 through the term of the contract, Solutia Inc. contracted to purchase an amount of product equal to 110% of the amount of product it was required to purchase in the prior year.

Critical Accounting Policies and Estimates

The accompanying discussion and analysis of our financial condition and results of operations are based upon our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States (GAAP). The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. These estimates form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. We base our estimates and judgments on historical experience and on various other assumptions that we believe are reasonable under the circumstances. However, future events cannot be forecasted with certainty, and the best estimates and judgments routinely require adjustment. We are required to make estimates and judgments in many areas, including those related to: revenue recognition, accrual for product returns and warranties, allowance for doubtful accounts, quarterly income taxes, inventory valuations (including reserves for excess and obsolete and impaired inventories), impairment of intangibles and goodwill, reserves for decommissioning costs associated with leasehold asset retirement obligations and valuation of stock-based compensation. We believe these policies are the most critical to our financial statements because their application places the most significant demands on management's judgment. Senior management has discussed the development, selection and disclosure of these estimates with the Audit Committee of our Board of Directors.

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We believe there have been no significant changes during the first six months of fiscal 2011 to the items that we disclosed as our critical accounting policies and estimates in our discussion and analysis of financial condition and results of operations in our 2010 Form 10-K.

Three and Six Months Ended June 30, 2011 compared with Three and Six Months Ended June 30, 2010

Results of Operations

Net revenues

Net revenues by operating segment are summarized in the following table:

| | Three Months Ended | | Change in | | | Six Months Ended | | Change in | | |
|--------------------|--------------------|----------|-----------|---------|----------|------------------|---------|-----------|--|--|
| | June 30, | | Dollars | Percent | June 30, | | Dollars | Percent | | |
| | 2011 | 2010 | | | 2011 | 2010 | | | | |
| Net revenues: | | | | | | | | | | |
| Film: | | | | | | | | | | |
| Automotive film | \$6,085 | \$5,426 | \$659 | 12 % | \$12,239 | \$9,886 | \$2,353 | 24 % | | |
| Window film | 5,460 | 4,614 | 846 | 18 % | 11,630 | 9,310 | 2,320 | 25 % | | |
| Architectural | 1,374 | 1,273 | 101 | 8 % | 3,225 | 2,571 | 654 | 25 % | | |
| Other | 179 | 44 | 135 | 307 % | 352 | 71 | 281 | 396 % | | |
| Total film | 13,098 | 11,357 | 1,741 | 15 % | 27,446 | 21,838 | 5,608 | 26 % | | |
| Glass | 436 | 433 | 3 | 1 % | 619 | 433 | 186 | 43 % | | |
| Total net revenues | \$13,534 | \$11,790 | \$1,744 | 15 % | \$28,065 | \$22,271 | \$5,794 | 26 % | | |

Total net revenues increased 15% and 26% for the three and six months ended June 30, 2011, from the same periods in 2010. The increase for both periods for automotive film net revenues was due to increased demand from our OEM customers and the higher window film net revenues was primarily due to greater demand resulting from higher sales of automobiles in the second quarter of 2011, compared to the same period in 2010. The net revenues growth in architectural film was primarily due to increased material required for a major project in China.

Cost of revenues

Cost of revenues increased \$1,872, or 32 %, to \$7,763 for the three months ended June 30, 2011 from \$5,891 for the same period in 2010 primarily as a result of higher sales volume in the three months ended June 30, 2011 as compared to the same period in 2010. Cost of revenues increased \$4,508, or 39 %, to \$16,167 for the six months ended June 30, 2011 from \$11,659 for the same period in 2010 primarily as a result of higher sales volume in the six months ended June 30, 2011 as compared to the same period in 2010.

Gross profit

| | Three Months Ended | | Change in | | | Six Months Ended | | Change in | | |
|----------------------------|--------------------|---------|-----------|---------|----------|------------------|---------|-----------|--|--|
| | June 30, | | Dollars | Percent | June 30, | | Dollars | Percent | | |
| | 2011 | 2010 | | | 2011 | 2010 | | | | |
| Gross profit | \$5,771 | \$5,899 | \$(128) | -2 % | \$11,898 | \$10,612 | \$1,286 | 12 % | | |
| Percentage of net revenues | 43 % | 50 % | | | 42 % | 48 % | | | | |

Our gross profit percentage decreased by approximately 7 percentage points to 43 percent for the three months ended June 30, 2011 compared to 50 percent for the same period in 2010. Our gross profit percentage decreased by approximately 6 percentage points to 42 percent for the six months ended June 30, 2011 compared to 48 percent for the same period in 2010. The decrease was primarily due to costs associated with the addition of SIG that we began consolidating into our results in the second quarter of 2010 and increased cost of precious metals consumed to manufacture sputtered film.

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Operating expenses

Operating expenses are summarized in the following table:

| | Three Months Ended | | | | Six Months Ended | | | | | |
|---|--------------------|---------|-----------|---------|------------------|---------|-----------|---------|--|--|
| | June 30, | | Change in | | June 30, | | Change in | | | |
| | 2011 | 2010 | Dollars | Percent | 2011 | 2010 | Dollars | Percent | | |
| Research and development | \$1,113 | \$792 | \$321 | 41 % | \$2,147 | \$1,584 | \$563 | 36 % | | |
| Percentage of net revenues | 8 % | 7 % | | | 8 % | 7 % | | | | |
| Selling, general and administrative | 2,938 | 2,266 | 672 | 30 % | 5,877 | 4,266 | 1,611 | 38 % | | |
| Percentage of net revenues | 22 % | 19 % | | | 21 % | 19 % | | | | |
| Goodwill and intangible assets impairment | 1,833 | - | 1,833 | nm | 1,833 | - | 1,833 | nm | | |
| Percentage of net revenues | 14 % | - | | | 7 % | - | | | | |
| Total | \$5,884 | \$3,058 | \$2,826 | 92 % | \$9,857 | \$5,850 | \$4,007 | 68 % | | |
| Percentage of net revenues | 43 % | 26 % | | | 35 % | 26 % | | | | |

nm – not meaningful

Research and development. The increase in research and development expenses for the three and six months ended June 31, 2011, as compared to the same periods in 2010, was primarily due to higher headcount related expenses and increased spending for travel and outside services.

Selling, general and administrative. The increase in selling, general and administrative expenses for the three and six months ended June 31, 2010, as compared to the same periods in 2010, was primarily due to higher headcount related expenses, including stock-based compensation expense, increased spending for consulting and outside services and the consolidation of SIG and Crown Operations.

Goodwill and intangible assets impairment. The Company reviews goodwill for impairment annually as of December 31 and whenever events or changes in circumstances indicate the carrying value of an asset may not be recoverable in accordance with authoritative guidance. The circumstances that could trigger a goodwill impairment could include, but are not limited to, the following items to the extent that management believes the occurrence of one or more would make it more likely than not that we would fail the first step of the goodwill impairment test: significant adverse change in legal factors or in the business climate, an adverse action or assessment by a regulator, unanticipated competition, a loss of key personnel, a more-likely-than-not expectation that a reporting unit or a significant portion will be sold or otherwise disposed of, a portion of a reporting unit's goodwill has been included in the carrying amounts of a business that will be disposed or if our market capitalization is below our net book value.

During the three month period ending June 30, 2011, the Company altered its business strategy to no longer support the Glass Segment's standard IGU product and reevaluated its ability to gain market share during the technology

development stage. As a result, the Company determined that the goodwill and intangible assets related to the Glass Segment was impaired. As a result, the Company recorded a one-time impairment charge of \$1,833, which represents one hundred percent of the goodwill and intangible assets related to the Glass Segment.

Income from operations

Income from operations decreased \$2,954 to an operating loss of \$113 for the three months ended June 30, 2011, as compared to operating income of \$2,841 for the same period in 2010. Income from operations decreased \$2,721 to an operating income of \$2,041 for the six months ended June 30, 2011, as compared to operating income of \$4,762 for the same period in 2010. The decrease for both periods was primarily due to higher operating expenses relating to acquisitions and a goodwill and intangible assets impairment charge of \$1,833.

Interest expense, net

Interest expense, net of \$65 for the three months ended June 30, 2011 was relatively unchanged as compared to \$64 for the same period in 2010 and decreased to \$131 for the six months ended June 30, 2011 from \$159 for the same period in 2010. The decrease in net interest expense was primarily due to lower average outstanding debt balances for the six months ended June 30, 2011, as compared to the same period in 2010.

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Other income (expense), net

Other income (expense), net, was net other income of \$64 and \$336 for the three and six months ended June 30, 2011, respectively, and was primarily foreign currency gains related to transactions with foreign customers that were denominated in foreign currencies, principally the Euro, as compared to a net other expense of \$123 for the same period in 2010. For the three months ended June 30, 2010, we recognized foreign exchange losses of \$483 and our 66.3% share of net losses incurred by SIG of \$108.

Income (loss) before provision for income taxes

Loss before provision for income taxes for the three months ended June 30, 2011 was \$114 and income before provision for income taxes was \$2,246 for the six months ended June 30, 2011, as compared to income before provision for income taxes \$2,900 and 4,245, respectively for the same periods in 2010. The increases were primarily due to higher sales and production volumes.

Provision for income taxes

We recorded an income tax provision of \$531 and \$1,481 in the three and six months ended June 30, 2011, respectively, as compared to a benefit from income taxes of \$107 and \$99 for the three and six months ended June 30, 2011, respectively. The effective tax rate was 66% for the six months ended June 30, 2011 and (2.3%) for the same period in 2010. The primary reason for the change in the effective tax rates for the period in 2011 as compared to the same period in 2010 is due to the impairment charge for goodwill and the impact of the valuation allowance during 2010. Our effective tax rate differs from the statutory rate due to various factors, such as tax legislation, the mix of domestic and international pre-tax income, research and development credits, foreign tax credits, share-based compensations and change in valuation allowance.

The impact of an uncertain income tax position on the income tax return must be recognized at the largest amount that is more likely than not to be sustained upon audit by the relevant tax authority. An uncertain income tax position will not be recognized if it has less than a 50% likelihood of being sustained. As of June 30, 2011, we identified and recorded unrecognized tax benefits in the amount of approximately \$394, that if reversed, would impact the tax expense, but no interest and penalties have been recorded due to the immaterial impact to the financial statements. We do not expect material changes in the balance of unrecognized tax benefits will occur within the next twelve months.

Net loss attributable to noncontrolling interest

Net loss attributable to noncontrolling interest of \$58 and \$219 for the three and six months ended June 30, 2011, respectively, is related to the consolidation of SIG upon acquisition of a controlling interest during the second quarter of 2010. Net loss attributable to noncontrolling interest was \$30 and \$30 for the three and six months ended June 30, 2010, respectively

Deemed dividend on preferred stock

We accrued \$122 of deemed dividend on preferred stock in each of the three months ended June 30, 2011 and 2010, respectively, and \$244 in each of the six months ended June 30, 2011 and 2010, respectively. The holders of our secured convertible promissory notes converted those notes to shares of Series A preferred stock in December 2004. The Series A preferred stock accrues cumulative dividends at the rate of 10% per annum.

Liquidity and Capital Resources

Liquidity

Our principal liquidity requirements are for working capital, consisting primarily of accounts receivable and inventories, for debt repayments and capital expenditures. We believe that because of the production cycle of certain of our products, our inventories will continue to represent a significant portion of our working capital.

Our cash and cash equivalents decreased \$376 from \$13,776 at December 31, 2010 to \$13,400 at June 30, 2011. The decrease in cash is primarily due to an increase in current assets and a decrease in accounts payable and accrued liabilities, partially offset by net income and non-cash expenses.

Specifically, cash used in operating activities of \$1,103 for the six months ended June 30, 2011 was primarily the result of net income of \$765, non-cash depreciation and amortization of \$1,749, non-cash stock-based compensation expense of \$452 and non-cash impairment charge for goodwill and intangible assets of \$1,833, offset by an increase in accounts receivable of \$1,307, a decrease in accounts payable and accrued liabilities of \$864 and an increase in inventories, net of \$1,000.

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Cash used in investing activities for the six months ended June 30, 2011 was for capital expenditures of \$866.

Cash used in financing activities for the six months ended June 30, 2011 of \$441 was the result of scheduled payments of other term debt and capital lease obligations of \$521, offset by proceeds from stock option exercises of \$71.

Borrowing arrangements

Credit Agreement with Wells Fargo Bank

In June 2011, we renewed our Credit Agreement with Wells Fargo Bank (the "Bank"). The Credit Agreement provides for a \$3,000 revolving line of credit. Advances under the line exceeding \$1,500 will be limited to 80% of eligible accounts receivable. We will not be eligible for additional borrowings if our consolidated cash balance falls below \$3,500. Amounts borrowed under the facility bear interest at either prime plus 0.75% or LIBOR plus 3.5%, determined at our discretion, and is annualized on the average daily financed amount outstanding. All borrowings under the facilities are collateralized by our assets in the United States and are subject to certain covenants including minimum quarterly net income and minimum liquid asset requirements.

Generally, if any event of default occurs, the Bank may declare all outstanding indebtedness under the Credit Agreement to be due and payable. The maturity date of the facility is June 2012. Although we expect to renew the credit line, we can provide no assurance that we will be successful in obtaining a new or replacement credit facility due to restrictive credit markets. As of June 30, 2011, we had no balance outstanding on our line of credit. The foregoing does not purport to be a complete statement of the parties' rights and obligations under the Credit Agreement, and the transactions contemplated thereby or a complete explanation of material terms thereof.

In August 2010, our Credit Agreement with the Bank was amended to provide for a \$1,250 term loan, which was funded on September 2, 2010. Amounts borrowed under the term loan are payable over 36 months in equal installments and bear interest at a fixed rate 4.05%. The Credit Agreement was further amended to provide covenants for tangible net worth and fixed charge coverage ratio.

We have classified \$481 and \$695 outstanding under the Bank term loan and capital lease as a short-term liability and long-term liability, respectively, at June 30, 2011. We are obligated to pay an aggregate of \$417 in principal under our Wells Fargo term loan in 2011.

On December 27, 2010, we entered into a lease agreement with the Bank to finance research and development equipment. The lease term is 48 months and requires monthly payments. As of June 30, 2011, the principal balance of this lease was \$238.

We were not in compliance with the minimum net income covenant under the Credit Agreement and capital lease with the Bank as of June 30, 2011. On August 4, 2011, the Company obtained a waiver of noncompliance from the Bank as of June 30, 2011.

Borrowing Arrangements with German Banks

Our borrowing arrangements with various German banks as of June 30, 2011 are described in Note 7 of the Notes to Unaudited Condensed Consolidated Financial Statements (Item 1. "Financial Statements") set forth herein. We are in compliance with all of the covenants of the German bank loans and capital leases, and we have classified \$435 and \$2,518 outstanding under the German bank loans and capital leases as a short-term liability and long-term liability, respectively, at June 30, 2011.

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Capital expenditures

We expect to spend approximately \$5,800 in 2011 primarily related to machinery and equipment for production automation and additional equipment investment in our Germany facility.

Future payment obligations

Our future payment obligations on our borrowings pursuant to our term debt, non-cancelable operating and capital leases and other non-cancelable contractual commitments were as follows at June 30, 2011:

| | Total | Less Than 1 Year | 1-3 Years | 3-5 Years | Greater Than 5 Years |
|--|-----------|---------------------|-----------|-----------|-------------------------|
| Term debt (1) | \$ 3,816 | \$ 777 | \$ 1,240 | \$ 719 | \$ 1,080 |
| Capital lease obligations (1) | 445 | 271 | 138 | 36 | - |
| Term debt and capital lease obligation interest (1) | 734 | 207 | 261 | 169 | 97 |
| Other obligations (2) | 5,438 | 2,258 | - | - | 3,180 |
| Operating leases (3) | 2,859 | 383 | 1,386 | 865 | 225 |
| Total | \$ 13,292 | \$ 3,896 | \$ 3,025 | \$ 1,789 | \$ 4,582 |

(1) Represents the principal and interest allocations of loan and capital lease agreements with Varilease Finance Inc. and several German Banks and Wells Fargo Bank.

(2) Represents commitments to purchase manufacturing material (less than one year) and accumulated dividends on Series A preferred stock (greater than five years).

(3) Represents the remaining rents owed on buildings we rent in Palo Alto, California, and Chicago, Illinois.

As of June 30, 2011, we maintained 30,174 square feet of office and warehouse space at 3780-3788 Fabian Way, Palo Alto, California 94303. In 2011, the monthly rent payments are \$40 and will increase annually at a rate of 3% through the expiration of the lease.

As of June 30, 2011, we had a lease obligation for 9,200 square feet at 3961 East Bayshore Road, Palo Alto, California 94303. The monthly rent payments for this facility are \$4.

As of June 30, 2011, we had a lease obligation for 75,640 square feet at 4404 W. Ann Lurie Place, Chicago, IL 60632. The monthly rent payments for this facility are \$20, which increases to \$25 in April 2011, \$26 in October 2011, and increases thereafter annually at a rate of 3.6% through the expiration of the lease.

As of June 30, 2011, we had unconditional purchase obligations to procure equipment of \$2,986.

Item 3 – Quantitative and Qualitative Disclosures about Market Risk

We are exposed to the impact of interest rate changes, foreign currency fluctuations, and changes in the market values of our investments.

Financing risk. The interest rate on one of our German loans was reset to the prevailing market rate of 5.73% in September 2009. Fluctuations or changes in interest rates may adversely affect our expected interest expense. The effect of a 10% fluctuation in the interest rate on our line of credit and term debt would not have a material effect on

our interest expense for the first quarter of 2011.

Investment risk. We invest our excess cash in money market accounts and, by practice, make every effort to limit the amount of exposure by investing with strong, well-known institutions. Investments in both fixed rate and floating rate interest earning instruments carry a degree of interest rate risk. Fixed rate securities may have their fair market value adversely affected due to a rise in interest rates, while floating rate securities may produce less income than expected if interest rates fall. The effect of a 10% fluctuation in the interest rate on our excess cash investments would not have had a material effect on our interest income in the six months ended June 30, 2011.

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Foreign currency risk. International net revenues (defined as sales to customers located outside of the United States) accounted for approximately 84% of our total net revenues in the three months ended June 30, 2011. Approximately 46% of our international net revenues were denominated in Euros in the second quarter of 2011. The remaining 38% of our international net revenues were denominated in U.S. dollars. In addition, certain transactions with foreign suppliers are denominated in foreign currencies. The effect of a 10% fluctuation in the Euro exchange rate would have had an effect of approximately \$616 on net revenues and \$630 on expenses and the effect on expenses of a 10% reduction in the Yen exchange rate would have an effect of approximately \$134 for the second quarter of 2011.

Item 4 – Controls and Procedures

- (a) Evaluation of Disclosure Controls and Procedures. Under the supervision and with the participation of our management, including our Principal Executive Officer and Principal Financial Officer, we conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended. Based on this evaluation, our Principal Executive Officer and Principal Financial Officer concluded as of the end of the period covered by this report, that our disclosure controls and procedures were effective, such that the information relating to our company, including our consolidated subsidiaries, required to be disclosed in our Securities and Exchange Commission (“SEC”) reports (i) is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and (ii) is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.
- (b) Changes in Internal Controls. There were no changes during the six month period ended June 30, 2011 in our internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, the internal controls over financial reporting.

Internal control systems, no matter how well designed and operated, have inherent limitations. Consequently, even a system which is determined to be effective cannot provide absolute assurance that all control issues have been detected or prevented. Our systems of internal controls are designed to provide reasonable assurance with respect to financial statement preparation and presentation.

PART II – OTHER INFORMATION

Item 1– Legal Proceedings

We may be a party to various pending judicial and administrative proceedings arising in the ordinary course of business. While the outcome of the pending proceedings cannot be predicted with certainty, based on our review, we believe that any unrecorded liability that may result is not likely to have a material effect on our liquidity, financial condition or results of operations.

Item 1A – Risk Factors

The following information updates should be read in conjunction with the information disclosed in Item 1A, “Risk Factors,” of our Annual Report on Form 10-K for the year ended December 31, 2010, filed with the SEC on March 29, 2011.

Financial Risks

There have been no significant changes in financial risk factors for the six months ended June 30, 2011. See the information set forth in the section entitled “Risk Factors” in our Annual Report on Form 10-K for the fiscal year ended December 31, 2010.

Operational Risks

There have been no significant changes in operational risk factors for the six months ended June 30, 2011. See the information set forth in the section entitled “Risk Factors” in our Annual Report on Form 10-K for the fiscal year ended December 31, 2010.

Market Risks

There have been no significant changes in market risk factors for the six months ended June 30, 2011. See the information set forth in the section entitled “Risk Factors” in our Annual Report on Form 10-K for the fiscal year ended December 31, 2010.

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

None.

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Item 3 – Defaults upon Senior Securities

None.

Item 5 – Other Information

None.

Item 6 – Exhibits

(a) Exhibits

| Exhibit Number | Item |
|----------------|---|
| <u>31.1</u> | Certification of Principal Executive Officer pursuant to Exchange Act Rules 13a-14 and 15d-14 |
| <u>31.2</u> | Certification of Principal Financial Officer pursuant to Exchange Act Rules 13a-14 and 15d-14 |
| <u>32.1</u> | Certification of Principal Executive Officer pursuant to 18 U.S.C Section 1350 |
| <u>32.2</u> | Certification of Principal Financial Officer pursuant to 18 U.S.C Section 1350 |
| 101.ins | XBRL Instance Document (.xml) |
| 101.sch | XBRL Taxonomy Extension Schema Document (.xsd) |
| 101.cal | XBRL Taxonomy Extension Calculation Linkbase Document (cal) |
| 101.lab | XBRL Taxonomy Extension Label Linkbase (lab) |
| 101.pre | XBRL Taxonomy Extension Presentation Linkbase Document (pre) |

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Dated: August 12, 2011

Southwall Technologies Inc.

By: /s/ Dennis F. Capovilla
Dennis F. Capovilla
Chief Executive Officer

By: /s/ Mallorie Burak
Mallorie Burak
Vice President and Chief Accounting Officer