LEAP WIRELESS INTERNATIONAL INC
Form 10-Q
August 14, 2002

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2002

OR

o **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 0-29752

Leap Wireless International, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**33-0811062**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
10307 Pacific Center Court, San Diego, CA	**92121**
(Address of principal executive offices)	**(Zip Code)**

(858) 882-6000

(Registrant s telephone number, including area code)

Not applicable

(Former name, former address and former fiscal year, if changed since last reported)

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 ninety days. Yes x No o

The number of shares of registrant s common stock outstanding on August 7, 2002 was 37,579,781.

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LEAP WIRELESS INTERNATIONAL, INC.

QUARTERLY REPORT ON FORM 10-Q

For the Quarter Ended June 30, 2002

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PART I

FINANCIAL INFORMATION

Item 1. Financial Statements.

LEAP WIRELESS INTERNATIONAL, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share data)

	June 30, 2002	December 31, 2001
	(Unaudited)	
Assets		
Cash and cash equivalents	$ 73,365	$ 242,979
Short-term investments	133,560	81,105
Restricted cash equivalents and short-term investments	38,291	27,628
Inventories	40,390	45,338
Other current assets	12,770	22,044
Total current assets	298,376	419,094
Property and equipment, net	1,223,861	1,112,284
Wireless licenses, net	758,428	718,222
Goodwill, net	26,919	26,919
Other intangible assets, net	13,325	16,694
Restricted investments		13,127
Deposit for wireless licenses	10,773	85,000
Other assets	66,320	59,555
Total assets	$ 2,398,002	$ 2,450,895
Liabilities and Stockholders Equity		
Accounts payable and accrued liabilities	$ 103,364	$ 147,695
Current portion of long-term debt	92,987	26,049
Other current liabilities	94,002	55,843
Total current liabilities	290,353	229,587
Long-term debt	1,997,212	1,676,845
Other long-term liabilities	105,068	186,023
Total liabilities	2,392,633	2,092,455
Commitments and contingencies (Note 4)		
Stockholders equity:		
Preferred stock authorized 10,000,000 shares; $.0001 par value, no shares issued and outstanding		
Common stock authorized 300,000,000 shares; $.0001 par value, 37,556,713 and 36,979,664 shares issued and outstanding at June 30, 2002 and December 31, 2001, respectively	4	4
Additional paid-in capital	1,148,593	1,148,337

Unearned stock-based compensation	(2,237)	(5,138)
Accumulated deficit	(1,141,432)	(786,195)
Accumulated other comprehensive income	441	1,432
Total stockholders equity	5,369	358,440
Total liabilities and stockholders equity	$ 2,398,002	$ 2,450,895

See accompanying notes to condensed consolidated financial statements.

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LEAP WIRELESS INTERNATIONAL, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(UNAUDITED)
(In thousands, except per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	**2001**	**2002**	**2001**
Revenues:				
Service revenues	$ 144,390	$ 39,554	$ 272,410	$ 65,209
Equipment revenues	6,752	8,292	18,913	19,390
Total revenues	151,142	47,846	291,323	84,599
Operating expenses:				
Cost of service	(43,512)	(17,480)	(85,403)	(29,706)
Cost of equipment	(60,163)	(32,497)	(144,174)	(63,435)
Selling and marketing	(32,758)	(21,786)	(62,917)	(38,801)
General and administrative	(46,714)	(32,715)	(96,708)	(57,401)
Depreciation and amortization	(68,975)	(20,511)	(130,863)	(35,298)
Total operating expenses	(252,122)	(124,989)	(520,065)	(224,641)
Gain on sale of wireless license			364	
Operating loss	(100,980)	(77,143)	(228,378)	(140,042)
Equity in net loss of unconsolidated wireless operating company		(17,116)		(43,298)
Interest income	1,661	7,874	3,421	18,773
Interest expense	(57,240)	(41,840)	(110,149)	(79,451)
Other income (expense), net	8	(40)	100	2,301
Loss before income taxes	(156,551)	(128,265)	(335,006)	(241,717)
Income taxes	(2,039)	(265)	(20,231)	(1,198)
Net loss	$ (158,590)	$ (128,530)	$ (355,237)	$ (242,915)
Other comprehensive loss:				
Foreign currency translation losses		(287)		(605)
Unrealized holding gains (losses) on investments, net	513	(225)	(239)	127
Comprehensive loss	$ (158,077)	$ (129,042)	$ (355,476)	$ (243,393)
Basic and diluted net loss per common share	$ (4.23)	$ (3.91)	$ (9.54)	$ (7.79)
Shares used in per share calculations:				
Basic and diluted	37,451	32,882	37,226	31,181

See accompanying notes to condensed consolidated financial statements.

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LEAP WIRELESS INTERNATIONAL, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)
(In thousands)

	Six Months Ended June 30, 2002	Six Months Ended June 30, 2001
Operating activities:		
Net cash used in operating activities	$(122,346)	$(172,299)
Investing activities:		
Purchase of property and equipment	(80,035)	(71,062)
Loan to unconsolidated wireless operating company		(10,000)
Acquisitions, net of cash acquired		(2,900)
Purchase of and deposits for wireless licenses		(230,876)
Refund of deposits for wireless licenses	74,230	
Proceeds from the sale of wireless license	380	
Purchase of investments	(195,696)	(102,298)
Sale and maturity of investments	140,586	183,817
Restricted cash equivalents and investments, net	2,976	12,736
Sale and repayment of notes receivable		108,138
Other		(3,468)
Net cash used in investing activities	(57,559)	(115,913)
Financing activities:		
Proceeds from long-term debt	34,902	177,204
Repayment of note payable and long-term debt	(19,102)	(909)
Issuance of common stock	440	154,561
Payment of debt financing costs	(5,949)	
Net cash provided by financing activities	10,291	330,856
Net increase (decrease) in cash and cash equivalents	(169,614)	42,644
Cash and cash equivalents at beginning of period	242,979	338,878
Cash and cash equivalents at end of period	$ 73,365	$ 381,522

See accompanying notes to condensed consolidated financial statements.

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LEAP WIRELESS INTERNATIONAL, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1. The Company and Basis of Presentation

The Company and Nature of Business

Leap Wireless International, Inc., a Delaware corporation, together with its wholly-owned subsidiaries (the Company or Leap), is a wireless communications carrier that offers digital wireless service in the United States under the brand Cricket®. Cricket service is operated by the Company s wholly-owned subsidiary, Cricket Communications, Inc. (Cricket Communications), a wholly-owned subsidiary of Cricket Communications Holdings, Inc. (Cricket Communications Holdings). The Company has launched wireless service in 40 markets, which together constitute what the Company refers to as its 40 Market Plan.

Financing Risks

The Company expects to generate significant negative net cash flows from operating activities at least through the third quarter of 2002 and to continue incurring significant operating losses. The Company also expects to generate positive net cash flows from operating activities in the aggregate during the 12 months beginning July 1, 2002. The Company expects that it will require significant additional borrowings in 2002 and 2003 under its existing vendor credit facilities to improve the coverage and capacity of the wireless networks in its 40 Market Plan and to pay interest and fees on its vendor facilities. The Company s debt is high compared to the current size of its business and the Company will be required to generate substantial cash flows in order to meet its debt repayment obligations. With the borrowings currently available under its vendor credit facilities, and assuming continued compliance with the covenants under those facilities, the Company believes that it will have sufficient capital resources to carry on its business at least through June 30, 2003. In addition, the Company may require significant additional capital to acquire wireless licenses on which it was the winning bidder in the Federal Communications Commission s (FCC) Auction 35 for an aggregate payment obligation of $350.1 million. Furthermore, an arbitrator recently determined that the seller of a previously completed wireless license acquisition was entitled to a purchase price adjustment of $40.8 million immediately payable in cash, or, in the Company s sole discretion, 21,548,415 shares of the Company s common stock. If the Company elects to pay the award in stock, it may be subject to accelerated debt payments and other penalties under FCC rules and regulations. In addition, the issuance of common stock to the seller without the consent of the lenders under the Company s vendor credit facilities could constitute a change in control and an event of default under the Company s vendor credit facilities. Any substantial payment of cash in connection with the award would significantly reduce the Company s liquidity. See Note 4.

The Company has a business plan that would allow it to meet its vendor credit facility covenants at least through June 30, 2003. This business plan is based on estimates of key operating metrics, including customer growth, customer churn, average monthly revenue per customer, losses on sales of handsets and other customer acquisition costs, and other operating costs. This business plan assumes that the Company operates at levels generally consistent with its overall results for the first half of 2002 for gross customer additions and churn. These levels represent a significant improvement in these metrics from the results of the second quarter of 2002 but not an improvement to the levels of the first quarter of 2002. In addition, the plan assumes that the Company achieves a significant reduction in customer acquisition costs, including losses on the sale of handsets, and the number of customers who are deactivated for failure to pay their first month s bill. The unsettled nature of the wireless market, decreased consumer confidence in the economy and the telecommunications industry, new service offerings of increasingly large bundles of minutes of use at increasingly low prices by some major carriers, and other issues facing the telecommunications industry have created a level of uncertainty that affects the Company s ability to predict future customer growth, as well as other key operating metrics that are dependent on customer growth.

In light of the wireless market issues described above and the Company s failure to meet planned levels for certain key operating matrics during the last two quarters, there is a significant risk that the Company will

LEAP WIRELESS INTERNATIONAL, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

not meet its business plan. If the Company does not meet the performance goals included in that plan, it is likely that the Company will not remain in compliance with covenant requirements in its vendor credit facilities. In such a case, the Company would likely need to obtain covenant waivers or amendments prior to the first quarter of 2003, including waivers or amendments for covenants related to earnings before interest, taxes and depreciation and amortization (EBITDA) and minimum numbers of customers. In addition, even assuming the Company meets the goals of its business plan described above, the Company will need to amend or refinance its vendor indebtedness, or raise approximately $225 million of additional cash in 2003 and use approximately $200 million of such cash to pay down vendor indebtedness to meet its total indebtedness to total capitalization covenant at January 1, 2004 and to provide working capital at Leap Wireless International, Inc. The Company cannot provide assurances that any such covenant waivers, amendments or refinancing will be obtained, or that the lenders will not require additional collateral, significant cash payments or additional incentives in connection with any such waivers, amendments or refinancing.

If the Company fails to meet the covenants under the vendor credit facilities, and does not obtain appropriate waivers, amendments or refinancing, the Company s vendors could refuse to lend it additional sums under the vendor credit agreements, which would severely limit the Company s ability to improve the coverage and capacity of existing networks and would require the Company to fund 2002 and 2003 interest payments and fees with cash. In addition, the lenders under the vendor credit facilities could declare all of the amounts outstanding under the facilities to be immediately due and payable. An acceleration of the indebtedness under the Company s vendor credit facilities would also constitute an event of default under other Leap agreements including the indenture governing the Company s senior notes and senior discount notes. Thus, a failure to comply with the covenants under the vendor credit agreements could have a material adverse effect on the Company s ability to continue as a going concern.

If market conditions permit, the Company intends to refinance its vendor indebtedness in the future. The Company s ability to refinance its vendor indebtedness will depend on, among other things, its financial condition, the state of the public and private debt and equity markets, the restrictions in the instruments governing its indebtedness and other factors. The Company may not be able to obtain financing or refinancing on terms that are acceptable to it, or at all.

Interim Financial Statements

The accompanying interim condensed consolidated financial statements have been prepared by the Company without audit, in accordance with the instructions to Form 10-Q and, therefore, do not include all information and footnotes necessary for a fair presentation of its financial position, results of operations, cash flows and stockholders equity in accordance with accounting principles generally accepted in the United States of America. In the opinion of management, the unaudited financial information for the interim periods presented reflects all adjustments (which include only normal, recurring adjustments) necessary for a fair presentation. These condensed consolidated financial statements and notes thereto should be read in conjunction with the consolidated financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2001 filed with the Securities and Exchange Commission on March 29, 2002. Operating results for interim periods are not necessarily indicative of operating results for an entire fiscal year. The Company recognizes its share of net earnings or losses of its foreign investee on a three-month lag.

Revenues and Cost of Revenues

For the Company s Cricket business, revenues include wireless services and the sale of handsets and accessories. Wireless services are provided on a month-to-month basis and are generally paid in advance. The Company does not currently charge fees for the initial activation of service. Revenues from wireless services are recognized as services are rendered. Amounts received in advance are recorded as deferred revenue. Cost

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LEAP WIRELESS INTERNATIONAL, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

of service generally includes direct costs and related overhead, excluding depreciation and amortization, of operating the Company s networks. Equipment revenues arise from the sale of handsets and accessories. Revenues and related costs from the sale of handsets are recognized when service is activated by customers. Revenues and related costs from the sale of accessories are recognized at the point of sale. The costs of handsets and accessories sold are recorded in cost of equipment. Handsets sold to third-party dealers and distributors are recognized as inventory until they are sold to and activated by customers. Amounts due from third-party dealers and distributors for handsets are recorded as deferred revenue upon shipment by the Company and are recognized as equipment revenues when service is activated by customers. Sales incentives offered without charge to customers and volume-based incentives paid to the Company s third-party dealers and distributors are recognized as a reduction of revenue when the related service or equipment revenue is recognized. Customers have limited rights to return handsets and accessories based on time and/or usage. The Company records an estimate for returns of handsets and accessories at the time of recognizing revenue. Returns of handsets and accessories have historically been insignificant.

Property and Equipment

Property and equipment are recorded at cost. Additions and improvements are capitalized, while expenditures that do not enhance or extend the asset s useful life are charged to operating expenses as incurred. Depreciation is applied using the straight-line method over the estimated useful lives of the assets once the assets are placed in service, which are generally five to seven years for network infrastructure assets, three to five years for computer hardware, software and other, and three to seven years for furniture, fixtures and retail and office equipment. Leasehold improvements are amortized over the shorter of their estimated useful lives or the remaining term of the related lease.

The Company s network construction expenditures are recorded as construction-in-progress until the network or assets are placed in service, at which time the assets are transferred to network infrastructure. As a component of construction-in-progress, the Company capitalizes interest and salaries and related costs of engineering employees, to the extent time and expense are contributed to the construction effort, during the construction period. The Company capitalized $1.3 million and $6.2 million of interest to property and equipment during the six months ended June 30, 2002 and 2001, respectively.

Wireless Licenses

Wireless licenses are recorded at cost. Through December 31, 2001, wireless licenses were amortized using the straight-line method over their estimated useful lives upon commencement of commercial service, generally 40 years. The Company adopted Statement of Financial Accounting Standard (SFAS) No. 142 Goodwill and Other Intangible Assets on January 1, 2002. Upon adoption, the Company ceased amortizing wireless license costs as the Company determined that these assets meet the definition of indefinite-lived intangible assets under SFAS No. 142. Wireless licenses, net, totaled $718.2 million at January 1, 2002. SFAS No. 142 requires wireless licenses classified as indefinite-lived intangible assets to be tested for impairment as of January 1, 2002 and at least annually thereafter. The Company completed its transitional impairment review of its wireless licenses during the three months ended March 31, 2002 and concluded that no impairment exists. The Company adopted Emerging Issues Task Force (EITF) Issue No. 02-07 Unit of Accounting for Testing Impairment of Indefinite-Lived Intangible Assets in completing this impairment review, which requires that separately recorded indefinite-lived intangible assets be combined in a single unit of accounting for purposes of testing impairment if they are operated as a single asset and, as such, are essentially inseparable from one another. During the three months ended March 31, 2002, the Company recorded an income tax expense of $15.9 million to increase the valuation allowance related to its net operating loss carry-forwards in connection with the adoption of SFAS No. 142. Because of the indefinite reversal of the deferred tax liabilities related to the amortization of wireless licenses for tax purposes, the deferred tax

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LEAP WIRELESS INTERNATIONAL, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

liabilities can no longer be used as a source of taxable income to support the realization of a corresponding amount of deferred tax assets. Wireless license amortization was $0.9 million and $1.7 million for the three and six months ended June 30, 2001.

Goodwill

Goodwill represents the excess of the purchase price and related costs over the fair value assigned to the net tangible and identifiable intangible assets of businesses acquired. Through December 31, 2001, goodwill was amortized on a straight-line basis over its estimated useful life, generally 20 years. In connection with the adoption of SFAS No. 142, the Company ceased amortization of goodwill effective January 1, 2002. As of January 1, 2002, the Company had goodwill of $26.9 million related to its June 2000 acquisition of the remaining interest in Cricket Communications Holdings that it did not already own. SFAS No. 142 requires goodwill to be tested for impairment as of January 1, 2002 and at least annually thereafter. The Company completed its transitional impairment review of its goodwill during the three months ended March 31, 2002 and concluded that no impairment exists. The Company recognized $0.4 million and $0.7 million of goodwill amortization expense for the three and six months ended June 30, 2001, respectively.

Impairment of Long-lived and Intangible Assets

In October 2001, the FASB issued SFAS No. 144 Accounting for the Impairment or Disposal of Long-Lived Assets. SFAS No. 144 replaces SFAS No. 121 Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of. SFAS No. 144 applies to all long-lived assets (including discontinued operations) and consequently amends Accounting Principles Board Opinion No. 30, Reporting Results of Operations Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual, and Infrequently Occurring Events and Transactions. SFAS No. 144 develops one accounting model for long-lived assets that are to be disposed of by sale. SFAS No. 144 requires that long-lived assets that are to be disposed of by sale be measured at the lower of carrying value or fair value less cost to sell. Additionally, SFAS No. 144 expands the scope of discontinued operations to include all components of an entity with operations that (1) can be distinguished from the rest of the entity and (2) will be eliminated from the ongoing operations of the entity in a disposal transaction. The Company adopted SFAS No. 144 on January 1, 2002. The adoption of SFAS No. 144 did not have a material impact on the Company s consolidated financial position or its results of operations.

Basic and Diluted Net Income (Loss) Per Common Share

Basic earnings per common share is calculated by dividing net income (loss) by the weighted average number of common shares outstanding during the reporting period. Diluted earnings per common share reflects the potential dilutive effect of additional common shares that are issuable upon exercise of outstanding stock options and warrants calculated using the treasury stock method and the conversion of convertible preferred securities using the as-if converted method.

Recent Accounting Requirements

In June 2001, the FASB issued SFAS No. 143 Accounting for Asset Retirement Obligations. SFAS No. 143 addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. It applies to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development and/or normal operation of a long-lived asset. The Company will adopt SFAS No. 143 on January 1, 2003. The Company has not yet determined the financial impact the adoption of SFAS No. 143 will have on its consolidated financial position or its results of operations.

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LEAP WIRELESS INTERNATIONAL, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In June 2002, the FASB issued SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities. SFAS No. 146 requires that a liability associated with an exit or disposal activity be recognized at its fair value when the liability has been incurred, and supercedes EITF Issue No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity. Under EITF Issue No. 94-3, certain exit costs were accrued upon management s commitment to an exit plan, which is generally before an actual liability has been incurred. The Company will adopt SFAS No. 146 on January 1, 2003. The Company has not yet determined the financial impact the adoption of SFAS No. 146 will have on its consolidated financial position or its results of operations.

Reclassifications

Certain prior period amounts have been reclassified to conform to the current period presentation.

Note 2. Supplementary Financial Information

Supplementary Balance Sheet Information (in thousands):

	June 30, 2002	December 31, 2001
	(Unaudited)	
Property and equipment, net:		
Network infrastructure	$	