ILLUMINA INC
Form 10-Q
May 07, 2014
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

þ Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the Quarterly Period Ended March 30, 2014

¨ 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 001-35406
Illumina, Inc.
(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	33-0804655 (I.R.S. Employer Identification No.)
5200 Illumina Way, San Diego, CA (Address of principal executive offices)	92122 (Zip Code)

(858) 202-4500
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ 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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes þ No ¨

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

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

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

As of April 11, 2014, there were 128.4 million shares of the registrant's Common Stock outstanding.

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PART I. FINANCIAL INFORMATION
Item 1. Financial Statements.

ILLUMINA, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands)

	March 30, 2014 (Unaudited)	December 29, 2013
ASSETS		
Current assets:		
Cash and cash equivalents	$518,513	$711,637
Short-term investments	573,289	453,966
Accounts receivable, net	293,045	238,946
Inventory	164,231	154,099
Deferred tax assets, current portion	40,349	36,076
Prepaid expenses and other current assets	42,516	22,811
Total current assets	1,631,943	1,617,535
Property and equipment, net	210,372	202,666
Goodwill	723,259	723,061
Intangible assets, net	316,984	331,173
Deferred tax assets, long-term portion	101,336	88,480
Other assets	69,676	56,091
Total assets	$3,053,570	$3,019,006
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$86,471	$73,655
Accrued liabilities	215,292	219,120
Long-term debt, current portion	848,016	29,288
Total current liabilities	1,149,779	322,063
Long-term debt	—	839,305
Long-term legal contingencies	138,780	132,933
Other long-term liabilities	191,398	191,221
Conversion option subject to cash settlement	—	282
Stockholders' equity:		
Preferred stock	—	—
Common stock	1,778	1,753
Additional paid-in capital	2,681,983	2,562,705
Accumulated other comprehensive income	1,208	1,234
Retained earnings	267,832	207,855
Treasury stock, at cost	(1,379,188)	(1,240,345)
Total stockholders' equity	1,573,613	1,533,202
Total liabilities and stockholders' equity	$3,053,570	$3,019,006

See accompanying notes to the condensed consolidated financial statements.

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

	Three Months Ended	
	March 30, 2014	March 31, 2013
Revenue:		
Product revenue	$362,211	$296,170
Service and other revenue	58,570	34,788
Total revenue	420,781	330,958
Cost of revenue:		
Cost of product revenue	111,441	89,978
Cost of service and other revenue	21,513	15,138
Amortization of acquired intangible assets	9,535	6,550
Total cost of revenue	142,489	111,666
Gross profit	278,292	219,292
Operating expense:		
Research and development	77,041	61,450
Selling, general and administrative	109,573	85,074
Acquisition related (gain) expense, net	(1,013)	3,821
Headquarter relocation	595	757
Legal contingencies	—	105,853
Unsolicited tender offer related expense	—	7,484
Total operating expense	186,196	264,439
Income (loss) from operations	92,096	(45,147)
Other income (expense):		
Interest income	956	1,933
Interest expense	(9,743)	(9,747)
Cost-method investment related gain	—	6,113
Other income (expense), net	479	(714)
Total other expense, net	(8,308)	(2,415)
Income (loss) before income taxes	83,788	(47,562)
Provision for (benefit from) income taxes	23,811	(24,975)
Net income (loss)	$59,977	$(22,587)
Net income (loss) per basic share	$0.47	$(0.18)
Net income (loss) per diluted share	$0.40	$(0.18)
Shares used in calculating basic net income (loss) per share	128,146	123,768
Shares used in calculating diluted net income (loss) per share	150,619	123,768

See accompanying notes to the condensed consolidated financial statements.

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ILLUMINA, INC.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(Unaudited)
(In thousands)

	Three Months Ended	
	March 30, 2014	March 31, 2013
Net income (loss)	$59,977	$(22,587)
Unrealized loss on available-for-sale securities, net of deferred tax	(26)	(420)
Total comprehensive income (loss)	$59,951	$(23,007)

See accompanying notes to the condensed consolidated financial statements.

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

	Three Months Ended	
	March 30, 2014	March 31, 2013
Cash flows from operating activities:		
Net income (loss)	$59,977	$(22,587)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation expense	14,593	11,759
Amortization of intangible assets	13,814	8,772
Share-based compensation expense	33,424	24,219
Accretion of debt discount	8,992	9,009
Contingent compensation expense	2,417	1,393
Incremental tax benefit related to share-based compensation	(50,528)	(5,278)
Deferred income taxes	33,943	(36,704)
Change in fair value of contingent consideration	(1,760)	464
Cost-method investment related gain	—	(6,113)
Other	(636)	4,107
Changes in operating assets and liabilities:		
Accounts receivable	(52,156)	6,129
Inventory	(9,991)	(8,266)
Prepaid expenses and other current assets	125	1,536
Other assets	(8,972)	(2,088)
Accounts payable	10,060	8,459
Accrued liabilities	(23,147)	(15,267)
Accrued legal contingencies	5,847	106,922
Other long-term liabilities	1,085	1,374
Net cash provided by operating activities	37,087	87,840
Cash flows from investing activities:		
Purchases of available-for-sale securities	(253,255)	(97,480)
Sales of available-for-sale securities	89,030	278,181
Maturities of available-for-sale securities	44,075	111,333
Net cash paid for acquisitions	—	(345,111)
(Purchases of) sales proceeds from strategic investments	(4,600)	9,998
Purchases of property and equipment	(19,012)	(21,441)
Cash paid for intangible assets	(625)	(501)
Net cash used in investing activities	(144,387)	(65,021)
Cash flows from financing activities:		
Payments on financing obligations	(29,654)	(58)
Payments on acquisition related contingent consideration liability	—	(3,985)
Incremental tax benefit related to share-based compensation	50,528	5,278
Common stock repurchases	(130,017)	(25,011)
Taxes paid related to net share settlement of equity awards	(8,826)	(2,468)
Proceeds from issuance of common stock	32,045	13,238
Net cash used in financing activities	(85,924)	(13,006)
Effect of exchange rate changes on cash and cash equivalents	100	(712)

Net (decrease) increase in cash and cash equivalents	(193,124)	9,101
Cash and cash equivalents at beginning of period	711,637	433,981
Cash and cash equivalents at end of period	$518,513	$443,082

See accompanying notes to the condensed consolidated financial statements.

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Illumina, Inc.
Notes to Condensed Consolidated Financial Statements
(Unaudited)
Unless the context requires otherwise, references in this report to “Illumina,” “we,” “us,” the “Company,” and “our” refer to Illumina, Inc. and its consolidated subsidiaries.

1. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information and 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 GAAP for complete financial statements. The unaudited condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All intercompany transactions and balances have been eliminated in consolidation. In management’s opinion, the accompanying financial statements reflect all adjustments, consisting of normal recurring adjustments, considered necessary for a fair presentation of the results for the interim periods presented.

Interim financial results are not necessarily indicative of results anticipated for the full year. These unaudited condensed consolidated financial statements should be read in conjunction with the Company’s audited consolidated financial statements and footnotes included in the Company’s Annual Report on Form 10-K for the fiscal year ended December 29, 2013, from which the balance sheet information herein was derived.

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expense, and related disclosure of contingent assets and liabilities. Actual results could differ from those estimates.

Segment Information

Effective December 30, 2013, the Company reorganized and separated the roles of the Chief Executive Officer and the President, with core market and operational functions centralized and reporting to the President for the primary purpose of achieving scalability in business operations to support the growth in its strategic markets. Corporate functions and the President report to the CEO. As a result, the Company operates under one operating segment and reports under one reportable segment.

Fiscal Year

The Company’s fiscal year consists of 52 or 53 weeks ending the Sunday closest to December 31, with quarters of 13 or 14 weeks ending the Sunday closest to March 31, June 30, September 30, and December 31. The three months ended March 30, 2014 and March 31, 2013 were both 13 weeks.

Derivatives

The Company is exposed to foreign exchange rate risks in the normal course of business. To manage a portion of the accounting exposure resulting from changes in foreign currency exchange rates, the Company enters into foreign exchange contracts to hedge monetary assets and liabilities that are denominated in currencies other than the U.S. dollar. These foreign exchange contracts are carried at fair value and are not designated as hedging instruments. Changes in the value of the derivative are recognized in other expense, net, along with an offsetting remeasurement gain or loss on the underlying foreign currency denominated assets or liabilities.

As of March 30, 2014, the Company had foreign exchange forward contracts in place to hedge exposures in the euro, Japanese yen, and Australian dollar. As of March 30, 2014 and December 29, 2013, the total notional amounts of outstanding forward contracts in place for foreign currency purchases were approximately $74.7 million and $54.7 million, respectively.

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Reserve for Product Warranties

The Company generally provides a one-year warranty on instruments. Additionally, the Company provides a warranty on consumables through the expiration date, which generally ranges from six to twelve months after the manufacture date. At the time revenue is recognized, the Company establishes an accrual for estimated warranty expenses based on historical experience as well as anticipated product performance. The Company periodically reviews the adequacy of its warranty reserve and adjusts the warranty accrual, if necessary, based on actual experience and estimated costs to be incurred. Warranty expense is recorded as a component of cost of product revenue.

Revenue Recognition

The Company's revenue is generated primarily from the sale of products and services. Product revenue primarily consists of sales of instruments and consumables used in genetic analysis. Service and other revenue primarily consists of revenue generated from genotyping and sequencing services and instrument service contracts.

The Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the seller's price to the buyer is fixed or determinable, and collectibility is reasonably assured. In instances where final acceptance of the product or system is required, revenue is deferred until all the acceptance criteria have been met. All revenue is recorded net of any discounts.

Revenue from product sales is recognized generally upon transfer of title to the customer, provided that no significant obligations remain and collection of the receivable is reasonably assured. Revenue from instrument service contracts is recognized as the services are rendered, typically evenly over the contract term. Revenue from genotyping and sequencing services is recognized when earned, which is generally at the time the genotyping or sequencing analysis data is made available to the customer or agreed upon milestones are reached.

In order to assess whether the price is fixed or determinable, the Company evaluates whether refund rights exist. If there are refund rights or payment terms based on future performance, the Company defers revenue recognition until the price becomes fixed or determinable. The Company assesses collectibility based on a number of factors, including past transaction history with, and the creditworthiness of, the customer. If the Company determines that collection of a payment is not reasonably assured, revenue recognition is deferred until receipt of payment.

The Company regularly enters into contracts where revenue is derived from multiple deliverables including products or services. These products or services are generally delivered within a short time frame, approximately three to six months, after the contract execution date. Revenue recognition for contracts with multiple deliverables is based on the individual units of accounting determined to exist in the contract. A delivered item is considered a separate unit of accounting when the delivered item has value to the customer on a stand-alone basis. Items are considered to have stand-alone value when they are sold separately by any vendor or when the customer could resell the item on a stand-alone basis. Consideration is allocated at the inception of the contract to all deliverables based on their relative selling price. The relative selling price for each deliverable is determined using vendor specific objective evidence (VSOE) of selling price or third-party evidence of selling price if VSOE does not exist. If neither VSOE nor third-party evidence exists, the Company uses its best estimate of the selling price for the deliverable.

In order to establish VSOE of selling price, the Company must regularly sell the product or service on a standalone basis with a substantial majority priced within a relatively narrow range. VSOE of selling price is usually the midpoint of that range. If there are not a sufficient number of standalone sales and VSOE of selling price cannot be determined, then the Company considers whether third party evidence can be used to establish selling price. Due to the lack of similar products and services sold by other companies within the industry, the Company has rarely established selling price using third-party evidence. If neither VSOE nor third party evidence of selling price exists, the Company determines its best estimate of selling price using average selling prices over a rolling 12-month period coupled with an assessment of current market conditions. If the product or service has no history of sales or if the sales volume is not sufficient, the Company relies upon prices set by the Company's pricing committee adjusted for applicable discounts. The Company recognizes revenue for delivered elements only when it determines there are no uncertainties regarding customer acceptance.

In certain markets, the Company sells products and provides services to customers through distributors that specialize in life science products. In most sales through distributors, the product is delivered directly to customers. In cases where the product is delivered to a distributor, revenue recognition is deferred until acceptance is received from the distributor, and/or the end-user, if required by the applicable sales contract. The terms of sales transactions through distributors are consistent with

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the terms of direct sales to customers. These transactions are accounted for in accordance with the Company's revenue recognition policy described herein.

Net Income (Loss) per Share

Basic net income (loss) per share is computed based on the weighted average number of common shares outstanding during the period. Diluted net income (loss) per share is computed based on the sum of the weighted average number of common shares and dilutive potential common shares outstanding during the period.

Dilutive potential common shares consist of shares issuable under convertible senior notes, equity awards, and warrants. Convertible senior notes have a dilutive impact when the average market price of the Company's common stock exceeds the applicable conversion price of the respective notes. Potentially dilutive common shares from equity awards and warrants are determined using the average share price for each period under the treasury stock method. In addition, the following amounts are assumed to be used to repurchase shares: proceeds from exercise of equity awards and warrants; the average amount of unrecognized compensation expense for equity awards; and estimated tax benefits that will be recorded in additional paid-in capital when the expenses related to equity awards become deductible. In loss periods, basic net loss per share and diluted net loss per share are identical because the otherwise dilutive potential common shares become anti-dilutive and are therefore excluded.

The following table presents the calculation of weighted average shares used to calculate basic and diluted net income (loss) per share (in thousands):

	Three Months Ended	
	March 30, 2014	March 31, 2013
Weighted average shares outstanding	128,146	123,768
Effect of dilutive potential common shares from:		
Convertible senior notes	5,518	—
Equity awards	4,816	—
Warrants	12,139	—
Weighted average shares used in calculation of diluted net income (loss) per share	150,619	123,768
Potentially dilutive shares excluded from calculation due to anti-dilutive effect	124	32,942

2. Balance Sheet Account Details

Short-Term Investments

The following is a summary of short-term investments (in thousands):

	March 30, 2014				December 29, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Available-for-sale securities:								
Debt securities in government sponsored entities	$81,077	$26	$(78)	$81,025	$82,226	$18	$(101)	$82,143
Corporate debt securities	427,130	284	(427)	426,987	342,034	312	(376)	341,970
	65,211	70	(4)	65,277	29,795	58	—	29,853

U.S. Treasury securities								
Total available-for-sale securities	$573,418	$380	$(509	) $573,289	$454,055	$388	$(477	) $453,966

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As of March 30, 2014, the Company had 118 available-for-sale securities in a gross unrealized loss position which had been in such position for less than twelve months. There were no impairments considered other-than-temporary as it is more likely than not the Company will hold the securities until maturity or the recovery of the cost basis. The following table shows the fair values and the gross unrealized losses of such available-for-sale securities that were in an unrealized loss position for less than twelve months as of March 30, 2014 and December 29, 2013, aggregated by investment category (in thousands):

	March 30, 2014		December 29, 2013	
	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses
Debt securities in government sponsored entities	$53,076	$(78)	$73,362	$(101)
Corporate debt securities	197,841	(398)	168,118	(373)
U.S. Treasury securities	15,117	(4)	—	—
Total	$266,034	$(480)	$241,480	$(474)

Realized gains and losses are determined based on the specific identification method and are reported in interest income.

Contractual maturities of available-for-sale debt securities as of March 30, 2014 were as follows (in thousands):

	Estimated Fair Value
Due within one year	$204,870
After one but within five years	368,419
Total	$573,289

Cost-Method Investments

As of March 30, 2014 and December 29, 2013, the aggregate carrying amounts of the Company's cost-method investments in non-publicly traded companies were $26.7 million and $22.1 million, respectively, which were included in other assets. During the three months ended March 31, 2013, the Company sold a cost-method investment and recognized a $6.1 million gain. The Company's cost-method investments are assessed for impairment quarterly. No impairment loss was recorded during the three months ended March 30, 2014 or March 31, 2013. The Company does not reassess the fair value of cost-method investments if there are no identified events or changes in circumstances that may have a significant adverse effect on the fair value of the investments.

Headquarter Facility Exit Obligation

Changes in the Company's facility exit obligation related to its former headquarters lease during the three months ended March 30, 2014 and March 31, 2013 are as follows (in thousands):

	Three Months Ended	
	March 30, 2014	March 31, 2013
Balance at beginning of period	$38,218	$45,352
Additional facility exit obligation accrued	—	286
Accretion of interest expense	595	471
Cash payments	(1,633)	(2,201)

Balance at end of period	$37,180	$43,908

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Warranties

Changes in the Company's reserve for product warranties during the three months ended March 30, 2014 and March 31, 2013 are as follows (in thousands):

	Three Months Ended	
	March 30, 2014	March 31, 2013
Balance at beginning of period	$10,407	$10,136
Additions charged to cost of revenue	4,192	5,421
Repairs and replacements	(3,107)	(4,751)
Balance at end of period	$11,492	$10,806

Inventory

Inventory consists of the following (in thousands):

	March 30, 2014	December 29, 2013
Raw materials	$56,798	$57,398
Work in process	78,742	70,016
Finished goods	28,691	26,685
Total inventory	$164,231	$154,099

Goodwill

Changes in the Company's goodwill balance during the three months ended March 30, 2014 are as follows (in thousands):

	Goodwill
Balance as of December 29, 2013	$723,061
Purchase price allocation adjustments related to a prior year acquisition	198
Balance as of March 30, 2014	$723,259

Accrued Liabilities

Accrued liabilities consist of the following (in thousands):

	March 30, 2014	December 29, 2013
Accrued compensation expenses	$66,623	$82,705
Deferred revenue, current portion	59,535	50,834
Accrued taxes payable	30,644	30,435
Customer deposits	14,312	13,569
Reserve for product warranties	11,492	10,407
Acquisition related contingent liability, current portion	6,950	6,719
Facility exit obligation, current portion	6,102	5,570
Other	19,634	18,881
Total accrued liabilities	$215,292	$219,120

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3. Acquisitions

2013 Acquisitions

On February 21, 2013, the Company acquired all of the outstanding capital stock of Verinata Health, Inc., a provider of non-invasive tests for the early identification of fetal chromosomal abnormalities. The aggregate purchase price was $396.3 million, including total cash payment of $339.3 million, $56.2 million in fair value of the contingent milestone payments of up to $100.0 million, $0.2 million in fair value of converted stock options attributed to pre-combination services, and $0.5 million in loss realized on settlement of preexisting relationships.

Assumptions used to estimate the acquisition date fair value of the contingent consideration included discount rates ranging from 6% to 20%, volatility of 50%, risk-free rate of 0.26%, revenue projections, and the probability of achieving regulatory milestones. This fair value measurement of the contingent consideration is based on significant inputs not observed in the market and thus represents a Level 3 measurement. Level 3 instruments are valued based on unobservable inputs that are supported by little or no market activity and reflect the Company’s own assumptions in measuring fair value.

During 2013, the Company also completed acquisitions of Advanced Liquid Logic Inc., a provider of liquid handling solutions, NextBio, a provider of clinical and genomic informatics tools, and another development-stage company. As a result of these transactions, the Company recorded $126.5 million in goodwill. The purchase price allocation for the NextBio acquisition is preliminary and subject to change as more detailed analyses are completed and additional information with respect to the fair values of the assets and liabilities acquired becomes available.

2012 Acquisition

On September 19, 2012, the Company announced the acquisition of BlueGnome Ltd., a provider of cytogenetics and in vitro fertilization screening products. Total consideration for the acquisition was $95.5 million, which included $88.0 million in initial cash payments and $7.5 million in fair value of contingent cash consideration of up to $20.0 million based on the achievement of certain revenue based milestones by December 28, 2014.

Summary of Contingent Compensation Expenses

Contingent compensation expenses recorded as a result of acquisitions consist of the following (in thousands):

	Three Months Ended	
	March 30, 2014	March 31, 2013
Contingent compensation, included in research and development expense	$83	$489
Contingent compensation, included in selling, general and administrative expense	2,756	2,929
Total contingent compensation expense	$2,839	$3,418

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4. Fair Value Measurements

The following table presents the Company’s hierarchy for assets and liabilities measured at fair value on a recurring basis as of March 30, 2014 and December 29, 2013 (in thousands):

	March 30, 2014				December 29, 2013			
	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3	Total
Assets:								
Money market funds (cash equivalents)	$344,622	$—	$—	$344,622	$478,755	$—	$—	$478,755
Debt securities in government-sponsored entities	—	81,025	—	81,025	—	82,143	—	82,143
Corporate debt securities	—	426,987	—	426,987	—	341,970	—	341,970
U.S. Treasury securities	65,277	—						