

NETLOGIC MICROSYSTEMS INC  
Form 10-Q  
November 12, 2004  
Table of Contents

---

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington D.C. 20549

---

**FORM 10-Q**

---

(Mark One)

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

For the quarterly period ended September 30, 2004

OR

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

For the Transition Period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 000-50838

---

**NETLOGIC MICROSYSTEMS, INC.**

(Exact name of registrant as specified in its charter)

---

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**77-0455244**  
(I.R.S. Employer  
Identification No.)

**1875 Charleston Rd.**  
**Mountain View, CA 94043**  
**(650) 961-6676**

(Address and telephone number of principal executive offices)

---

Indicate by check mark whether 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) had been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). Yes  No

The number of shares outstanding of the Registrant's Common Stock, \$0.01 par value, was 17,578,125 as of November 1, 2004.

---

**Table of Contents**

**NETLOGIC MICROSYSTEMS, INC.**

**FORM 10-Q**

**TABLE OF CONTENTS**

	<b><u>Page No.</u></b>
<b>PART I: <u>INTERIM FINANCIAL INFORMATION</u></b>	
Item 1. <u>Financial Statements (unaudited)</u>	3
<u>Condensed Balance Sheets as of September 30, 2004 and December 31, 2003</u>	3
<u>Condensed Statements of Operations for the three and nine months ended September 30, 2004 and September 30, 2003</u>	4
<u>Condensed Statements of Cash Flows for the nine months ended September 30, 2004 and September 30, 2003</u>	5
<u>Notes to Unaudited Condensed Financial Statements</u>	6
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	12
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	31
Item 4. <u>Controls and Procedures</u>	32
<b>PART II: <u>OTHER INFORMATION</u></b>	
Item 2. <u>Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities</u>	32
Item 6. <u>Exhibits</u>	32
<u>Signatures</u>	33

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

## NETLOGIC MICROSYSTEMS, INC.

## CONDENSED BALANCE SHEETS

(IN THOUSANDS)

(UNAUDITED)

	September 30, 2004	December 31, 2003
	<u>          </u>	<u>          </u>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 39,636	\$ 13,155
Restricted cash		5,000
Short-term investments		2,995
Accounts receivable, net	3,634	4,062
Inventory	8,471	3,584
Prepaid expenses and other current assets	1,731	560
	<u>          </u>	<u>          </u>
Total current assets	53,472	29,356
Property and equipment, net	2,105	2,031
Other assets	50	457
	<u>          </u>	<u>          </u>
Total assets	<u>\$ 55,627</u>	<u>\$ 31,844</u>
<b>LIABILITIES, REDEEMABLE CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS EQUITY (DEFICIT)</b>		
Current liabilities:		
Revolving line of credit	\$	\$ 9,910
Accounts payable	3,961	3,581
Accrued liabilities	4,152	8,118
Deferred revenue		500
Capital lease obligations, current	276	351
	<u>          </u>	<u>          </u>
Total current liabilities	8,389	22,460
Capital lease obligations, long-term	6	135
Other liabilities	72	
	<u>          </u>	<u>          </u>
Total liabilities	8,467	22,595
	<u>          </u>	<u>          </u>
Redeemable convertible preferred stock		91,600
	<u>          </u>	<u>          </u>

Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-Q

Stockholders' equity (deficit):		
Common stock	176	36
Additional paid-in capital	150,932	10,686
Notes receivable from stockholders	(515)	(1,620)
Deferred stock-based compensation	(4,326)	(4,300)
Accumulated deficit	(99,107)	(87,153)
	<u>47,160</u>	<u>(82,351)</u>
Total liabilities, redeemable convertible preferred stock and stockholders' equity (deficit)	<u>\$ 55,627</u>	<u>\$ 31,844</u>

The accompanying notes are an integral part of these unaudited condensed financial statements.

**Table of Contents**

## NETLOGIC MICROSYSTEMS, INC.

## CONDENSED STATEMENTS OF OPERATIONS

(IN THOUSANDS, EXCEPT FOR PER SHARE AMOUNTS)

(UNAUDITED)

	Three months ended September 30,		Nine months ended September 30,	
	2004	2003	2004	2003
<b>Revenue:</b>				
Product revenue	\$ 12,441	\$ 2,594	\$ 31,456	\$ 5,106
License and engineering service revenue		8	1,128	3,013
<b>Total revenue</b>	<b>12,441</b>	<b>2,602</b>	<b>32,584</b>	<b>8,119</b>
<b>Cost of revenue:</b>				
Cost of product revenue (1)	6,861	8,248	18,766	10,015
Cost of license and engineering service revenue		2		5
<b>Total cost of revenue</b>	<b>6,861</b>	<b>8,250</b>	<b>18,766</b>	<b>10,020</b>
<b>Gross profit</b>	<b>5,580</b>	<b>(5,648)</b>	<b>13,818</b>	<b>(1,901)</b>
<b>Operating expenses:</b>				
Research and development	3,891	4,634	12,365	12,346
Selling, General and Administrative	1,735	1,201	4,895	3,256
Stock-based compensation (2)	1,090	683	4,616	1,495
<b>Total operating expenses</b>	<b>6,716</b>	<b>6,518</b>	<b>21,876</b>	<b>17,097</b>
<b>Loss from operations</b>	<b>(1,136)</b>	<b>(12,166)</b>	<b>(8,058)</b>	<b>(18,998)</b>
<b>Other income (expense), net:</b>				
Interest income	94	71	207	305
Interest expense	(2,564)	(21)	(3,996)	(82)
Other income (expense), net	(32)	(12)	(108)	(62)
<b>Total interest and other income (expense), net</b>	<b>(2,502)</b>	<b>38</b>	<b>(3,897)</b>	<b>161</b>
<b>Net loss</b>	<b>\$ (3,638)</b>	<b>\$ (12,128)</b>	<b>\$ (11,955)</b>	<b>\$ (18,837)</b>
<b>Net loss per share - Basic and Diluted</b>	<b>\$ (0.22)</b>	<b>\$ (3.68)</b>	<b>\$ (1.50)</b>	<b>\$ (5.23)</b>
<b>Shares used in calculation - Basic and Diluted</b>	<b>16,243</b>	<b>3,292</b>	<b>7,954</b>	<b>3,599</b>

## Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-Q

(1) Stock-based compensation included in cost of product revenue	\$ 67	\$ 11	\$ 168	\$ 71
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
(2) Components of stock-based compensation included in operating expenses:				
Research and development	\$ 410	\$ 447	\$ 1,843	\$ 974
Selling, general and administrative	680	236	2,773	521
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Total	\$ 1,090	\$ 683	\$ 4,616	\$ 1,495
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

The accompanying notes are an integral part of these unaudited condensed financial statements.

**Table of Contents**

## NETLOGIC MICROSYSTEMS, INC.

## CONDENSED STATEMENTS OF CASH FLOWS

(IN THOUSANDS)

(UNAUDITED)

	Nine months ended September 30,	
	2004	2003
<b>Cash flows from operating activities:</b>		
Net loss	\$ (11,955)	\$ (18,837)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,223	1,766
Issuance of stock options for services	11	6
Non-cash interest expense	3,445	22
Provision for allowance for doubtful accounts	192	102
Amortization of deferred stock-based compensation	4,784	1,566
Changes in assets and liabilities:		
Accounts receivable	236	(831)
Inventory	(4,887)	(2,294)
Prepaid expenses and other assets	(616)	(4,802)
Accounts payable	380	(945)
Accrued liabilities	(3,966)	7,125
Deferred revenue	(500)	(550)
Other long-term liabilities	72	
<b>Net cash used in operating activities</b>	<b>(11,581)</b>	<b>(17,672)</b>
<b>Cash flows from investing activities:</b>		
Purchase of fixed assets	(1,034)	(1,070)
Sale (purchase) of short-term investments, net	2,995	(2,398)
Restricted cash	5,000	
<b>Net cash provided by (used in) investing activities</b>	<b>6,961</b>	<b>(3,468)</b>
<b>Cash flows from financing activities:</b>		
Proceeds from convertible promissory notes	7,650	
Repayment of convertible promissory notes	(7,650)	
Proceeds from initial public offering, net	39,228	
Proceeds from issuance of common stock	1,048	49
Repurchase of restricted common stock for cash		(48)
Principal payments on capital lease obligations	(347)	(47)
Proceeds from notes payable and lines of credit	560	5,661
Repayment of notes payable and lines of credit	(10,470)	(1,755)
Proceeds from repayment of notes receivable from stockholders	1,082	57
<b>Net cash provided by financing activities</b>	<b>31,101</b>	<b>3,917</b>
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>26,481</b>	<b>(17,223)</b>



## Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-Q

Cash and cash equivalents at the beginning of the period	13,155	37,881
	<u>          </u>	<u>          </u>
Cash and cash equivalents at the end of the period	\$ 39,636	\$ 20,658
	<u>          </u>	<u>          </u>
Supplemental disclosure of cash flow information:		
Cash paid for interest	\$ 276	\$ 55
	<u>          </u>	<u>          </u>
Supplemental disclosure of non-cash investing and financing activities:		
Acquisition of property and equipment under capital leases	\$ 143	\$ 441
	<u>          </u>	<u>          </u>
Repurchase of restricted common stock through cancellation of stockholder notes	\$ 23	\$ 124
	<u>          </u>	<u>          </u>
Issuance of warrants in connection with the lines of credit	\$ 223	\$ 17
	<u>          </u>	<u>          </u>
Conversion of redeemable convertible preferred stock into common stock	\$ 91,600	\$
	<u>          </u>	<u>          </u>

The accompanying notes are an integral part of these unaudited condensed financial statements.

**Table of Contents**

**NetLogic Microsystems, Inc.**

**Notes to Condensed Financial Statements**

**(Unaudited)**

**1. Basis of Presentation**

The accompanying unaudited condensed financial statements of NetLogic Microsystems, Inc. ( we, our and the Company ) have been prepared in accordance with accounting principles generally accepted in the United States of America and with the instructions for Form 10-Q and Regulation S-X statements. Accordingly, they do not include all of the information and notes required for complete financial statements. In the opinion of management, all adjustments and reclassifications considered necessary for a fair and comparable presentation have been included and are of a normal recurring nature. Operating results for the three and nine-month periods ended September 30, 2004 are not necessarily indicative of the results that may be expected for the year ending December 31, 2004.

On July 8, 2004, the Securities and Exchange Commission declared effective our registration statement, which we filed on Form S-1 under the Securities Act of 1933 in connection with an initial public offering of our common stock. Under this registration statement, we registered 5,775,000 shares of our common stock, excluding shares subject to the underwriters' overallotment option (which was not exercised), with a public offering price of \$12 per share. We sold 3,736,876 shares and certain stockholders of the Company sold the remaining 2,038,124 shares. We received \$39.2 million in proceeds after deducting underwriters' fees and other transaction costs. In connection with the initial public offering, 38,560,664 shares of redeemable convertible preferred stock were converted into 9,640,145 shares of common stock and the carrying value of convertible preferred stock was reclassified to common stock and additional paid-in capital.

**2. Significant Accounting Policies**

*Revenue Recognition*

We derive revenue mainly from product sales and, to a lesser extent, from licensing of our technology and engineering services.

Revenue from product sales is recognized upon shipment when persuasive evidence of an arrangement exists, legal title and risk of ownership has transferred, the price is fixed or determinable, and collection of the resulting receivables is reasonably assured. We have no obligation to provide any modification or customization, upgrades, enhancements, post-contract customer supports, additional products or enhancements. Our customers have no rights of return unless the product does not perform according to specifications. Provisions for warranty expenses are recorded when revenue is recognized.

From time to time, we perform engineering services for third parties. Engineering service revenue is recognized as services are performed, agreed-upon milestones are achieved and customer acceptance, if required, is received from the customer.

## Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-Q

In 2002, we entered into a license and technology transfer agreement with Micron Technology, which was subsequently amended in May 2003. Under the terms of the agreement, we are entitled to receive payments related to the licensing of certain technology and completion of certain milestones. Revenue related to the licensing of our technology was recognized upon signing the amended agreement as the technology had been delivered, the price was fixed and all of our obligations had been met. Revenue related to milestone payments is recognized on a cash-receipt basis.

### **3. Stock-Based Compensation**

We account for stock-based employee compensation arrangements using the intrinsic value method prescribed by Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, ( APB No. 25 ) and the related interpretation, Financial Accounting Standards Board Interpretation ( FIN ) No. 44 Accounting for Certain Transactions Involving Stock Compensation.

We provide additional pro forma disclosures as required under Statement of Financial Accounting Standards ( SFAS ) No. 123 Accounting for Stock-Based Compensation and SFAS No. 148, Accounting for Stock-Based Compensation, Transition and Disclosure.

**Table of Contents**

The following table illustrates the effect on our net loss as if we had recorded compensation costs based on the estimated grant date fair value as defined by SFAS No. 123 for all granted stock-based awards (in thousands, except per share data):

	Three months ended September 30,		Nine months ended September 30,	
	2004	2003	2004	2003
Net loss - as reported	\$ (3,638)	\$ (12,128)	\$ (11,955)	\$ (18,837)
Add: stock-based compensation expense included in reported net loss	1,157	694	4,784	1,566
Deduct: stock-based compensation expense determined under fair value based method for all awards	(1,996)	(783)	(5,863)	(1,778)
Net loss - pro forma	\$ (4,477)	\$ (12,217)	\$ (13,034)	\$ (19,049)
Net loss per common share - basic and diluted:				
As reported	\$ (0.22)	\$ (3.68)	\$ (1.50)	\$ (5.23)
Pro forma	\$ (0.28)	\$ (3.71)	\$ (1.64)	\$ (5.29)

We account for equity instruments issued to non-employees in accordance with the provisions of SFAS No. 123 and Emerging Issues Task Force Consensus No. 96-18, Accounting for Equity Instruments That are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services ( EITF 96-18 ). Under SFAS No. 123 and EITF 96-18, equity instruments issued to non-employees are accounted for at fair value using the Black-Scholes option pricing model. We believe that the fair value of the equity instruments is more reliably measured than the fair value of the services received. The fair value of each non-employee equity instrument is remeasured at each period until a commitment date is reached, which is generally the vesting date.

*Fair value disclosures*

We calculated the fair value of each option grant on the date of grant using the following assumptions:

	Three months ended September 30,		Nine months ended September 30,	
	2004	2003	2004	2003
Risk-free interest rate	3.43%	2.44% - 3.07%	2.70% - 3.62%	1.95% - 3.07%
Expected life of options	4 years	4 years	4 years	4 years
Expected dividend yield	0%	0%	0%	0%
Volatility	80%	0%	0% - 80%	0%

## Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-Q

The weighted average fair value of employee stock option grants was \$7.26 and \$11.96 for the three months ended September 30, 2004 and 2003, respectively, and \$9.38 and \$10.30 for the nine months ended September 30, 2004 and 2003, respectively.

### **4. Basic and Diluted Net Loss Per Share**

We compute net loss per share in accordance with SFAS 128, Earnings per Share. Basic net income (loss) per share is computed by dividing net income attributable to common stockholders (numerator) by the weighted average number of common shares outstanding (denominator) during the period. Diluted net income per share gives effect to all dilutive potential common shares outstanding during the period including stock options and warrants using the treasury stock method and preferred stock using the as-if-converted method.

**Table of Contents**

The following is a reconciliation of the weighted average common shares used to calculate basic net loss per share to the weighted average common and potential common shares used to calculate diluted net loss per share for the three and nine months ended September 30, 2004 and 2003 (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2004	2003	2004	2003
<b>Numerator:</b>				
Net loss	\$ (3,638)	\$ (12,128)	\$ (11,955)	\$ (18,837)
<b>Denominator:</b>				
Weighted-average common shares outstanding	16,552	3,582	8,263	3,606
Less: shares subject to repurchase	(309)	(290)	(309)	(290)
Shares used in calculation - basic and diluted	16,243	3,292	7,954	3,316

For the three and nine months ended September 30, 2004, employee stock options to purchase 1.9 million shares of common stock were excluded from the computation of diluted net loss per share as their effect would be anti-dilutive.

**5. Cash, Cash Equivalents and Short-term Investments**

We consider all highly liquid investments purchased with a remaining maturity of three months or less at the date of purchase to be cash equivalents. Short-term investments comprise primarily debt instruments that have been classified as available-for-sale. Short-term investments are carried at their fair market value based on quoted market prices as of the balance sheet date. Realized gains or losses are determined on the specific identification method and are reflected in income. Short-term investments at December 31, 2003, were acquired at an aggregate cost of \$3.0 million. Unrealized gains and losses at September 30, 2004 and December 31, 2003 were not material.

Cash, cash equivalents and short-term investments consist of the following (in thousands):

	September 30, 2004	December 31, 2003
<b>Cash and cash equivalents:</b>		
Cash and money market funds	\$ 36,838	\$ 12,905
Commercial paper	2,798	250
	\$ 39,636	\$ 13,155
<b>Short-term investments:</b>		

Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-Q

U.S. Government debt securities	\$	\$ 2,995
	<u>          </u>	<u>          </u>

**6. Balance Sheet Components**

The components of our inventory at September 30, 2004 and December 31, 2003 were as follows (in thousands):

	September 30, 2004	December 31, 2003
	<u>          </u>	<u>          </u>
<b>Inventories:</b>		
Finished goods	\$ 4,717	\$ 229
Work-in-progress	3,754	3,355
	<u>          </u>	<u>          </u>
	<u>\$ 8,471</u>	<u>\$ 3,584</u>

**Table of Contents**

The components of our accrued liabilities at September 30, 2004 and December 31, 2003 were as follows (in thousands):

	September 30, 2004	December 31, 2003
	<u>          </u>	<u>          </u>
<b>Accrued liabilities:</b>		
Accrued inventory	\$ 1,390	\$ 812
Adverse purchase commitments	418	3,365
Other accrued liabilities	2,344	3,941
	<u>          </u>	<u>          </u>
	<u>\$ 4,152</u>	<u>\$ 8,118</u>

**7. Product Warranties**

We provide a limited warranty on our products for one year from the date of sale. We provide for the estimated future costs of repair or replacement upon shipment of the product. Our warranty accrual is estimated based on actual and historical claims compared to historical revenue and assumes that we have to replace products subject to a claim. The following table summarizes the activity related to the product warranty liability during the three and nine months ended September 30, 2004 (in thousands):

	Three months ended September 30, 2004	Nine months ended September 30, 2004
	<u>          </u>	<u>          </u>
<b>Warranty accrual:</b>		
Beginning balance	\$ 651	\$ 1,051
Settlements made during the period		(400)
Provision for warranty		
Change in estimate	(300)	(300)
	<u>          </u>	<u>          </u>
Ending balance	<u>\$ 351</u>	<u>\$ 351</u>

During the three months ended September 30, 2004, we reassessed the warranty accrual requirements based on our most recent warranty expense data as our manufacturing yield became normalized. As a result of this reassessment, we released approximately \$0.3 million of warranty accrual during the three months ended September 30, 2004.

**8. Revolving line of credit**

In October 2003, we entered into an agreement with Silicon Valley Bank to establish a working capital and accounts receivable line of credit (the Working Capital Line), which enabled us to borrow up to \$4.5 million for working capital purposes and up to \$3.0 million based on certain outstanding accounts receivable balances. The terms of the loan required \$5.0 million to be on deposit with the bank and this amount was



## Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-Q

included as restricted cash on the balance sheet at December 31, 2003.

In July 2004, we repaid in full \$10.5 million outstanding under a line of credit (the Working Capital Line). Subsequent to our initial public offering on July 8, 2004, the Working Capital Line was amended and our line of credit was increased to \$14.5 million available for general working capital purposes. As of September 30, 2004, we had no balance outstanding under the Working Capital Line. Borrowings under the Working Capital Line will bear interest at a rate of the Silicon Valley Bank prime rate plus one quarter of one percent, or 4.25%, whichever is higher, except in the event of our default in which case the interest rate would be increased by 5% over the rate in effect immediately before the event of default. The Working Capital Line is secured by all of our assets, including receivables and intangible assets, but excluding our intellectual property. To maintain the Working Capital Line, our total unrestricted cash, cash equivalents and marketable securities must be at least \$30 million. We complied with this covenant as of September 30, 2004.

### **9. Convertible Promissory Notes**

In March 2004, we issued \$7.6 million in convertible promissory notes (the Notes) bearing interest at 10.0% per annum and warrants to purchase 76,500 shares of common stock at \$2.00 per share. The Notes were issued to existing stockholders, directors and management. The Notes were convertible at a conversion price of \$3.25 at the option of the holder in March 2005 into approximately 2.6 million shares of Series D Redeemable Convertible Preferred Stock, if not earlier repaid. The difference between the conversion price and the fair value of the common stock on the transaction date resulted in a

## **Table of Contents**

beneficial conversion feature of \$2.5 million. The warrants had a fair value of \$1.0 million, estimated using the Black-Scholes valuation model, with a risk-free interest rate of 2.44%, a four-year life of the warrants, expected dividend yield of zero, volatility of 90% and a fair value of \$3.55. The beneficial conversion feature and the fair value of the warrants were reflected as a discount to the promissory notes. Both the beneficial conversion feature and the warrants were being charged to interest expense over the term of the notes.

In July 2004, the promissory notes and accrued interest were repaid in full following the closing of the initial public offering of our common stock. The unamortized value of the beneficial conversion feature and the warrants of \$2.5 million at the time of notes repayment was charged to interest expense during the three months ended September 30, 2004.

## **10. Commitments and Contingencies**

### *Purchase Commitments*

At September 30, 2004, we had approximately \$7.0 million in non-cancelable purchase commitments with suppliers. We have recorded a liability of \$0.4 million for adverse purchase commitments related to a portion of these commitments which is considered unsalable.

### *Contingencies*

We may be party to claims and litigation proceedings arising from time to time in the normal course of business. Although the legal responsibility and financial impact with respect to such claims and litigation cannot currently be ascertained, we do not believe that we currently have any matters that will result in the payment of monetary damages, net of any applicable insurance proceeds, that, in the aggregate, would be material in relation to our consolidated financial position or results of operations. There can be no assurance that any such matters will be resolved without costly litigation, in a manner that is not adverse to our financial position, results of operations or cash flows, or without requiring royalty payments in the future, which may adversely impact gross margins.

### *Indemnities, Commitments and Guarantees*

In the normal course of business, we have made certain indemnities, commitments and guarantees under which we may be required to make payments in relation to certain transactions. These indemnities include intellectual property indemnities to our customers in connection with the sales of our products, indemnities for liabilities associated with the infringement of other parties' technology based upon our products, indemnities to various lessors in connection with facility leases for certain claims arising from such facility or lease, and indemnities to our directors and officers to the maximum extent permitted under the laws of the state of Delaware. The duration of each of these indemnities, commitments and guarantees varies and, in certain cases, is indefinite. We have not recorded any liability for these indemnities, commitments and guarantees in the accompanying balance sheets. We do, however, accrue for losses for any known contingent liability, including those that may arise from indemnification provisions, when future payment is probable.

## **11. Related Party Transactions**

## Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-Q

In May 2004, we entered into a lease agreement (the Lease Agreement ) for our headquarters facility in Mountain View, California with an affiliate of Berg & Berg Enterprises, LLC (the Affiliate ), which is currently a holder of more than 5.0% of our voting securities. Prior to entering into the Lease Agreement, we had a sublease agreement (the Sublease ) for our previous headquarters facility with a lessee of the Affiliate. During the nine months ended September 30, 2004, we made lease payments of approximately \$138,000 in aggregate under the Lease Agreement and the Sublease.

**Table of Contents****12. Operating Segments and Geographic Information**

We operate in one business segment. We sell our products directly to customers in the United States, Asia and Europe. Sales for geographic regions reported below are based upon the customer headquarter locations. Following is a summary of geographic information related to revenue for the three months ended September 30, 2004 and 2003 and for the nine months ended September 30, 2004 and 2003 (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2004	2003	2004	2003
Revenue:				
North America	\$ 11,758	\$ 1,951	\$ 30,551	\$ 7,075
Asia	550	179	1,250	302
Europe	133	472	783	742
<b>Total</b>	<b>\$ 12,441</b>	<b>\$ 2,602</b>	<b>\$ 32,584</b>	<b>\$ 8,119</b>

The following table summarizes the revenue from customers representing in excess of 10% of the total revenue:

	Three months ended September 30,		Nine months ended September 30,	
	2004	2003	2004	2003
Customer A	76%	17%	69%	12%
Customer B	0%	0%	3%	37%
Customer C	6%	22%	8%	14%
Customer D	3%	14%	2%	7%
Customer E	1%	15%	2%	5%

**13. Recent Accounting Pronouncements***EITF 03-01 The Meaning of Other-Than-Temporary Impairment and its Application to Certain Issues*

In March 2004, the Emerging Issues Task Force ( EITF ) amended and ratified previous consensus reached on EITF 03-01, *The Meaning of Other-Than-Temporary Impairment*, to introduce a three-step model to: 1) determine whether an investment is impaired; 2) evaluate whether the impairment is other-than-temporary; and 3) account for other-than-temporary impairments. In part, this amendment requires companies to apply qualitative and quantitative measures to determine whether a decline in the fair value of a security is other-than-temporary. The amount of other-than-temporary impairments to be recognized, if any, will be dependent on market conditions and management's intentions and ability at the time of evaluation to hold underwater investments until forecasted recovery in the fair value up to and beyond the adjusted cost. This

## Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-Q

amendment is effective for financial periods beginning after June 15, 2004. The adoption of EITF 03-01 did not have a material impact on our results of operations or financial conditions.

## **Table of Contents**

### **Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations**

#### **Forward-looking Statements**

*This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, which include, without limitation, statements about the market for our technology, our strategy and competition. Such statements are based upon current expectations that involve risks and uncertainties. Any statements contained herein that are not statements of historical fact may be deemed forward-looking statements. For example, the words believes, anticipates, plans, expects, intends and similar expressions are intended to identify forward-looking statements. Our actual results and the timing of certain events may differ significantly from the results discussed in the forward-looking statements. Factors that might cause such a discrepancy include, but are not limited to, those discussed in Overview, Results of Operations, Liquidity and Capital Resources and Risks Factors below. All forward-looking statements in this document are based on information available to us as of the date hereof and we assume no obligation to update any such forward-looking statements. The following discussion should be read in conjunction with our condensed financial statements and the accompanying notes contained in this quarterly report. Unless expressly stated or the context otherwise requires, the terms we, our, us and NetLogic Microsystems refer to NetLogic Microsystems, Inc.*

#### **Overview**

We are a fabless semiconductor company that designs, develops, and markets high performance knowledge-based processors for a variety of advanced Internet, corporate and other networking systems, such as routers, switches, network access equipment and networked storage devices offered by companies such as Alcatel, ARRIS, Atrica, Cisco, Extreme Networks, Fujitsu, Foundry Networks, Force10, Hitachi, Huawei, Juniper Networks and Nortel Networks.

We organized our business in 1995 to design and develop integrated circuits to address basic forwarding functions used in networking systems for the core and enterprise networking markets. We introduced our first product in July 1997, which generated minimal revenue through sales to networking original equipment manufacturers, or OEMs. To respond to evolving networking requirements, we developed our next generation of products, our network search engines, which featured more advanced processing capabilities. From 1998 to 2001, we introduced several of these network search engine products. During this time, our revenue from these products was low, and we experienced significant net operating losses.

In December 2002, we entered into a strategic agreement with Micron Technology Inc., or Micron, to facilitate broader acceptance of our knowledge-based processors and to access additional manufacturing capacity. In early 2003, Micron announced a significant restructuring of its operations, which effectively eliminated any future development activities under this agreement, and we restructured the agreement to limit the products covered by the agreement. Under the current license and agreement, Micron is obligated to pay us fees totaling \$5.3 million, of which \$3.5 million has been recognized as engineering service revenue in 2003, \$500,000 in the first quarter of 2004 and \$625,000 in the second quarter of 2004. The majority of our revenue in the second quarter 2003 consisted of fees received from Micron under the current agreement. The remaining \$625,000 is due to us upon completion of a certain milestone, which we expect to recognize as revenue by the end of 2005. After completion of the remaining milestone, we do not expect any additional revenue to be generated under this agreement.

In the third quarter of 2003, industry economic conditions improved and we accelerated production of a customized version of our knowledge-based processors designed specifically for Cisco. In the third and fourth quarters of 2003, we shipped a substantial quantity of these knowledge-based processors to Cisco, which processors met our yield objectives and passed the qualification and testing procedures that Cisco and we had applied to them. At the time, the number of processors passing these procedures resulted in production yields that were within our

## Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-Q

expectations. We continued to ship a significant number of these processors through the end of 2003; however, in the first quarter of 2004, Cisco began to apply more rigorous testing on their networking systems that identified certain situations in which our products failed to perform to specification. Cisco returned approximately 11,000 units of these products to us under the terms of our standard warranty. Of these, approximately 5,000 units were shipped in 2003. We retested the 11,000 returned units and approximately 4,000 units passed the rescreening process. We reshipped those units and replaced the remaining returned units with our processors that passed more stringent testing procedures. Yield on products tested with more stringent testing procedures was unusually low resulting in a cost per unit that exceeded selling price. To improve yield on future products, we modified the design. Since that time, our production yields have improved to projected levels. As a result of these events, we have reduced the carrying value of our inventory at December 31, 2003 by \$7.0 million to properly record them at their estimated market value. This includes a \$6.4 million transfer of charges recognized in the third quarter of 2003 for adverse purchase commitments. To date, the replacement products and products incorporating the design modification have met and continue to meet Cisco's testing and qualification requirements.

## **Table of Contents**

We have recently experienced significant revenue growth, primarily due to a rapid rise in new customer orders for our knowledge-based processors, which began in the second half of 2003. Specifically, our product revenue increased 518% to \$31.5 million during the nine months ended September 30, 2004 from \$5.1 million during the same period in 2003. The volume of our knowledge-based processor shipments increased more than 1,700% during the nine months ended September 30, 2004, compared to that of the same period of 2003. Our total revenue for the nine months ended September 30, 2004 and 2003 included non-recurring license fees of approximately \$1.1 million and \$3.0 million, respectively, related to our license agreement with Micron Technology, Inc. We do not expect similar revenue growth rates in future periods, nor do we expect to receive any significant revenues from non-recurring engineering services beyond 2004.

As a fabless semiconductor company, our business model is less capital intensive because we rely on third parties to manufacture, assemble, and test our products. In transitioning from a design and development company to volume production as a fabless semiconductor company, we required significant funds for our ramp up in production to support increased sales of our knowledge-based processors. For example, we required additional funds to procure product mask sets, order elevated quantities of wafers from our foundry partners, perform qualification testing and assemble and test our products.

We employ a direct sales force as well as a sales representative network to sell our products. The majority of our revenue comes from customers located in the United States. All revenue to date has been denominated in U.S. dollars.

Our product sales cycles can take up to 24 months to complete and volume production can take an additional six months to be achieved, if at all. Cancellations of customer orders or changes in product specifications could result in the loss of anticipated sales without allowing us sufficient time to reduce our inventory or operating expenses. Our recent rapid revenue growth makes it difficult for us to assess the impact of seasonal factors on our business.

## **Critical Accounting Policies**

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the U.S. requires management to make fair and reasonable estimates and assumptions that affect reported amounts of assets, liabilities and operating expenses during the period reported. The following accounting policies require management to make estimates and assumptions. These estimates and assumptions are reviewed periodically and the effects of revisions are reflected in the period that they are determined to be necessary. If actual results differ significantly from management's estimates, our financial statements could be materially impacted. Our estimates are guided by observing the following critical accounting policies.

*Revenue Recognition.* One of the criteria for revenue recognition is that the collectability of the resulting receivable is reasonably assured. Determination of this criterion is based on management's judgments regarding the collectability of those fees. The recent growth and the establishment of new or more significant customer relationships mean that management does not have a substantial history of making these judgments. To date, our customers consist primarily of large, well-established publicly traded companies. Should our customer base change to include smaller, less-established companies, and collectability of accounts receivable from these customers be uncertain, revenue recognition for a reporting period may be negatively affected. Should changes in conditions cause management to determine these criteria are not met for certain future transactions, revenue recognized for any reporting period could be adversely affected.

*Inventory Valuation and Adverse Purchase Commitments.* We value our inventories at the lower of cost or market. We record inventory reserves for estimated obsolescence or unmarketable inventories based upon assumptions about future demand and market conditions. These estimates are based on a 12-month forecast prepared by management. If our inventory on hand is in excess of our forecast, the excess amounts are written



## Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-Q

off. If actual market conditions are less favorable than those expected by management, additional inventory reserves may be required. The carrying value of inventory and the determination of possible adverse purchase commitments are dependent on our estimate of the yield that will be achieved, or the percent of good products identified when the product is tested. A small change in yield could result in a significant adjustment and have a significant impact on our financial position and results of operations.

During the year ended December 31, 2003, we recorded charges to cost of revenue of \$10.4 million as a result of a low expected yield on work-in-process inventories on hand and on order with our vendors that resulted in the estimated cost of finished product exceeding its estimated market value. The estimated cost was based on actual yield experience, and estimated costs to test and package our products. These estimates were based on historical costs of similar products. The charge reduced the carrying value of our inventory to record them at their estimated market value and established reserves to cover expected future losses and adverse purchase commitments. While we have implemented a modified design of some of our products to improve production yields, we may experience lower than expected yields in the future, primarily upon the introduction of new products.

## **Table of Contents**

*Warranty Accrual.* Our products are generally subject to warranty and we provide for the estimated future costs of replacement upon shipment of the product in the accompanying statements of operations. Our warranty accrual is estimated based on historical claims compared to historical revenue and assumes that we have to replace products subject to a claim. For new products, we use our historical percentage for the appropriate class of product. Should actual product failure rates differ from our estimates, revisions to the estimated warranty liability would be required. During the fourth quarter of 2003, we recorded a charge of \$1.0 million for the expected costs of replacing product that was returned in early 2004. This level of warranty claims was much higher than we experienced in the past. We have subsequently implemented more stringent testing procedures to reduce the level of warranty claims when compared to the volume shipped. In the future, as we continue to introduce new products, warranty expenses may increase.

*Allowance for Doubtful Accounts.* In order to determine the collectability of our accounts receivable, we continually assess factors such as previous customer transactions and the credit-worthiness of the customer. To date, our accounts receivable write-offs have been immaterial. We maintain allowances for doubtful accounts for estimated losses resulting from the inability of certain customers to make required payments. If the financial conditions of our customers were to deteriorate, additional allowances may be required.

*Accounting for Income Taxes.* We account for income taxes under the provisions of Statement of Financial Accounting Standards (SFAS) No. 109 Accounting for Income Taxes. In applying SFAS 109, we are required to estimate our current tax exposure together with assessing temporary differences resulting from differing treatments of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities. Significant management judgment is required to assess the likelihood that our deferred tax assets will be recovered from future taxable income. We have established a full valuation allowance against our deferred tax assets due to uncertainties regarding our ability to realize these assets. These uncertainties relate primarily to the level of our historical losses and the absence of objective evidence supporting the future realization of these assets. In the event we were to determine that it is more likely than not that we are able to realize our deferred tax assets in the future, an adjustment to the valuation allowance would increase income in the period such determination is made.

*Stock-based Compensation.* We account for stock-based employee compensation arrangements in accordance with provisions of Accounting Principals Board, or APB, Opinion No. 25, Accounting for Stock Issued to Employees, and Financial Accounting Standards Board, or FASB, Interpretation, or FIN No 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans, and comply with the disclosure provisions of SFAS No. 123, Accounting for Stock-Based Compensation and SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure. Under APB Opinion No. 25, compensation cost is recognized based on the difference, if any, on the date of grant between the fair value of our stock and the amount an employee must pay to acquire the stock. SFAS No. 123 defines a fair value based method of accounting for an employee stock option or similar equity investment.

We award a limited number of stock options and warrants to non-employees. We account for non-cash stock-based expense issued to non-employees in accordance with the provisions of SFAS No. 123 and Emerging Issues Task Force Pronouncement No. 96-18, Accounting for Equity Investments That Are Issued to Non-Employees for Acquiring, or in Conjunction with Selling, Goods or Services. For these options and warrants, we recognize the stock-based expense over the service period of the underlying awards, based on an estimate of their fair value on the vesting dates using the Black-Scholes option-pricing model.

**Table of Contents****Results of Operations***Comparison of Three Months Ended September 30, 2004 to Three Months Ended September 30, 2003***Revenue, cost of revenue and gross profit**

The table below sets forth the fluctuations in revenue, cost of revenue and gross profit data for the three months ended September 30, 2004 and the three months ended September 30, 2003 (in thousands, except percentage data):

	Three Months		Three Months		Year-to-Year	
	ended	Percentage	ended	Percentage	Increase	Increase
	September 30,	of	September 30,	of	(Decrease)	(Decrease)
	2004	Revenue	2003	Revenue		Percentage
Revenue:						
Product revenue	\$ 12,441	100.0%	\$ 2,594	99.7%	\$ 9,847	379.6%
License and engineering service revenue			8	0.3%	(8)	-100.0%
<b>Total revenue</b>	<b>12,441</b>	<b>100.0%</b>	<b>2,602</b>	<b>100.0%</b>	<b>9,839</b>	<b>378.1%</b>
Cost of revenue:						
Cost of product revenue	6,861	55.1%	8,248	317.0%	(1,387)	-16.8%
Cost of license and engineering service revenue			2	0.1%	(2)	-100.0%
<b>Total cost of revenue</b>	<b>6,861</b>	<b>55.1%</b>	<b>8,250</b>	<b>317.1%</b>	<b>(1,389)</b>	<b>-16.8%</b>
<b>Gross profit</b>	<b>\$ 5,580</b>	<b>44.9%</b>	<b>\$ (5,648)</b>	<b>-217.1%</b>	<b>\$ 11,228</b>	<b>-198.8%</b>

*Revenue.* The increase in total revenue during the three months ended September 30, 2004 resulted from the growth in sales of our knowledge-based processors. During the three months ended September 30, 2004, the volume of knowledge-based processor shipments increased approximately 1,700% compared to that of the three months ended September 30, 2003. Revenue from sales to one of Cisco Systems, Inc.'s contract manufacturers, Solectron, represented 76% of total revenue for the three months ended September 30, 2004 compared to 17% during the three months ended September 30, 2003.

*Cost of Revenue.* The cost of revenue decreased to \$6.9 million for the three months ended September 30, 2004 despite the increased unit shipments of knowledge-based processors primarily as a result of the lower unit cost realized by the continued improvement in our manufacturing yield. During the three months ended September 30, 2004, we reassessed the warranty accrual requirements based on our most recent warranty expense data as our manufacturing yield became normalized. As a result of this reassessment, we released approximately \$0.3 million of warranty accrual to cost of sales during the three months ended September 30, 2004. We also recorded a provision for excess and obsolete inventory reserve of \$0.3 million during the three months ended September 30, 2004 as we determined that a portion of inventory related to our previous generation products was unsalable. The cost of revenue for the three months ended September 30, 2003 was adversely affected by the low manufacturing yield of our products due to Cisco's applying more rigorous testing on their networking systems that identified

## Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-Q

certain situation in which our products failed to perform to specification. As a result of this yield issue, we recorded a \$6.6 million charge for adverse purchase commitments during the three months ended September 30, 2003 to cover expected future losses on non-cancelable commitments to purchase wafers. To improve yield, we modified the design of our knowledge-based processors. To date, the products incorporating the design modification have met and continue to meet Cisco's testing and qualification requirements and our production yields have improved to projected levels.

*Gross Profit /Gross Margin.* Gross margin increased to 44.9% during the three months ended September 30, 2004 from (217.1)% during the three months ended September 30, 2003. The increase resulted from higher sales of knowledge-based processors, which have a higher average selling price than other products, and continued improvements in production yields for these products. Gross margin was favorably impacted by the sale of \$0.3 million of products that had been fully reserved in prior periods and accordingly had no associated costs of revenue.

### Operating expenses

The table below sets forth operating expense data for the three months ended September 30, 2004 and the three months ended September 30, 2003 (in thousands, except percentage data):

	Three Months ended September 30, 2004	Percentage of Revenue	Three Months ended September 30, 2003	Percentage of Revenue	Year-to-Year Increase (Decrease)	Increase (Decrease) Percentage
<i>Operating expenses:</i>						
Research and development	\$ 3,891	31.3%	\$ 4,634	178.1%	\$ (743)	-16.0%
Selling, general and administrative	1,735	13.9%	1,201	46.2%	534	44.5%
Stock-based compensation	1,090	8.8%	683	26.2%	407	59.6%
<b>Total operating expenses</b>	<b>\$ 6,716</b>	<b>54.0%</b>	<b>\$ 6,518</b>	<b>250.5%</b>	<b>\$ 198</b>	<b>3.0%</b>

*Research and Development Expenses.* Research and development expenses decreased during the three months ended September 30, 2004 primarily due to decreases in product development and qualification expenses of \$1.1

**Table of Contents**

million. The decrease in product development and qualification expenses was offset by the increase in mask expenses of \$0.3 million. During the three months ended September 30, 2003, product development and qualification expenses were significantly higher as we began to ramp up the production of knowledge-based processor products. The remainder of the fluctuation in research and development expenses was caused by individually minor items.

*Selling, General and Administrative Expenses.* Selling, general and administrative expenses increased over the same period in 2003 primarily due to the increases in directors and officers' insurance premium of \$0.2 million, audit and legal fees of \$0.1 million and salaries and benefits of \$0.1 million. The increases in directors and officers' insurance premium and legal and audit fees were the results of the Company's becoming a publicly-traded company in July 2004. The increase in salaries and benefits was due to the increase in headcount to support our growing operations. The remainder of the fluctuation in selling, general and administrative expenses was caused by individually minor items.

*Stock-based compensation.* The increase in stock-based compensation amortization was primarily due pre-IPO grants of stock options with exercise prices below the fair value of common stock. Stock-based compensation expense is based on the difference between the exercise price of the option grants and the fair value of our common stock at the time of such grants.

**Other items**

The table below sets forth other data for the three months ended September 30, 2004 and the three months ended September 30, 2003 (in thousands, except percentage data):

	Three Months ended September 30, 2004		Three Months ended September 30, 2003		Year-to-Year Change	
	Percentage of Revenue		Percentage of Revenue		Change Percentage	
Other income (expense), net:						
Interest income	\$ 94	0.8%	\$ 71	2.7%	\$ 23	32.39%
Interest expense	(2,564)	-20.6%	(21)	-0.8%	(2,543)	12109.52%
Other income (expense), net	(32)	-0.3%	(12)	-0.5%	(20)	166.67%
Total interest and other income (expense), net	\$ (2,502)	-20.1%	\$ 38	1.5%	\$ (2,540)	-6684.21%

*Interest and Other Income (Expenses), net.* The significant increase in interest and other expense, net during the three months ended September 30, 2004 was primarily due to the accelerated amortization of beneficial conversion feature that was originally recorded in connection with the issuance of promissory notes in March 2004. The promissory notes were repaid in full in July 2004, and accordingly, the remaining value of beneficial conversion feature of \$2.5 million was charged entirely to interest expense.

**Table of Contents****Comparison of Nine Months Ended September 30, 2004 to Nine Months Ended September 30, 2003****Revenue, cost of revenue and gross profit**

The table below sets forth the fluctuations in revenue, cost of revenue and gross profit data for the nine months ended September 30, 2004 and the nine months ended September 30, 2003 (in thousands, except percentage data):

	Nine Months		Nine Months		Year-to-Year	
	ended	Percentage	ended	Percentage	Increase	Increase
	September 30,	of	September 30,	of	(Decrease)	(Decrease)
	2004	Revenue	2003	Revenue		Percentage
<b>Revenue:</b>						
Product revenue	\$ 31,456	96.5%	\$ 5,106	62.9%	\$ 26,350	516.1%
License and engineering service revenue	1,128	3.5%	3,013	37.1%	(1,885)	-62.6%
<b>Total revenue</b>	<b>32,584</b>	<b>100.0%</b>	<b>8,119</b>	<b>100.0%</b>	<b>24,465</b>	<b>301.3%</b>
<b>Cost of revenue:</b>						
Cost of product revenue	18,766	57.6%	10,015	123.4%	8,751	87.4%
Cost of license and engineering service revenue			5	0.1%	(5)	-100.0%
<b>Total cost of revenue</b>	<b>18,766</b>	<b>57.6%</b>	<b>10,020</b>	<b>123.4%</b>	<b>8,746</b>	<b>87.3%</b>
<b>Gross profit</b>	<b>\$ 13,818</b>	<b>42.4%</b>	<b>\$ (1,901)</b>	<b>-23.4%</b>	<b>\$ 15,719</b>	<b>-826.9%</b>

*Revenue.* The increase in total revenue during the nine months ended September 30, 2004 was primarily due to the growth in sales of our knowledge-based processors. During the nine months ended September 30, 2004, the volume of knowledge-based processor shipments increased approximately 1,700% compared to that of the nine months ended September 30, 2003. Revenue from sales to one of Cisco Systems, Inc.'s contract manufacturers, Solectron, represented 69% of total revenue for the nine months ended September 30, 2004 compared to 12% during the nine months ended September 30, 2003.

License and engineering service revenue for the nine months ended September 30, 2004 and 2003 totaled \$1.1 million and \$3.0 million respectively. All such revenue arose under our agreement with Micron Technologies, Inc.

*Cost of Revenue.* The increase in cost of product revenue during the nine months ended September 30, 2004 was primarily due to the increase in sales volumes of our knowledge-based processors. During the nine months ended September 30, 2004, the volume of knowledge-based processor shipments increased by 1,700% compared to that of the nine months ended September 30, 2003. During the three months ended September 30, 2004, we reassessed the warranty accrual requirements based on our most recent warranty expense data as our manufacturing yield became normalized. As a result of this reassessment, we released approximately \$0.3 million of warranty accrual to cost of sales during the three months ended September 30, 2004. We also recorded a provision for excess and obsolete inventory reserve of \$0.3 million during the three

## Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-Q

months ended September 30, 2004 as we determined that a portion of inventory related to our previous generation products was unsalable. The cost of revenue for the nine months ended September 30, 2003 was adversely affected by the low manufacturing yield of our products due to Cisco's applying more rigorous testing on their networking systems that identified certain situation in which our products failed to perform to specification. As a result of this yield issue, we recorded a \$6.6 million charge for adverse purchase commitments during the nine months ended September 30, 2003 to cover expected future losses on non-cancelable commitments to purchase wafers. To improve yield, we modified the design of our knowledge-based processors. To date, the products incorporating the design modification have met and continue to meet Cisco's testing and qualification requirements and our production yields have improved to projected levels.

*Gross Profit/Gross Margin.* Gross margin increased to 42.4% during the nine months ended September 30, 2004 from (96.1)% during the three months ended September 30, 2003. The increase resulted from higher sales of knowledge-based processors, which have a higher average selling price, and continued improvements in production yields for these products. During the nine months ended September 30, 2004, gross margin was favorably impacted by the sale of \$0.7 million of products that had been fully reserved in prior periods and accordingly had no associated costs of revenue.

### Operating expenses

The table below sets forth operating expense data for the nine months ended September 30, 2004 and the nine months ended September 30, 2003 (in thousands, except percentage data):

	Nine Months		Nine Months		Year-to-Year	
	ended	Percentage	ended	Percentage	Increase	Increase
	September 30,	of	September 30,	of	(Decrease)	(Decrease)
	2004	Revenue	2003	Revenue	(Decrease)	Percentage
	_____	_____	_____	_____	_____	_____
Operating expenses:						
Research and development	\$ 12,365	37.9%	\$ 12,346	152.1%	\$ 19	0.2%
Selling, general and administrative	4,895	15.0%	3,256	40.1%	1,639	50.3%
Stock-based compensation	4,616	14.2%	1,495	18.4%	3,121	208.8%
	_____	_____	_____	_____	_____	_____
Total operating expenses	\$ 21,876	67.1%	\$ 17,097	210.6%	\$ 4,779	28.0%
	_____	_____	_____	_____	_____	_____

**Table of Contents**

*Research and Development Expenses.* Research and development expenses remained relatively stable during the nine months ended September 30, 2004. Semiconductor mask expense increased by \$0.6 million, while product development and qualification expenses increased by \$0.7 million. During the nine months ended September 30, 2003, product development and qualification expenses were significantly higher as we began to ramp up the production of knowledge-based processor products. The remainder of the fluctuation in research and development expenses was caused by individually minor items.

*Selling, General and Administrative Expenses.* Selling, general and administrative expenses increased during the nine months ended September 30, 2004 primarily due to the increases in salaries and benefits of \$0.3 million, commission expense of \$0.2 million, audit and legal fees of \$0.5 million, consulting fees of \$0.2 million and directors and officers' insurance premium of \$0.2 million. The increase in salaries and benefits was due to the increase in headcount to support our growing operations. The increase in sales commission was due to the increase in sales of our knowledge-based processors. The increases in legal and audit fees, and insurance premium were the results of the Company's becoming a publicly-traded company in July 2004. Consulting fees increased as we utilized consultants in the areas of marketing and public relations to support our growing operations.

*Stock-based compensation.* The increase in stock-based compensation amortization was primarily due pre-IPO grants of stock options with exercise prices below the fair value of common stock.

**Other items**

The table below sets forth other data for the nine months ended September 30, 2004 and the nine months ended September 30, 2003 (in thousands, except percentage data):

	Nine Months		Nine Months		Year-to-Year	
	ended	Percentage	ended	Percentage	Change	Change
	September 30,	of	September 30,	of		Percentage
	2004	Revenue	2003	Revenue		
Other income (expense), net:						
Interest income	\$ 207	0.6%	\$ 305	3.8%	\$ (98)	-32.13%
Interest expense	(3,996)	-12.3%	(82)	-1.0%	(3,914)	4773.17%
Other income (expense), net	(108)	-0.3%	(62)	-0.8%	(46)	74.19%
<b>Total interest and other income (expense), net</b>	<b>\$ (3,897)</b>	<b>-12.0%</b>	<b>\$ 161</b>	<b>2.0%</b>	<b>\$ (4,058)</b>	<b>-2520.50%</b>

*Interest and Other Income (Expenses), net.* The significant increase in interest and other expense, net during the nine months ended September 30, 2004 was primarily due to the accelerated amortization of beneficial conversion feature and warrants that were originally recorded in connection with the issuance of promissory notes in March 2004. The promissory notes were repaid in full in July 2004, and accordingly, the remaining value of beneficial conversion feature at the time of repayment was entirely charged to interest expense. During the nine months ended September 30, 2004, amortization of beneficial conversion feature and warrant fair values totaled \$2.5 million.



## Liquidity and Capital Resources

At September 30, 2004, our principal sources of liquidity were our cash and cash equivalents which totaled \$39.6 million. Our investment portfolio consists of fixed-income securities, with maturities of two years or less, diversified among industries and individual issuers. Our investments are liquid, investment grade securities.

On July 8, 2004, we completed an initial public offering of our common stock at a price of \$12.00 per share. We sold 3,736,876 shares and additional 2,038,124 shares were sold by selling stockholders, excluding shares subject to the underwriters' over-allotment option (which was not exercised). We received \$39.2 million in proceeds after deducting underwriters' fees and other transaction costs.

In July 2004, we repaid in full \$10.5 million outstanding under a line of credit (the Working Capital Line). Subsequent to our initial public offering on July 8, 2004, the Working Capital Line was amended and our line of credit was increased to \$14.5 million available for general working capital purposes. As of September 30, 2004, we had no balance outstanding under the Working Capital Line. Borrowings under the Working Capital Line will bear interest at a rate of the Silicon Valley Bank prime rate plus one quarter of one percent, or 4.25%, whichever is higher, except in the event of our default in which case the interest rate would be increased by 5% over the rate in effect immediately before the event of default. The Working Capital Line is secured by all of our assets, including receivables and intangible assets, but excluding our intellectual property. To maintain the Working Capital Line, our total unrestricted cash, cash equivalents and marketable securities must be at least \$30 million. We had complied with this covenant as of September 30, 2004.

**Table of Contents**

In March 2004, we issued \$7.6 million in convertible promissory notes (the Notes) bearing interest at 10.0% per annum and warrants to purchase 76,500 shares of common stock at \$2.00 per share. The Notes were issued to existing stockholders, directors and management. In July 2004, the Notes and accrued interest were repaid in full following the closing of the initial public offering of our common stock.

The table below (in thousands) sets forth the key components of cash flow for the nine months ended September 30, 2004 and 2003:

	Nine Months ended September 30, 2004	Nine Months ended September 30, 2003
Net cash used in operating activities	\$ (11,513)	\$ (17,672)
Net cash provided by (used in) investing activities	\$ 6,893	\$ (3,468)
Net cash provided by financing activities	\$ 31,101	\$ 3,917

**Nine months ended September 30, 2004**

During the nine months ended September 30, 2004, our operating activities used net cash of \$11.5 million. For cash used in operating activities, net loss of \$12.0 million was adjusted for non-cash items primarily related to depreciation, amortization of stock-based compensation and interest expense, which represented amortization and write-off of promissory notes discount. The primary use of cash for operating activities during the nine months ended September 30, 2004 was for our inventory, which increased as we ramped up our production volume in order to meet our customers' increasing demand for our knowledge-based processors. Cash was also used to reduce our accrued liabilities as we settled our product warranty obligations during the period and used a portion of our IPO proceeds to reduce overall liability balance. Other uses of cash for operating activities included an increase in prepaid and other assets due to the payment of a directors and officers' insurance premium in connection with our initial public offering, and a decrease in deferred revenue as we completed our obligation under the agreement with Micron Technology, Inc. Cash used for activities related to inventory, accrued liabilities, prepaid and other assets and deferred revenue was offset by an increase in accounts receivable due to the growth in product sales and an increase in accounts payable due to the growth in our operations.

Our investing activities provided net cash of \$6.9 million during the nine months ended September 30, 2004. Cash was provided by the sale of short-term investments and the reduction in restricted cash as our amended line of credit agreement with a bank no longer required restricted cash deposit. Cash provided by the sale of short-term investments and the reduction in restricted cash was offset by the acquisition of property and equipment totaling \$1.1 million. The property and equipment expenditures were primarily for purchases of computer equipment and research and development design tools to support our growing operations. We expect to make capital expenditures of approximately \$0.4 million for the remainder of fiscal 2004. These capital expenditures will be used primarily to support product development activities. We will use our cash and cash equivalents to fund these purchases.

Our financing activities provided net cash of \$31.1 million for the nine months ended September 30, 2004. The primary source of cash was the net proceeds received in connection with our initial public offering of \$39.2 million. The other sources of cash included the issuance of convertible promissory notes, repayment of stockholder notes received, and proceeds from exercises of stock options and warrants and borrowings under the line of credit. Cash provided by activities above was offset by repayment of convertible promissory notes, repayment of outstanding balance under the line of credit and the payments for capital lease obligations.

**Nine months ended September 30, 2003**

During the nine months ended September 30, 2003, our operating activities used net cash of \$17.7 million. For cash used in operating activities, net loss of \$18.8 million was adjusted for non-cash items primarily related to depreciation, amortization of stock-based compensation and provision for allowance for doubtful accounts. The primary uses of cash for operating activities during the nine months ended September 30, 2003 were for our inventory which increased in balance as we ramped up our production volume in order to meet our customers' increasing demand for our products and the payments for accounts payable during the period. Other changes in working capital, including an

**Table of Contents**

increase in accounts receivable due to the product sales growth, an increase in prepaid expense and other assets due to prepayments for wafer purchases from our foundry and a decrease in deferred revenue contributed to the use of cash in operating activities. Cash used for activities related to inventory, accounts payable, prepaid and other assets, accounts receivable and deferred revenue was offset by an increase in accrued liabilities due to recording of adverse purchase commitment accrual to cover expected future losses on non-cancelable commitments to purchase wafers.

Our investing activities used cash of \$3.5 million during the nine months ended September 30, 2003. Cash was used for the purchase of short-term investments and the acquisition of equipment totaling \$2.4 million. The equipment expenditures were primarily for purchases of computer equipment and research and development design tools to support our growing operations.

Our financing activities provided net cash of \$3.9 million for the nine months ended September 30, 2003. The primary source of cash was borrowings under our line of credit. Other sources of cash included the proceeds from exercises of stock options and repayment of stockholder notes received. We used cash to repay outstanding balances under the line of credit, pay capital lease obligations and repurchase restricted stock.

**Capital Resources**

We believe that our existing cash and cash equivalents balance of \$39.6 million, together with the Working Capital Line of \$14.5 million, will be sufficient to meet our anticipated cash needs for the foreseeable future. Our future capital requirements will depend on many factors, including the amount of revenue we generate, the timing and extent of spending to support product development efforts, the expansion of sales and marketing activities, the timing of introductions of new products, the costs to ensure access to adequate manufacturing capacity, and the continuing market acceptance of our products. However, if we do not meet our plan, we could be required, or might elect, to seek additional funding through public or private equity or debt financing and additional funds may not be available on terms acceptable to us or at all.

**Contractual obligations**

As of September 30, 2004, our principal commitments consisted of operating and capital lease payments, which are summarized below (in thousands):

	<b>Total</b>	<b>Less than 1 year</b>	<b>1-3 years</b>	<b>4-5 years</b>	<b>After 5 years</b>
Operating lease obligations	\$ 3,646	\$ 315	\$ 1,101	\$ 1,162	\$ 1,068
Capital lease obligations	282	276	6		
Wafer purchases	6,519	6,519			
Other	474	474			
<b>Total</b>	<b>\$ 10,921</b>	<b>\$ 7,584</b>	<b>\$ 1,107</b>	<b>\$ 1,162</b>	<b>\$ 1,068</b>

## Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-Q

In addition to the enforceable and legally binding obligations quantified in the table above, we have other obligations for goods and services entered into in the normal course of business. These obligations, however, either are not enforceable or legally binding or are subject to change based on our business decisions.

### **Off-Balance Sheet Arrangements**

As part of our ongoing business, we do not participate in transactions that generate relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, or SPEs, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. As of September 30, 2004, we were not involved in any unconsolidated SPE transactions.

### **Indemnities, Commitments and Guarantees**

In the normal course of business, we have made certain indemnities, commitments and guarantees under which we may be required to make payments in relation to certain transactions. These indemnities include intellectual property indemnities to our customers in connection with the sales of our products, indemnities for liabilities associated with the infringement of other parties' technology based upon our products, indemnities to various lessors in connection with facility leases for certain claims arising from such facility or lease, and indemnities to our directors and officers to the maximum extent permitted under the laws of the state of Delaware. The duration of each of these indemnities, commitments and guarantees varies and, in certain cases, is indefinite. We have not recorded any liability for these indemnities, commitments and guarantees in the accompanying balance sheets. We do, however, accrue for losses for any known contingent liability, including those that may arise from indemnification provisions, when future payment is probable.

## **Table of Contents**

### **Risk Factors**

*If any of the following risks actually occur, our business, results of operations and financial condition could suffer significantly.*

**We expect to derive substantially all of our revenue from sales of our knowledge-based processors, and, if the demand for these products does not grow, we may not achieve our growth and strategic objectives.**

Our knowledge-based processors are used primarily in networking systems, including routers, switches, network access equipment and networked storage devices. We derive a substantial portion of our total revenue from sales of our knowledge-based processors in the networking market and expect to continue to derive a substantial portion of our total revenue from this market for the foreseeable future. Sales of our knowledge-based processors accounted for 85% and 23% of our total revenue during the nine months ended September 30, 2004 and 2003, respectively. We believe our future business and financial success depends on continued market acceptance and increasing sales of our knowledge-based processors. In order to meet our growth and strategic objectives, networking original equipment manufacturers, or OEMs, must continue to incorporate our products into their systems as their preferred means of enabling network-aware processing of IP packets, and the demand for their systems must grow as well. Thus, our future success depends in large part on factors outside our control, and sales of our knowledge-based processors may not meet our revenue growth and strategic objectives.

**Because we rely on a small number of customers for a significant portion of our total revenue, the loss of, or a significant reduction in, orders for our products from these customers would negatively affect our total revenue and business.**

To date, we have been dependent upon orders for sales of knowledge-based processors to a limited number of customers, and, in particular, Cisco, for most of our total revenue. During the nine months ended September 30, 2004, Cisco and its contract manufacturers accounted for 71% of our total revenue (and 74% of our total product revenue). During the nine months ended September 30, 2003, Cisco and its contract manufacturers accounted for 16% of our total revenue (and 26% of our total product revenue), license fees from Micron Technology, Inc., or Micron, accounted for 37% of our total revenue and orders placed by sales representatives at the request of Hitachi accounted for 11% of our total revenue. We expect that our future financial performance will continue to depend in large part upon our relationship with Cisco and several other networking OEMs.

We cannot assure you that existing or potential customers will not develop their own solutions, purchase competitive products or acquire companies that use alternative methods to enable network-aware processing in their systems. We do not have long-term purchase commitments from any of our OEM customers or their contract manufacturers, all of whom do business with us currently only on the basis of short-term purchase orders, which often are cancelable prior to shipment. The loss of orders for our knowledge-based processors for Cisco products or products of other major users of our knowledge-based processors would have a significant negative impact on our business.

**We face additional risks to our business success and financial condition because of our dependence on a small number of customers for sales of our products.**

Our dependence on a small number of customers, especially Cisco and its contract manufacturers, for most of our revenue in the foreseeable future creates additional risks for our business, including the following:

## Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-Q

we may face problems in collecting a substantial portion of our accounts receivable if any of these companies faces financial difficulties or dispute payments;

we may face increased pressure to reduce the average selling prices of our knowledge-based processors;

we may find it difficult to pass through increases in our manufacturing and other direct costs; and

the reputation of our knowledge-based processors in the marketplace may be affected adversely if Cisco or other networking OEMs that represent a significant percentage of our sales of knowledge-based processors reduce or cease their use of our products.

## **Table of Contents**

**We have a history of operating losses, may incur significant operating losses in the future and may not be able to achieve or sustain profitability.**

We have recorded operating losses in each year since our inception in 1995. At September 30, 2004, we had an accumulated deficit of approximately \$99.1 million. To become profitable, we will have to generate greater total revenue and control costs and expenses. We cannot assure you that we will be able to generate greater total revenue, or limit our costs and expenses, sufficiently to achieve profitability. Even if we become profitable, we may not be able to sustain or increase profitability on a quarterly or annual basis.

**Our limited history of sales of our knowledge-based processors makes it difficult to evaluate our prospects.**

Although our first knowledge-based processor was introduced in the second quarter of 2002, we did not have significant sales of these products until the third quarter of 2003. We cannot provide assurance that sales of our knowledge-based processors will increase substantially in the future. Due to our limited historical sales data and the high concentration of our sales with a small number of networking OEMs, our ability to predict future sales and operating results for our products is limited, and, accordingly, prior quarterly or annual results may not be an indication of our future revenue growth or financial results.

**We have sustained substantial losses from low production yields in the past and may incur such losses in the future.**

Designing and manufacturing integrated circuits is a difficult, complex and costly process. Once research and development has been completed and the foundry begins to produce commercial volumes of the new integrated circuit, products still may contain errors or defects that could adversely affect product quality and reliability. We have experienced low yields and have incurred substantial research and development expenses in the design and initial production phases of all of our legacy network search engine products and knowledge-based processors during the past three years. For example, after the introduction of our first knowledge-based processor, we shipped a substantial quantity of these knowledge-based processors to Cisco in 2003, which processors met our yield objectives and passed the qualification and testing procedures that Cisco and we had applied to them. Subsequently, Cisco began to apply more rigorous testing on their networking systems that identified certain situations in which our products failed to perform to specification. As a result, Cisco returned these products to us under the terms of our standard warranty, and we replaced them with processors that passed more stringent testing procedures. The more stringent testing resulted in unusually low production yields which increased our per unit cost to an amount in excess of selling price. As a result of these events, we reduced the carrying value of our inventory at December 31, 2003 by \$7.0 million to properly record them at their estimated market value. In addition, we established reserves to cover expected future losses on non-cancelable commitments to purchase wafers from our foundries as we estimated that the cost of these wafers and the additional expenses required to package and test the finished products would exceed the price at which the final products could be sold by approximately \$3.4 million. The reserves were recorded in the third and fourth quarters of 2003. Although the previously identified errors have not appeared in tests of Cisco networking systems replacement parts, and some of the products that we have written down may be reclassified as good parts and resold, we cannot assure you that this error or other material problems will not occur in knowledge-based processors that we have shipped previously or may ship in the future. Moreover, we cannot be certain that other low yield problems with similar or even greater consequences will not arise in the future.

**Because we sell our products on a purchase order basis and rely on estimated forecasts of our customers' needs, inaccurate forecasts could adversely affect our business.**

We sell our products pursuant to individual purchase orders, and not pursuant to long-term purchase commitments. Therefore, we rely on estimated demand forecasts, based upon input from our customers, to determine how much product to manufacture. Because our sales are based



## Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-Q

on purchase orders, our customers may cancel, delay or otherwise modify their purchase commitments with little or no consequence to them and with little or no notice to us. For these reasons, we generally have limited visibility regarding our customers' product needs. We cannot provide assurance as to the quantities or timing required by our customers for our products. We cannot assure you that we will not experience subsequent substantial warranty claims or that warranty claims will not result in cancellation of existing orders or reluctance of customers to place future orders. In addition, the product design cycle for networking OEMs is lengthy, and it may be difficult for us to accurately anticipate when they will commence commercial shipments of products that include our knowledge-based processors. Whether in response to changes affecting the industry or a customer's specific business pressures, any cancellation, delay or other modification in our customers' orders could significantly reduce our revenue, cause our operating results to fluctuate from period to period and make it more difficult for us to predict our revenue. In the event of a cancellation or reduction of an order, we may not have enough time to reduce operating expenses to minimize the effect of the lost revenue on our business, and we may purchase too much inventory and spend more capital than expected.

## **Table of Contents**

### **We do not expect to sustain our recent revenue growth rate.**

We have recently experienced significant revenue growth. Specifically, our total revenue increased 302% to \$32.6 million during the nine months ended September 30, 2004 from \$8.1 million during the same period of 2003, and 377% to \$12.4 million during the three months ended September 30, 2004 from \$2.6 million in the same period of 2003. In addition, our total revenue increased 367.5% from \$2.9 million in 2002 to \$13.5 million in 2003, including non-recurring license fees of approximately \$3.5 million in 2003. We do not expect similar revenue growth rates in future periods, nor do we expect to receive any significant payments from non-recurring engineering services beyond 2004. Accordingly, you should not rely on the results of any prior quarterly or annual periods as an indication of the future rate of our revenue growth or our future financial results.

### **We are dependent on contract manufacturers for a significant portion of our revenue.**

Many of our OEM customers, including Cisco, use third party contract manufacturers to manufacture their networking systems. These contract manufacturers represented 85% and 38% of our total revenue in the third quarter of 2004 and 2003, respectively. Contract manufacturers purchase our products directly from us on behalf of networking OEMs. Although we work with our OEM customers in the design and development phases of their systems, these OEM customers are gradually giving contract manufacturers more authority in product purchasing decisions. As a result, we depend on a concentrated group of contract manufacturers for a substantial portion of our revenue. If we cannot compete effectively for the business of these contract manufacturers or if any of the contract manufacturers, which work with our OEM customers, experience financial or other difficulties in their businesses, our revenue and our business could be adversely affected. In particular, if one of our OEM customer's contract manufacturers becomes subject to bankruptcy proceedings, neither we nor our OEM customer may be able to obtain any of our products held by the contract manufacturer. In addition, we may not be able to recover any payments owed to us by the contract manufacturer for products already delivered or recover the products held in the contract manufacturer's inventory when the bankruptcy proceeding is initiated. If we are unable to deliver our products to our OEM customers in a timely manner, our business would be adversely affected.

### **The average selling prices of our products may decline, which could reduce our revenue and gross margin.**

The average selling prices of our products may decline over the course of their commercial lives, principally due to the supply of competing products, reduction in demand from customers, pressure from customers to reduce prices and product cycle changes. Declining average selling prices will adversely affect our future operating results. To maintain acceptable operating results, we will need to develop and introduce new products and product enhancements on a timely basis and continue to reduce our costs. If we are unable to offset any reductions in our average selling prices by increasing our sales volumes and achieving corresponding production cost reductions, or if we fail to develop and introduce new products and enhancements on a timely basis, our revenue and operating results will suffer.

### **We rely on third parties for the manufacture of our products, and a significant increase in wafer pricing or our failure to secure sufficient capacity could limit our growth and adversely affect our operating results.**

As a fabless semiconductor company, we rely on third-party wafer foundries to manufacture our products. We currently do not have long-term supply contracts with either of our wafer foundries, Taiwan Semiconductor Manufacturing Co., Ltd., or TSMC, and United Microelectronics Corporation, or UMC. Neither TSMC nor UMC is obligated to perform services or supply products to us for any specific period, in any specific quantities or at any specific price, except as may be provided in a particular purchase order. As a result, there are numerous risks associated with our reliance on these wafer foundries, including the possibilities that TSMC or UMC may give higher priority to their other customers or that our

## Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-Q

relationships with either wafer foundry may deteriorate. We cannot assure you that TSMC and UMC will continue to provide us with our products at acceptable yields or in sufficient quantities, for reasonable costs and on a timely basis to meet our customers' needs. A failure to ensure the timely fabrication of our products could cause us to lose customers and could have a material adverse effect on our operating results.

If either wafer foundry, and in particular TSMC, ceases to provide us with required production capacity with respect to our products, we cannot assure you that we will be able to obtain manufacturing capacity from other wafer foundries on commercially reasonable terms or that these arrangements, if established, will result in the successful manufacturing of our products. These arrangements might require us to share our technology and might be subject to unilateral termination by the wafer foundries. Even if such capacity is available from another manufacturer, we would need to qualify the manufacturer, which process could take six months or longer. Furthermore, we may not be able to identify or qualify manufacturing sources that would be able to produce wafers with acceptable manufacturing yields.

## **Table of Contents**

**We also rely on third parties for other products and services, including the assembly and testing of our products, and any failure by third parties to provide the tools and services we require could limit our growth and adversely affect our future operating results.**

All of our products are assembled and tested by third-party vendors and require the use of high performance assembly and test equipment. In addition, in connection with the design of our products, we use software tools, which we obtain from third party software vendors, for simulation, layout and other design purposes. Our reliance on independent assembly, testing, software and other vendors involves a number of risks, including reduced control over delivery schedules, quality assurance and costs. We currently do not have long-term supply contracts with all of these third party vendors. As a result, most of these third party vendors are not obligated to provide products or perform services to us for any specific period, in any specific quantities or at any specific price, except as may be provided in a particular purchase order. The inability of these third party vendors to deliver high performance products or services of acceptable quality and in a timely manner, could lengthen our design cycle, result in the loss of our customers and reduce our revenue.

**Our costs may increase substantially if the wafer foundries that supply our products do not achieve satisfactory product yields or quality.**

The wafer fabrication process is an extremely complicated process where the slightest changes in the design, specifications or materials can result in material decreases in manufacturing yields or even the suspension of production. From time to time, we and our wafer foundries have experienced, and are likely to experience manufacturing defects and reduced manufacturing yields related to errors or problems in our wafer foundries manufacturing processes or the interrelationship of their processes with our designs. In some cases, our wafer foundries may not be able to detect these defects early in the fabrication process or determine the cause of such defects in a timely manner. We may incur substantial research and development expense for prototype or development stage products as we qualify the products for production.

Generally, in pricing our knowledge-based processors, we assume that manufacturing yields will continue to increase, even as the complexity of our products increases. Once our products are initially qualified with our wafer foundries, minimum acceptable yields are established. We are responsible for the costs of the wafers if the actual yield is above the minimum. If actual yields are below the minimum, we are not required to purchase the wafers. The minimum acceptable yields for our new products are generally lower at first and increase as we achieve full production. Whether as a result of a design defect or manufacturing error, unacceptably low product yields or other product manufacturing problems could substantially increase the overall production time and costs and adversely impact our operating results on sales of our products. Product yield losses will increase our costs and reduce our gross margin. In addition to significantly harming our operating results and cash flow, poor yields may delay shipment of our products and harm our relationships with existing and potential customers.

**To be successful we must continue to develop and have manufactured for us, innovative products to meet the evolving requirements of networking OEMs.**

To remain competitive, we devote substantial resources to research and development, both to improve our existing knowledge-based processor technology and to develop new technology. We also seek to improve the manufacturing processes for our knowledge-based processors, including the use of smaller process geometries, which we believe is important for our products to serve our OEM customers requirements for increased network-aware processing. Our failure to migrate our knowledge-based processors to logic processes at smaller process geometries could substantially reduce the future competitiveness of our products. In addition, from time to time, we may have to redesign some of our knowledge-based processors or modify the manufacturing process for them. We cannot give you any assurance that we will be able to improve our existing knowledge-based processor technology or develop and integrate new technology into our products. Even if we design better knowledge-based processors, we may encounter problems during the manufacturing or assembly process, including reduced manufacturing yields, production delays and increased expenses, all of which could adversely affect our business and results of operations.

In addition, given the highly complex nature of these products, even the slightest change or adjustment to our integrated circuit designs could require substantial resources to implement them. We may not be able to make these changes or adjustments to our knowledge-based processors or correct any errors or defects arising from their implementation. Failure to make these changes or adjustments or correct these errors or defects during the product development stages, or any resulting delays, could severely harm our existing and potential customer relationships and could likely increase our development costs, adversely affecting our operating results. If these changes, adjustments, errors or defects are not identified or requested until after commercial production has begun or after products have been delivered to customers, we may be required to re-test existing inventory, replace products already shipped or re-design the products, all of which would likely result in significant time delays and additional costs and expenses. For example, we accelerated production of our knowledge-based processors to meet the schedule demanded of Cisco in the fall of 2003. As a result of certain design issues, these production runs had relatively low production yields, which resulted in related costs and expenses of approximately \$11.4 million in 2003 including \$9.8 million in adverse purchase commitments, \$1.0 million in warranty accruals and a \$0.6 million write down of inventory.

## Table of Contents

### **If we fail to retain key personnel and hire additional personnel, our business and growth could be negatively affected.**

Our business has been dependent to a significant degree upon the services of a small number of executive officers and technical employees. We generally do not have employment or non-competition agreements with any of our executive officers. We do not maintain key-man life insurance on the lives of any of our key personnel. The loss of any of these individuals could negatively impact our technology development efforts and our ability to service our existing customers and obtain new customers.

Our future growth will also depend, in part, upon our ability to recruit and retain other qualified managers, engineers and sales and marketing personnel. There is intense competition for these individuals in our industry, and we cannot assure you that we will be successful in recruiting and retaining these individuals. If we are unable to recruit and retain these individuals, our technology development and sales and marketing efforts could be negatively impacted.

### **If we fail to maintain competitive stock option packages for our employees, or if our stock price declines materially for a protracted period of time, we might have difficulty retaining our employees and our business may be harmed.**

In today's competitive technology industry, employment decisions of highly skilled personnel are influenced by stock option packages, which offer incentives above traditional compensation only where there is a consistent, long-term upward trend over time of a company's stock price. If our stock price declines due to market conditions, investors' perceptions of the technology industry or managerial or performance problems we have, our stock option incentives may lose value to key employees, and we may lose these employees or be forced to grant additional options to retain them. This in turn could result in:

immediate and substantial dilution to investors resulting from the grant of additional options necessary to retain employees; and

potential compensation charges against the company, which could negatively impact our operating results.

In addition, if we were required to account for stock options as an operating expense, our net income would be reduced or net losses increased. Accordingly, our financial results would be adversely affected, particularly relative to companies that grant fewer stock options. If we reduce our level of stock option grants, our ability to recruit and retain employees may be adversely affected.

### **If the accounting treatment for employee stock options changes, our earnings will be adversely affected and we may be forced to change our employee compensation and benefits practices.**

We currently account for the issuance of employee stock options under principles that do not require us to record compensation expense for options granted at fair market value. Under a newly-proposed accounting standard, public companies would be required to report compensation expense related to stock options and other forms of stock-based compensation based on the estimated value of the awards at the date of grant. We expect the final standard to be issued later in 2004, and to be effective for us beginning in July 2005. If that proposed standard is adopted in its current form, our expenses will be higher and our earnings will decline compared to our current accounting. As a result, we may consider changing our employee compensation practices, and those changes could make it harder for us to retain existing employees and attract qualified candidates.

**A failure to successfully address the potential difficulties associated with international business could reduce our growth, increase our operating costs and negatively impact our business.**

We conduct a significant amount of our business with companies that operate primarily outside of the United States, and intend to increase sales to companies operating outside of the United States. For example, our OEM customers based outside the United States accounted for 6% of our total revenue during the nine months ended September 30, 2004, and for 13% of our total revenue during the same period of 2003. Not only are many of our customers located abroad, but our two wafer foundries are based in Taiwan, and we outsource the assembly and some of the testing of our products to companies based in Taiwan and Hong Kong. We face a variety of challenges in doing business internationally, including:

foreign currency exchange fluctuations;

## Table of Contents

unanticipated changes in local regulations;

potentially adverse tax consequences, such as withholding taxes;

timing and availability of export and import licenses;

political and economic instability;

reduced or limited protection of our intellectual property;

protectionist laws and business practices that favor local competition; and

additional financial risks, such as potentially longer and more difficult collection periods.

Because we anticipate that we will continue to rely heavily on foreign companies for our future growth, the occurrence of any of the circumstances identified above could significantly increase our operating costs, delay the timing of our revenue and harm our business and financial condition.

**We must design our knowledge-based processors to meet the needs of our OEM customers and convince them to use our products, or our revenue will be adversely affected.**

In general, our OEM customers design our knowledge-based processors into their products during the early stages of their development after an in-depth technical evaluation of both our and our competitors' products. These design wins are critical to the success of our business. In competing for design wins, if a competitor's product is already designed into the product offering of a potential customer, it becomes very difficult for us to sell our products to that customer. Changing suppliers involves additional cost, time, effort and risk for the customer. In addition, our products must comply with the continually evolving specifications of networking OEMs. Our ability to compete in the future will depend, in large part, on our ability to comply with these specifications. As a result, we expect to invest significant time and effort and to incur significant expense to design our products to ensure compliance with relevant specifications. Even if a networking OEM designs our knowledge-based processors into its systems, we cannot assure you that its systems will be commercially successful or that we will receive significant revenue from sales of knowledge-based processors for those systems.

**Factors that negatively affect the businesses of the networking OEMs that use or could use our knowledge-based processors could negatively impact our total revenue.**

The timing and amount of our revenue depend on the ability of the networking OEMs who use our knowledge-based processors to market, produce and ship systems incorporating our technology. Factors that negatively affect a significant customer or group of customers could negatively affect our results of operations and financial condition. Many issues beyond our control influence the success of the networking OEMs that use our products, including, for example, the highly competitive environment in which they operate, the strength of the markets for their products, their engineering capabilities, their ability or inability to obtain other components from other suppliers, the compatibility of any of their other components with our products, and their financial and other resources. Likewise, we have no control over their product development or pricing strategies, which directly affect sales of their products and, in turn, our revenue. A decline in sales of our OEM



customers' systems that use our knowledge-based processors would reduce our revenue. In addition, seasonal and other fluctuations in demand for their products could cause our operating results to fluctuate, which could cause our stock price to fall.

**We have a lengthy sales cycle, which may result in significant expenses that do not generate significant revenue or delayed revenue generation from our selling efforts and limits our ability to forecast our revenue.**

Based on our limited sales history for our knowledge-based processors, we have limited visibility on the length of the sales cycle for our knowledge-based processors. However, we expect that our product sales cycle, which results in our knowledge-based processors being designed into our customers' products, could take up to 24 months. It can take an additional six months to reach volume production on these products. A number of factors can contribute to the length of the sales cycle, including technical evaluations of our products by networking OEMs, the design process required to integrate our products into our OEM customers' products and the timing of networking OEMs' new product announcements. In anticipation of product orders, we may incur substantial costs before the sales cycle is complete and before we receive any customer payments. As a result, in the event that a sale is not completed or is cancelled or delayed, we may have incurred substantial expenses, making it more difficult for us to become profitable or otherwise negatively impacting our financial results. Furthermore, because of our lengthy sales cycle, our receipt of revenue from our selling efforts may be substantially delayed, our ability to forecast our future revenue may be more limited and our revenue may fluctuate significantly from quarter to quarter.

## **Table of Contents**

### **Our operating results could be adversely affected if we have to satisfy product warranty or liability claims.**

If our products are defective or malfunction, we could be subject to product warranty or product liability claims, such as the return of our products under warranty sold to Cisco in the third and fourth quarters of 2003 and the first quarter of 2004. These returns resulted in warranty and related charges to our financial statements of approximately \$1.0 million in the fourth quarter of 2003. While we have insurance for product liability claims for matters other than product warranty, we may not have sufficient insurance coverage for all of the claims that may be asserted against us. Moreover, these claims in the future, regardless of their outcome, could adversely affect our business.

### **Our revenue and operating results may fluctuate significantly from period to period, on a quarterly or annual basis, causing volatility in our stock price.**

Our total revenue and operating results have fluctuated from quarter to quarter in the past and are expected to continue to do so in the future. As a result, you should not rely on quarter-to-quarter comparisons of our operating results as an indication of our future performance. Fluctuations in our total revenue and operating results could negatively affect the trading price of our stock. In addition, our total revenue and results of operations may, in the future, be below the expectations of analysts and investors, which could cause our stock price to decline. Factors that are likely to cause our revenue and operating results to fluctuate include the risk factors discussed throughout this section, as well as under the section of this prospectus identified as Management's Discuss and Analysis of Financial Condition and Results of Operations.

### **We have grown rapidly, and a failure to manage any continued growth could reduce our potential revenue and could negatively impact our future operating results.**

In order to successfully implement our overall growth strategies, we will need to carefully and efficiently manage our planned expansion. Among other things, this will require us to continue to:

improve our existing knowledge-based processor technology and develop new processor technologies;

implement and manage new marketing and distribution channels to penetrate different and broader markets for our products;

manage an increasing number of complex relationships with our customers, wafer foundries and other third parties;

monitor and improve our operating systems, procedures and financial controls on a timely basis;

retain existing, and hire additional, key management and technical personnel; and

expand, train and manage our workforce and, in particular, our development, sales, marketing and support organizations.

We may not be able to adequately manage our growth or meet the foregoing objectives. A failure to do so could jeopardize our future revenue and cause our stock price to decline.

Our ability to execute our business plan and grow our business will be heavily dependent on our management team's ability to work effectively together. We may incur additional costs as we effect this integration while also satisfying the enhanced financial management requirements that will be imposed on us as we manage our growth and become a public company.

**The cyclical nature of the semiconductor industry and the networking markets could adversely affect our operating results and our business.**

Our business is subject to the cyclicity of the semiconductor industry, especially the market for communications integrated circuits. Historically, there have been significant downturns in this industry segment, characterized by reduced demand for integrated circuits and accelerated erosion of average selling prices. At times, these downturns have lasted for prolonged periods of time. Furthermore, from time to time, the semiconductor industry has also experienced periods of increased demand and production constraints, in which event we may not be able to have our products produced in sufficient quantities, if at all, to satisfy our customers' needs. It is likely that the communications integrated circuit business will experience similar downturns in the future and that, during such times, our business could be adversely affected. It is also likely that the semiconductor industry will experience periods of strong demand. We may have difficulty in obtaining enough product to sell to our customers or may face substantial increases in the wafer prices charged by our foundries.

## **Table of Contents**

In addition, the networking industry from time to time has experienced and may experience a pronounced downturn. To respond to a downturn, many networking service providers may be required to slow their research and development activities, cancel or delay new product developments, reduce their workforces and inventories and take a cautious approach to acquiring new equipment and technologies from networking OEMs, which would have a significant negative impact on our business. In the future, a downturn in the networking industry may cause our operating results to fluctuate significantly from year to year, which also may tend to increase the volatility of the price of our common stock.

**We may not be able to protect and enforce our intellectual property rights, which could impair our ability to compete and reduce the value of our technology.**

Our success and future revenue growth depend, in part, on our ability to protect our intellectual property. We rely primarily on patent, copyright, trademark and trade secret laws, as well as confidentiality procedures, to protect our proprietary technologies and processes. However, these measures may not provide meaningful protection for our intellectual property.

We cannot assure you that any patents will issue from any of our pending applications. Any rights granted under any of our existing or future patents may not provide meaningful protection or any commercial advantage to us. For example, such patents could be challenged or circumvented by our competitors or declared invalid or unenforceable in judicial or administrative proceedings. The failure of any patents to adequately protect our technology would make it easier for our competitors to offer similar products. We do not have foreign patents or pending applications corresponding to many of our U.S. patents and patent applications, including in some foreign countries where our products are sold or may be sold in the future. Even if foreign patents are granted, effective enforcement in foreign countries may not be available.

With respect to our other proprietary rights, it may be possible for third parties to copy or otherwise obtain and use our proprietary technology or marks without authorization or to develop similar technology independently. Monitoring unauthorized use of our proprietary technology or marks is difficult and costly, and we cannot be certain that the steps we have taken will prevent misappropriation or unauthorized use of our technology or marks. In addition, effective patent, copyright, trademark and trade secret protection may not be available or may be limited in certain foreign countries. Many companies based in the U.S. have encountered substantial infringement problems in foreign countries, including countries in which we sell products. Our failure to effectively protect our intellectual property could reduce the value of our technology and could harm our business, financial condition and operating results.

Furthermore, we have in the past and may in the future initiate claims or litigation against third parties to determine the validity and scope of proprietary rights of others. In addition, we may in the future initiate litigation to enforce our intellectual property rights or the rights of our customers or to protect our trade secrets. Litigation by us could result in significant expense and divert the efforts of our technical and management personnel and could materially and adversely affect our business, whether or not such litigation results in a determination favorable to us.

**Any claim that our products or our proprietary technology infringe third party intellectual property rights could increase our costs of operation and distract management and could result in expensive settlement costs.**

The semiconductor industry is characterized by vigorous protection and pursuit of intellectual property rights or positions, which have resulted in often protracted and expensive litigation. In the past, we have been involved in litigation relating to intellectual property rights. We are not aware of any currently pending intellectual property litigation against us. However, we have received notices from time to time that claim we have infringed upon or misappropriated intellectual property rights owned by others. We typically respond when appropriate and as advised by

## Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-Q

legal counsel. We cannot assure you that parties will not pursue litigation with respect to those allegations. We may, in the future, receive similar notices, any of which could lead to litigation against us. For example, parties may initiate litigation based on allegations that we have infringed their intellectual property rights or misappropriated or misused their trade secrets or may seek to invalidate or otherwise render unenforceable one or more of our patents. Litigation against us could result in significant expense and divert the efforts of our management, technical, marketing and other personnel, whether or not the litigation results in a determination adverse to us. We cannot assure you that we will be able to prevail or settle any such claims or that we will be able to do so at a reasonable cost. In the event of an adverse result in any such litigation, we could be required to pay substantial damages for past infringement and royalties for any future use of the technology. In addition, we may be required to cease the sale of certain products, recall certain products from the market, redesign certain products offered for sale or under development or cease the use of certain marks or names. We cannot assure you that we will be able to successfully redesign our products or do so at a reasonable cost. Additionally, we have in the past sought and may in the future seek to obtain a license to a third party's intellectual rights and have granted and may in the future grant a license to certain of our intellectual property rights to a third party in connection with a cross-license agreement or a settlement of claims or actions asserted against us. However, we cannot assure you that we would be able to obtain a license on commercially reasonable terms, or at all.

## **Table of Contents**

Our customers could also become the target of litigation relating to the patent and other intellectual property rights of others. This could trigger technical support and indemnification obligations in some of our license or customer agreements. These obligations could result in substantial expenses, including the payment by us of costs and damages related to claims of patent infringement. In addition to the time and expense required for us to provide support or indemnification to our customers, any such litigation could disrupt the businesses of our customers, which in turn could hurt our relations with our customers and cause the sale of our products to decrease. We cannot assure you that claims for indemnification will not be made or that if made, such claims would not have a material adverse effect on our business, operating results or financial condition. We do not have any insurance coverage for intellectual property infringement claims for which we may be obligated to provide indemnification. If we are obligated to pay damages in excess of, or otherwise outside of, our insurance coverage, or if we have to settle these claims, our operating results could be adversely affected.

### **If we are unable to compete effectively, our revenue and market share may be reduced.**

Our business is extremely competitive, especially during the design-in phase of networking OEMs' design cycles. Historically, we compete with the enterprise and networking divisions of large semiconductor manufacturers, such as Cypress Semiconductor Corporation and Integrated Device Technology, Inc., or IDT, which have more established reputations, more diverse customer bases and greater financial and other resources than we do. In addition, our OEM customers may design their own integrated circuits to address their needs for network-aware processing. As we develop new applications for our knowledge-based processors and expand into new markets, we expect to face even greater competition. Our present and future competitors may be able to better anticipate customer and industry demands and to respond more quickly and efficiently to those demands, such as with product offerings, financial discounts or other incentives. Furthermore, our OEM customers may be able to develop or acquire integrated circuits that satisfy their needs faster or most cost effectively than we can. We cannot assure you that we will be able to compete effectively against these and our other competitors. If we do not compete effectively, our revenue and market share may decline.

### **Any acquisitions we make could disrupt our business and harm our financial condition.**

In the future, we may consider opportunities to acquire other businesses or technologies that would complement our current offerings, expand the breadth of our markets or enhance our technical capabilities. To date, we have not made any acquisitions, and we are currently not subject to any agreement or letter of intent with respect to potential acquisitions. Acquisitions present a number of potential challenges that could, if not met, disrupt our business operations, increase our operating costs and reduce the value to us of the acquired company, including:

integration of the acquired employees, operations, technologies and products with our existing business and products;

focusing management's time and attention on our core business;

retention of business relationships with suppliers and customers of the acquired company;

entering markets in which we lack prior experience;

retention of key employees of the acquired company; and

## Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-Q

amortization of intangible assets, write-offs, stock-based compensation and other charges relating to the acquired business and our acquisition costs.

**Our success may depend on our ability to comply with new or evolving industry standards applicable to our products or our business.**

Our ability to compete in the future may depend on our ability to ensure that our products comply with evolving industry standards affecting the networking equipment and other markets in which we compete. In addition, from time to time, new industry standards may emerge which could render our products incompatible with the products of our customers or suppliers. In order to ensure compliance with the relevant standards, we may be required to devote significant time, capital and other resources to modify or redesign our existing products or to develop new products. We cannot assure you that we will be able to develop products which comply with prevailing standards. If we are unable to develop these products in a timely manner, we may miss significant business opportunities, and our revenue and operating results could suffer.

## **Table of Contents**

**If an earthquake or other natural disaster disrupts the operations of our third party wafer foundries or other vendors located in high risk regions, we could experience significant delays in the production or shipment of our products.**

TSMC and UMC, which manufacture our products, along with most of our vendors who handle the assembly and testing of our products, are located in Asia. The risk of an earthquake in the Pacific Rim region is significant due to the proximity of major earthquake fault lines. In September 1999, a major earthquake in Taiwan affected the facilities of several of these third party vendors, as well as other providers of these services. As a result of this earthquake, these vendors suffered power outages and disruptions that impaired their production capacity. In March 2002 and June 2003, additional earthquakes occurred in Taiwan. The occurrence of additional earthquakes or other natural disasters could result in the disruption of the wafer foundry or assembly and test capacity of the third parties that supply these services to us. We may not be able to obtain alternate capacity on favorable terms, if at all.

**Our stock price could drop, and there could be significantly less trading activity in our stock, if securities or industry analysts downgrade our stock or do not publish research or reports about our business.**

Our stock price and the trading market for our stock are likely to be affected significantly by the research and reports concerning our company and our business which are published by industry and securities analysts. We do not have any influence or control over these analysts, their reports or their recommendations. Our stock price and the trading market for our stock could be negatively affected if any analyst downgrades our stock, publishes a report which is critical of our business, or discontinues coverage of us.

**Our common stock has experienced substantial price volatility.**

Our common stock has experienced substantial price volatility. Such volatility may occur in the future, particularly because of quarter-to-quarter variations in our actual or anticipated financial results, other semiconductor companies, or our customers. Stock price volatility may also result from product announcements by us or our competitors, or from changes in perceptions about the various types of products we manufacture and sell. In addition, our stock price may fluctuate due to price and volume fluctuations in the stock market, especially in the technology sector.

**A limited number of stockholders will have the ability to influence the outcome of director elections and other matters requiring stockholder approval.**

Our executive officers, directors and entities affiliated with them will, in the aggregate, beneficially own more than 40% of our outstanding common stock. These stockholders acting together will have the ability to exert substantial influence over all matters requiring the approval of our stockholders, including the election and removal of directors and any proposed acquisition, consolidation or sale of all or substantially all of our assets. In addition, they could dictate the management of our business and affairs. This concentration of ownership could have the effect of delaying, deferring or preventing a change in control, or impeding an acquisition, consolidation, takeover or other business combination, which might otherwise involve the payment of a premium for your shares of our common stock.

**Provisions of our certificate of incorporation and bylaws or Delaware law might delay or prevent a change of control transaction and depress the market price of our stock.**



## Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-Q

Various provisions of our certificate of incorporation and bylaws might have the effect of making it more difficult for a third party to acquire, or discouraging a third party from attempting to acquire, control of us. These provisions could limit the price that certain investors might be willing to pay in the future for shares of our common stock. Certain of these provisions eliminate cumulative voting in the election of directors, limit the right of stockholders to call special meetings and establish specific procedures for director nominations by stockholders and the submission of other proposals for consideration at stockholder meetings.

We are also subject to provisions of Delaware law which could delay or make more difficult a merger, tender offer or proxy contest involving us. In particular, Section 203 of the Delaware General Corporation Law prohibits a Delaware corporation from engaging in any business combination with any interested stockholder for a period of three years unless specific conditions are met. Any of these provisions could have the effect of delaying, deferring or preventing a change in control, including, without limitation, discouraging a proxy contest or making more difficult the acquisition of a substantial block of our common stock.

## **Table of Contents**

Our board of directors might issue up to 50,000,000 shares of preferred stock without stockholder approval on such terms as the board might determine. The rights of the holders of common stock will be subject to, and might be adversely affected by, the rights of the holders of any preferred stock that might be issued in the future.

### **Our stockholder rights plan could prevent stockholders from receiving a premium over the market price for their shares from a potential acquiror.**

We adopted a stockholder rights plan that generally entitles our stockholders to rights to acquire additional shares of our common stock when a third party acquires 15.0% of our common stock or commences or announces its intent to commence a tender offer for at least 15.0% of our common stock, other than for certain stockholders that were stockholders prior to our initial public offering as to whom this threshold is 20.0%. This plan could delay, deter or prevent an investor from acquiring us in a transaction that could otherwise result in stockholders receiving a premium over the market price for their shares of common stock.

### **We may need to obtain financing in order to fund our growth strategy.**

We believe that we have or will have access to capital, including the net proceeds of our initial public offering, sufficient to satisfy our working capital requirements for at least the next 12 months. After that time, it may be necessary for us to raise additional funds to support our growth. We cannot assure you that we will be able to obtain financing when needed or that, if available to us, the terms will be acceptable to us. If we issue equity securities in any financing, the new securities may have rights and preferences senior to our shares of common stock, and the ownership interest in us of our current stockholders will be proportionately reduced. If we issued debt securities, they will rank senior to all equity securities. If we are unable to raise additional capital, we may not be able to implement our growth strategy, and our business could be harmed significantly.

### **Changes in laws and regulations that affect the governance of public companies has increased our operating expenses and will continue to do so.**

Recently enacted changes in the laws and regulations affecting public companies, including the provisions of the Sarbanes-Oxley Act of 2002 and the listing requirements for The Nasdaq National Market have imposed new duties on us and on our executives, directors, attorneys and independent accountants. In order to comply with these new rules, we have hired and expect to hire additional personnel and use additional outside legal, accounting and advisory services, which have increased and are likely to continue increasing our operating expenses. In particular, we expect to incur additional administrative expenses as we implement Section 404 of the Sarbanes-Oxley Act, which requires management to report on, and our Independent Registered Public Accounting Firm to attest to, our internal controls. For example, we expect to incur significant expenses in connection with the implementation, documentation and testing of our existing and possibly newly implemented control systems. Management time associated with these compliance efforts necessarily reduces time available for other operating activities, which could adversely affect operating results. If we are unable to achieve full and timely compliance with these regulatory requirements, we could be required to incur additional costs, expend additional management time on remedial efforts and make related public disclosures that could adversely affect our stock price and result in securities litigation.

## **Item 3: Quantitative and Qualitative Disclosures About Market Risk**

## Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-Q

The primary objective of our investment activities is to preserve principal while maximizing the income we receive from our investments without significantly increasing the risk of loss. Some of the investable securities permitted under our cash management policy may be subject to market risk for changes in interest rates. To mitigate this risk, we plan to maintain a portfolio of cash equivalent and short-term investments in a variety of securities which may include investment grade commercial paper, money market funds, government debt issued by the United States of America, state debt, certificates of deposit and investment grade corporate debt. Presently, we are exposed to minimal market risks associated with interest rate changes. We manage the sensitivity of our results of operations to these risks by maintaining investment grade short-term investments. Our cash management policy does not allow us to purchase or hold derivative or commodity instruments or other financial instruments for trading purposes. Additionally, our policy stipulates that we periodically monitor our investments for adverse material holdings related to the underlying financial solvency of the issuer. As of September 30, 2004, our investments consisted mostly of investment grade commercial paper and U.S. government debt. Our results of operations and financial condition would not be significantly impacted by either a 10% increase or decrease in interest rates due mainly to the short-term nature of our investment portfolio. Our exposure to interest rates also relates to an increase or decrease in the amount of interest expense we may incur depending upon our outstanding bank debt. As of September 30, 2004, our bank facility allowed us to borrow up to \$14.5 million at a variable interest rate based upon the prime rate. The risks associated with fluctuating interest expense are limited to this debt instrument, and we do not believe that a 10.0% change in the prime rate would have a material impact upon our results of operations.

**Table of Contents****Item 4: Controls and Procedures**

We have performed an evaluation under the supervision and with the participation of our management, including our Chief Executive Officer (CEO) and Chief Financial Officer (CFO), of the effectiveness of our disclosure controls and procedures, as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 (the Exchange Act). Based on that evaluation, our management, including our CEO and CFO, concluded that our disclosure controls and procedures were effective as of September 30, 2004 to ensure that information required to be disclosed by us in the reports filed or submitted by us under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. During our last fiscal quarter, there were no changes in our internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

**PART II. OTHER INFORMATION****Item 2. Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities**

(a) Not applicable.

(b) Not applicable.

(c) Not applicable.

(d) We are furnishing the following information with respect to the use of proceeds we received from our initial public offering in July 2004:

Gross proceeds to the company	\$ 44,842,512
Offering expenses:	
Underwriting fees	\$ 3,138,976
Other offering expenses (estimated)	2,476,000
	<hr/>
Total offering expenses	5,614,976
	<hr/>
Net proceeds to the company	\$ 39,227,536
	<hr/>

As of the date of this report, we used the net proceeds of the offering as follows:

We used \$10.5 million to repay existing debt under our credit lines with Silicon Valley Bank;

We used \$7.6 million to repay the convertible promissory notes we issued and sold in March 2004; and

We invested the remaining net proceeds in short-term, interest-bearing instruments, pending their use to fund working capital and other general corporate purposes, including capital expenditures and research and development.

**Item 6. Exhibits and Reports:**

An Exhibit Index has been attached as part of this quarterly report and is incorporated herein by reference.

Table of Contents

**SIGNATURE**

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.

**NETLOGIC MICROSYSTEMS, INC.**

Dated: November 12, 2004

By: /s/ RONALD JANKOV

---

Ronald Jankov  
Chief Executive Officer and President  
**(Principal Executive Officer)**

Dated: November 12, 2004

By: /s/ DONALD WITMER

---

Donald Witmer  
Vice President of Finance and Chief Financial Officer  
**(Principal Financial and Accounting Officer)**

**Table of Contents**

**EXHIBIT INDEX**

10.2.1	Form of stock option agreement under 2004 Equity Incentive Plan
31.1	Rule 13a-14 certification
31.2	Rule 13a-14 certification
32	Section 1350 certification