

TERAYON COMMUNICATION SYSTEMS

Form 10-Q

November 15, 2002

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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

**FOR THE QUARTERLY PERIOD ENDED September 30, 2002
OR**

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

FOR THE TRANSITION PERIOD FROM _____ TO _____.

TERAYON COMMUNICATION SYSTEMS, INC.

(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

DELAWARE	77-0328533
(STATE OR OTHER JURISDICTION	(IRS EMPLOYER
OF	IDENTIFICATION NO.)
INCORPORATION OR	
ORGANIZATION)	

4988 GREAT AMERICA PARKWAY
SANTA CLARA, CALIFORNIA 95054
(408) 235-5500

(ADDRESS, INCLUDING ZIP CODE, AND TELEPHONE NUMBER, INCLUDING AREA CODE, OF
THE REGISTRANT'S PRINCIPAL EXECUTIVE OFFICES)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for 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

As of October 31, 2002, registrant had outstanding 73,128,720 shares of Common Stock.

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SPECIAL NOTE ON FORWARD-LOOKING STATEMENTS

This report on Form 10-Q contains forward-looking statements of Terayon Communication Systems, Inc. within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 which are subject to the safe harbor created by those sections. The forward-looking statements include, but are not limited to: statements related to industry trends and future growth in the markets for cable modem systems; our strategies for reducing the cost of our products; our product development efforts; the effect of GAAP accounting pronouncements on our recognition of revenues; our future research and development; the timing of our introduction of new products; the timing and extent of deployment of our products by our customers; and future profitability. We usually use words such as may, will, should, expect, plan, anticipate, believe, estimate, predict, future, intend, or certain or the negative of these terms or similar expressions to identify forward-looking statements. Discussions containing such forward-looking statements may be found throughout the document. These forward-looking statements involve certain risks and uncertainties that could cause actual results to differ materially from those in such forward-looking statements. We disclaim any obligation to update these forward-looking statements as a result of subsequent events. The business risks discussed in Part 1, Item 2 of this Report on Form 10-Q, among other things, should be considered in evaluating our prospects and future financial performance.

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

TERAYON COMMUNICATION SYSTEMS, INC.
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TERAYON COMMUNICATION SYSTEMS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands)

	September 30, 2002	December 31, 2001
	(unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 128,610	\$ 100,274
Short-term investments	91,266	233,614
Accounts receivable, net	21,974	48,386
Accounts receivable from related parties	448	4,006
Other current receivables	6,942	7,476
Inventory	9,033	16,658
Other current assets	11,539	13,462
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Total current assets	269,812	423,876
Property and equipment, net	19,818	25,279
Intangibles and other assets, net	13,626	17,491
	<hr/>	<hr/>
Total assets	\$ 303,256	\$ 466,646
	<hr/>	<hr/>
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 21,120	\$ 42,821
Accrued payroll and related expenses	6,107	9,441
Deferred revenues	1,175	4,169
Accrued warranty	10,101	8,368
Accrued vendor cancellation charges	19,888	17,291
Accrued restructuring	7,435	8,197
Other accrued liabilities	11,288	14,015
Interest payable on long-term debt	542	3,273
Current portion of capital lease obligations	164	126
	<hr/>	<hr/>
Total current liabilities	77,820	107,701
Long-term portion of capital lease obligations	101	233
Long-term obligations	3,483	4,267
Convertible subordinated notes	65,081	174,141
Commitments and contingencies		
Stockholders' equity:		
Common stock	73	73
Additional paid in capital	1,077,800	1,074,203
Accumulated deficit	(916,741)	(892,994)
Deferred compensation	(40)	(458)
Treasury stock, at cost	(773)	(768)
Accumulated other comprehensive (loss) income	(3,548)	248
	<hr/>	<hr/>
Total stockholders' equity	156,771	180,304
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Total liabilities and stockholders' equity	\$ 303,256	\$ 466,646
	<hr/>	<hr/>

See accompanying notes.

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TERAYON COMMUNICATION SYSTEMS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)
(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	2001	2002	2001
Revenues:				
Product revenues	\$ 23,983	\$ 71,145	\$ 97,785	\$ 155,152
Related party product revenues	492	8,458	6,315	44,168
	<u>24,475</u>	<u>79,603</u>	<u>104,100</u>	<u>199,320</u>
Cost of goods sold:				
Cost of product revenues	23,872	63,716	72,880	177,223
Cost of related party product revenues	307	5,519	5,460	28,329
	<u>24,179</u>	<u>69,235</u>	<u>78,340</u>	<u>205,552</u>
Gross profit (loss)	296	10,368	25,760	(6,232)
Operating expenses:				
Research and development	14,315	20,163	45,959	61,942
Sales and marketing	9,026	16,105	28,020	47,922
General and administrative	4,467	8,086	11,653	24,697
Goodwill amortization		149		22,953
Restructuring costs and asset write-offs	4,950	5,301	8,922	582,594
	<u>32,758</u>	<u>49,804</u>	<u>94,554</u>	<u>740,108</u>
Loss from operations	(32,462)	(39,436)	(68,794)	(746,340)
Interest income	1,526	3,341	5,636	14,587
Interest expense	(990)	(2,351)	(5,347)	(12,399)
Other income (expense)	268	(698)	(4,197)	(819)
Gain on early retirement of debt	15,813	51,834	49,089	173,328
	<u>(15,845)</u>	<u>12,690</u>	<u>(23,613)</u>	<u>(571,643)</u>
Income tax (expense) benefit	(127)	392	(134)	14,021
Net income (loss)	<u>\$ (15,972)</u>	<u>\$ 13,082</u>	<u>\$ (23,747)</u>	<u>\$ (557,622)</u>
Basic net income (loss) per share	<u>\$ (0.22)</u>	<u>\$ 0.19</u>	<u>\$ (0.33)</u>	<u>\$ (8.23)</u>
Diluted net income (loss) per share	<u>\$ (0.22)</u>	<u>\$ 0.19</u>	<u>\$ (0.33)</u>	<u>\$ (8.23)</u>
Shares used in computing basic net income (loss) per share	<u>73,122</u>	<u>68,181</u>	<u>72,828</u>	<u>67,723</u>
Shares used in computing diluted net income (loss) per share	<u>73,122</u>	<u>69,632</u>	<u>72,828</u>	<u>67,723</u>

See accompanying notes.

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TERAYON COMMUNICATION SYSTEMS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands, unaudited)

	Nine Months Ended September 30,	
	2002	2001
Operating activities:		
Net loss	\$ (23,747)	\$(557,622)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	9,059	13,082
Write-off and amortization of intangible assets	3,972	615,447
Amortization related to stock options	469	3,647
Gain on early retirement of debt	(49,088)	(175,828)
Lower of cost or market inventory provision	6,135	
Impairment of investment	4,500	
Write-off of fixed assets	2,257	
Interest payable	5,656	11,821
Changes in operating assets and liabilities:		
Accounts receivable	20,160	15,526
Accounts receivable from related parties	3,558	(9,809)
Interest paid	(8,387)	(21,395)
Inventory	5,856	55,732
Other assets	(6,253)	19,991
Accounts payable	(21,701)	(75,190)
Accrued payroll and related expenses	(3,334)	(322)
Deferred revenues	(2,994)	(1,583)
Accrued warranty	1,733	2,547
Accrued restructuring	(762)	7,449
Accrued vendor cancellation charges	2,597	15,392
Deferred taxes		(18,565)
Other accrued liabilities	(6,142)	(14,041)
Net cash used in operating activities	<u>(56,456)</u>	<u>(113,721)</u>
Investing activities:		
Purchases of investments	(236,081)	(279,085)
Proceeds from sales and maturities of investments	379,966	309,531
Purchases of property and equipment	(5,855)	(10,239)
Net cash provided by investing activities	<u>138,030</u>	<u>20,207</u>
Financing activities:		
Principal payments on capital leases	(94)	(348)
Principal payments on long-term obligations		(103)
Payments on repurchase of common stock	(5)	
Exercise of options to purchase common stock	1,708	3,003
Proceeds from issuance of common stock through employee stock purchase plan	1,838	
Principal payment on stockholders' note receivable		3
Retirement of debt	(57,627)	(113,428)
Net cash used in financing activities	<u>(54,180)</u>	<u>(110,873)</u>
Effect of exchange rate changes	942	(715)

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Net decrease in cash and cash equivalents	28,336	(205,102)
Cash and cash equivalents at beginning of period	100,274	347,015
Cash and cash equivalents at end of period	\$ 128,610	\$ 141,913

See accompanying notes.

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TERAYON COMMUNICATION SYSTEMS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. Organization and Summary of Significant Accounting Policies

Description of Business

Terayon Communication Systems, Inc. (Company) was incorporated under the laws of the State of California on January 20, 1993. In July 1998, the Company reincorporated in the State of Delaware.

The Company develops, markets and sells equipment to cable television operators, telecom carriers and satellite network operators who use the Company's products to deliver broadband data, voice and video services to residential and business subscribers.

Basis of Presentation

The accompanying condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States for interim financial information and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) necessary for a fair presentation of the financial statements at September 30, 2002 and for the three and nine months ended September 30, 2002 and 2001 have been included.

Results for the three and nine months ended September 30, 2002 are not necessarily indicative of results for the entire fiscal year or future periods. These financial statements should be read in conjunction with the consolidated financial statements and the accompanying notes included in the Company's Form 10-K dated April 1, 2002, as filed with the U.S. Securities and Exchange Commission. The accompanying balance sheet at December 31, 2001 is derived from audited consolidated financial statements at that date.

Reclassifications

Certain amounts in the 2001 financial statements have been reclassified to conform to the 2002 presentation. See Note 7.

Use of Estimates

The preparation of the condensed consolidated financial statements in conformity with generally accepted accounting principles in the United States requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates. See Critical Accounting Policies in Management's Discussion and Analysis of Financial Condition and Results of Operations.

Basis of Consolidation

The condensed consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All intercompany balances and transactions have been eliminated.

Inventory and Purchase Obligations

Inventory is stated at the lower of cost (first-in, first-out) or market. The components of inventory are as follows (in thousands):

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	September 30, 2002	December 31, 2001
Finished goods	\$5,688	\$ 6,433
Work-in-process	378	236
Raw materials	2,967	9,989
	<u>\$9,033</u>	<u>\$16,658</u>

The Company has purchase obligations to certain of its suppliers that support the Company's ability to manufacture its products. The obligations require the Company to purchase minimum quantities of the suppliers' products at a specified price. Cost of goods sold for the three and nine months ended September 30, 2002 included a reversal of \$0.6 million and \$13.1 million, respectively, in special charges taken in 2001 for vendor cancellation charges and inventory considered to be excess and obsolete. The Company was able to reverse the provision in 2002 as it was able to sell inventory originally considered to be excess and obsolete. In addition, the Company was able to negotiate downward certain vendor cancellation claims to terms more favorable to the Company. During the three and nine months ended September 30, 2001, the Company recorded special charges of \$6.4 million and \$35.1 million, respectively, relating to vendor cancellation fees as well as inventory obsolescence.

In the three and nine months ended September 30, 2002, the Company recorded an inventory reserve of \$1.6 million and \$6.1 million, respectively, to reduce certain inventories to the lower of cost or market as average selling prices fell below the cost of these products.

As of September 30, 2002, the Company had \$54.9 million of purchase obligations, of which \$19.9 million is included on the balance sheet as accrued vendor cancellation charges. The remaining obligations are expected to become payable at various times through mid 2003.

Net Income (Loss) Per Share

A reconciliation of the numerator and denominator of basic and diluted net loss per share is provided as follows (in thousands, except per share amounts):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	2001	2002	2001
Net income (loss)	\$(15,972)	\$13,082	\$(23,747)	\$(557,622)
Denominator:				
Basic weighted average shares of common stock outstanding				