

NETLOGIC MICROSYSTEMS INC  
Form 10-Q  
May 09, 2005  
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 March 31, 2005

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 17,750,733 as of April 29, 2005.

---

---

**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 March 31, 2005 and December 31, 2004</u>	3
<u>Condensed Statements of Operations for the three months ended March 31, 2005 and 2004</u>	4
<u>Condensed Statements of Cash Flows for the three months ended March 31, 2005 and 2004</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>	11
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	27
<b>PART II: <u>OTHER INFORMATION</u></b>	
Item 2. <u>Unregistered Sale of Equity Securities and Use of Proceeds</u>	28
Item 5. <u>Other Information</u>	28
Item 6. <u>Exhibits</u>	29
<u>Signatures</u>	30

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

## NETLOGIC MICROSYSTEMS, INC.

## CONDENSED BALANCE SHEETS

(IN THOUSANDS)

(UNAUDITED)

	March 31, 2005	December 31, 2004
	<u>          </u>	<u>          </u>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 46,270	\$ 41,411
Accounts receivable, net	8,683	5,873
Inventory	7,124	7,759
Prepaid expenses and other current assets	907	1,408
	<u>          </u>	<u>          </u>
Total current assets	62,984	56,451
Property and equipment, net	2,745	2,953
Other assets	104	50
	<u>          </u>	<u>          </u>
Total assets	\$ 65,833	\$ 59,454
	<u>          </u>	<u>          </u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 4,992	\$ 5,690
Accrued liabilities	4,965	4,164
Capital lease obligations, current	824	1,314
	<u>          </u>	<u>          </u>
Total current liabilities	10,781	11,168
Capital lease obligations, long-term	1	3
Other liabilities	240	181
	<u>          </u>	<u>          </u>
Total liabilities	11,022	11,352
	<u>          </u>	<u>          </u>
Stockholders' equity:		
Common stock	177	176
Additional paid-in capital	150,717	150,769
Notes receivable from stockholders	(94)	(434)
Deferred stock-based compensation	(2,230)	(3,227)
Accumulated deficit	(93,759)	(99,182)

Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-Q

Total stockholders' equity	54,811	48,102
Total liabilities and stockholders' equity	\$ 65,833	\$ 59,454

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	
	March 31,	
	2005	2004
Revenue:		
Product revenue	\$ 21,802	\$ 7,765
License and engineering service revenue		502
Total revenue	21,802	8,267
Cost of revenue:		
Cost of product revenue (1)	9,484	5,570
Gross profit	12,318	2,697
Operating expenses:		
Research and development	3,837	4,084
Selling, general and administrative	2,412	1,544
Stock-based compensation (2)	637	2,253
Total operating expenses	6,886	7,881
Income (loss) from operations	5,432	(5,184)
Interest and other income (expense), net	159	(221)
Income (loss) before income taxes	5,591	(5,405)
Provision for income taxes	168	
Net income (loss)	\$ 5,423	\$ (5,405)
Net income (loss) per share - Basic	\$ 0.31	\$ (1.58)
Net income (loss) per share - Diluted	\$ 0.29	\$ (1.58)
Shares used in calculation - Basic	17,462	3,427
Shares used in calculation - Diluted	18,558	3,427
(1) Stock-based compensation included in cost of product revenue	\$ 14	\$ 117

Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-Q

(2) Components of stock-based compensation included in operating expenses:		
Research and development	\$ 257	\$ 871
Selling, general and administrative	380	1,382
Total	\$ 637	\$ 2,253

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

**Table of Contents**

## NETLOGIC MICROSYSTEMS, INC.

## CONDENSED STATEMENTS OF CASH FLOWS

(IN THOUSANDS)

(UNAUDITED)

	<b>Three months ended</b>	
	<b>March 31,</b>	
	<b>2005</b>	<b>2004</b>
<b>Cash flows from operating activities:</b>		
Net income (loss)	\$ 5,423	\$ (5,405)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	408	430
Non-cash interest expense	68	138
Amortization of deferred stock-based compensation	651	2,370
Non-cash stock compensation charge	19	
Provision for allowance for doubtful accounts	(93)	112
Changes in assets and liabilities:		
Accounts receivable	(2,717)	(2,820)
Inventory	635	(3,540)
Prepaid expenses and other assets	379	(164)
Accounts payable	(698)	5,459
Accrued liabilities	801	(3,085)
Deferred revenue		(500)
Other long-term liabilities	59	
	<u>4,935</u>	<u>(7,005)</u>
<b>Cash flows from investing activities:</b>		
Purchase of property and equipment	(199)	(348)
Proceeds from sale of short-term investments		228
Restricted cash		5,000
	<u>(199)</u>	<u>4,880</u>
<b>Cash flows from financing activities:</b>		
Proceeds from issuance of convertible promissory notes and warrants		7,650
Proceeds from notes payable and lines of credit		13,539
Repayment of notes payable and lines of credit		(12,410)
Proceeds from issuance of common stock	280	752
Capital lease payments	(492)	126
Repurchase of common stock	(5)	(2)
Proceeds from payment of notes receivable from stockholders	340	23
	<u>123</u>	<u>9,678</u>
Net cash provided by financing activities		
	<u>4,859</u>	<u>7,553</u>
Net increase in cash and cash equivalents		
Cash and cash equivalents at the beginning of period	41,411	13,155



Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-Q

Cash and cash equivalents at the end of period	\$ 46,270	\$ 20,708
<b>Supplemental disclosure of cash flow information:</b>		
Cash paid for interest	\$	\$ 48
<b>Supplemental disclosure of non-cash investing and financing activities:</b>		
Acquisition of property and equipment under capital lease	\$	\$ 143
Issuance of warrants in connection with lines of credit	\$	\$ 223
Beneficial conversion feature of convertible notes	\$	\$ 2,466

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.

These unaudited financial statements should be read in conjunction with the audited financial statements and accompanying notes included in our Annual Report on Form 10-K for the year ended December 31, 2004. Operating results for the three-month period ended March 31, 2005 are not necessarily indicative of the results that may be expected for the year ending December 31, 2005.

**2. 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.

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):

	<b>Three months ended</b>	
	<b>March 31,</b>	
	<b>2005</b>	<b>2004</b>
Net income (loss) - as reported	\$ 5,423	\$ (5,405)
Add: stock-based compensation expense included in reported net loss	651	2,370
	(1,781)	(2,431)

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

Deduct: stock-based compensation expense determined under fair value based method for all awards		
Net income (loss) - pro forma	\$ 4,293	\$ (5,466)
Net income (loss) per common share		
As reported:		
Basic	\$ 0.31	\$ (1.58)
Diluted	\$ 0.29	\$ (1.58)
Pro forma:		
Basic	\$ 0.25	\$ (1.59)
Diluted	\$ 0.23	\$ (1.59)

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.

**Table of Contents***Fair value disclosures*

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

	Three months ended March 31,	
	2005	2004
Risk-free interest rate	3.47% - 4.16%	2.11% - 3.10%
Expected life of options	4 years	4 years
Expected dividend yield	0%	0%
Volatility	80%	0%

The weighted average fair value of employee stock option grants was \$6.43 and \$12.40 for the three months ended March 31, 2005 and 2004, respectively.

**3. Basic and Diluted Net Income (Loss) Per Share**

We compute net income (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.

The following is a reconciliation of the weighted average common shares used to calculate basic net income (loss) per share to the weighted average common and potential common shares used to calculate diluted net income (loss) per share for the three months ended March 31, 2005 and 2004 (in thousands, except per share data):

	Three months ended March 31,	
	2005	2004
Numerator:		
Net income (loss)	\$ 5,423	\$ (5,405)
Denominator:		
Weighted-average common shares outstanding	17,669	3,885
Less: shares subject to repurchase	(207)	(458)
Shares used in calculation - basic	17,462	3,427

Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-Q

Stock options and warrants	889	
Shares subject to repurchase	207	
	<u>18,558</u>	<u>3,427</u>
Shares used in calculation - diluted		
Net income (loss) per share		
Basic	\$ 0.31	\$ (1.58)
	<u>0.29</u>	<u>(1.58)</u>
Diluted		

For the three months ended March 31, 2005, employee stock options to purchase approximately 674,000 shares of common stock were excluded from the computation of diluted net loss per share as their effect would be anti-dilutive.

#### 4. Cash and Cash Equivalents

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. At March 31, 2005 and December 31, 2004, our cash and cash equivalents of \$46.3 million and \$41.4 million, respectively, consisted of cash and money market funds.

**Table of Contents****5. Balance Sheet Components**

The components of our inventory at March 31, 2005 and December 31, 2004 were as follows (in thousands):

	<b>March 31, 2005</b>	<b>December 31, 2004</b>
<b>Inventories:</b>		
Finished goods	\$ 5,028	\$ 4,790
Work-in-progress	2,096	2,969
	<u>\$ 7,124</u>	<u>\$ 7,759</u>

The components of our accrued liabilities at March 31, 2005 and December 31, 2004 were as follows (in thousands):

	<b>March 31, 2005</b>	<b>December 31, 2004</b>
<b>Accrued liabilities:</b>		
Accrued inventory	\$ 1,632	\$ 1,030
Accrued research and development expenses	718	1,282
Other accrued liabilities	2,615	1,852
	<u>\$ 4,965</u>	<u>\$ 4,164</u>

**6. 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 months ended March 31, 2005 and 2004 (in thousands):

	<b>Three months ended March 31, 2005</b>	<b>Three months ended March 31, 2004</b>
Warranty accrual:		
Beginning balance	\$ 381	\$ 1,051

Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-Q

Settlements made during the period		(1,051)
Provision for warranty	164	716
	<u>          </u>	<u>          </u>
Ending balance	\$ 545	\$ 716
	<u>          </u>	<u>          </u>

**7. Revolving line of credit**

In October 2003, we obtained a line of credit (the Working Capital Line ) with a bank, 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 Working Capital Line required \$5.0 million to be on deposit with the bank and this amount was included as restricted cash on the balance sheet.

In March 2004, we amended the Working Capital Line. The terms of the amended agreement no longer required the \$5.0 million deposit with the bank and allowed us to borrow up to \$4.5 million for working capital purposes to the extent we have cash, cash equivalents and short term investments in the custody of the bank. In addition, the portion of the facility that was also available based on certain accounts receivable balances was replaced by an Accounts Receivable Financing facility. The Accounts Receivable Financing facility allowed us to borrow up to \$10.0 million based on a percentage of certain customer purchase orders and accounts receivable balances.

In March 2004, in connection with the amendment to the Working Capital Line, we issued the bank a warrant to purchase 62,000 shares of our Series E Redeemable Convertible Preferred Stock at \$4.88 per share. The warrant remained outstanding at December 31, 2004 and expires in March 2011. The fair value of the warrants of \$223,000 is being amortized

## **Table of Contents**

as interest expense over the remaining 18-month life of the agreement. The fair value of the warrant was estimated using the Black-Scholes model using a risk-free interest rate of 3.49%, the seven-year contractual life of the warrant, expected dividend yield of zero, volatility of approximately 80% and a fair value of \$4.88 per share.

In July 2004, we repaid in full \$10.5 million outstanding under the Working Capital Line at that time. Subsequent to our initial public offering on July 14, 2004, the Working Capital Line was amended twice and our line of credit was increased to \$14.5 million available for general working capital purposes. As of March 31, 2005, 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 (6.0% at March 31, 2005), 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. Under the terms of the agreement, we are required to maintain a tangible net worth of at least \$40 million and a minimum Adjusted Quick Ratio of 2.0 (both as defined in the Working Capital Line agreement) at all times. We had complied with these covenants as of March 31, 2005.

## **8. 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 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 repayment was charged to interest expense.

## **9. Commitments and Contingencies**

### *Purchase Commitments*

At March 31, 2005, we had approximately \$5.8 million in non-cancelable purchase commitments with suppliers.

### *Contingencies*



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

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, however, 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.

**Table of Contents****10. Related Party Transactions**

We lease our headquarters facility in Mountain View, California with an affiliate of Berg & Berg Enterprises, LLC (the Affiliate), which holds our voting securities. During the three months ended March 31, 2005, we made lease payments of approximately \$113,000 under this lease arrangement.

**11. 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 March 31, 2005 and 2004:

	<b>Three months ended</b>	
	<b>March 31,</b>	
	<b>2005</b>	<b>2004</b>
Revenue:		
North America	83%	92%
Asia	16%	4%
Europe	1%	4%
<b>Total</b>	<b>100%</b>	<b>100%</b>

As of March 31, 2005 and December 31, 2004, the following customers accounted for more than 10% of our total accounts receivable:

	<b>March 31,</b>	<b>December 31,</b>
	<b>2005</b>	<b>2004</b>
Solectron Corporation	84%	64%
Celestica Thailand	1%	11%

**13. Recent Accounting Pronouncements**

In December 2004, the FASB issued SFAS No. 123 (revised 2004), Share-Based Payment. SFAS No. 123(R) would require us to measure all employee stock-based compensation awards using a fair value method and record such expense in its financial statements. In addition, the adoption of SFAS No. 123(R) will require additional accounting related to the income tax effects and additional disclosure regarding the cash flow effects resulting from share-based payment arrangements. SFAS No. 123(R) will be effective for us beginning in the first quarter of fiscal 2006. The adoption of SFAS No. 123(R) will have a material impact on our results of operations. Currently, we are evaluating what transition

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

method and what pricing model to select upon adoption.

In December 2004, the FASB issued SFAS No. 153, Exchanges of Nonmonetary Assets, an amendment of APB Opinion No. 29. SFAS No. 153 addresses the measurement of exchanges of nonmonetary assets and redefines the scope of transactions that should be measured based on the fair value of the assets exchanged. SFAS No. 153 will be effective for us for nonmonetary asset exchanges beginning in the first quarter of fiscal 2006. The adoption of SFAS No. 153 is not expected to have a material effect on our financial position or results of operations.

In November 2004, the FASB issued SFAS No. 151, Inventory Costs, an amendment of ARB No. 43, Chapter 4. SFAS No. 151 clarifies that abnormal inventory costs such as costs of idle facilities, excess freight and handling costs, and wasted materials (spoilage) are required to be recognized as current period charges. The provisions of SFAS No. 151 will be effective for us beginning in the first quarter of fiscal 2006. The adoption of SFAS No. 151 is not expected to have a material impact on our financial position, results of operations and cash flows.

## **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 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. Knowledge-based processors are integrated circuits that employ an advanced processor architecture and a large knowledge database containing network and network user information to make complex decisions about individual packets of information travelling through the network. Our knowledge-based processors significantly enhance the ability of networking original equipment manufacturers, or OEMs, to supply network service providers with systems offering more advanced functionality for the Internet, such as voice transmission over the Internet, or VoIP, virtual private networks, or VPNs, and streaming video and audio.

Our knowledge-based processors incorporate advanced technologies that enable rapid processing, such as a superscalar architecture, which uses parallel-processing techniques, and deep pipelining, which segments processing tasks into smaller sub-tasks, for higher decision throughput. These technologies enable networking systems to perform a broad range of network-aware processing functions, such as access control for network security, prioritization of traffic flow to maintain quality of service, or QoS, and statistical measurement of Internet traffic for transaction billing.

We provide complete, systems-level solutions that include interface designs and firmware, device driver, packet-processing and knowledge database management application software, design tools and environments and reference designs. By providing a comprehensive systems-level solution, we help networking OEMs reliably introduce next generation networking systems and significantly enhance their time-to-market. These systems-level solutions are provided free-of-charge to our OEM customers to encourage sales of our products.

Our products are designed into systems offered by leading networking OEMs, including Alcatel, ARRIS Group, Inc., Atrica, Inc., Cisco Systems, Inc., CloudShield Technologies, Inc., Extreme Networks, Inc., Fujitsu Limited, Hitachi, Ltd., Huawei, Juniper Networks, Inc. and Nortel Networks.

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

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. Our product revenue increased 163% to \$21.8 million during the three months ended March 31, 2005 from \$8.3 million during the three months ended March 31, 2004. Also, our product revenue increased 366% to \$46.7 million during the year ended December 31, 2004 from \$10.0 million in 2003. Our total revenue for the three months ended March 31, 2005 included two events we view as non-recurring: a significant order to stock a current customer's new production line, and the acceleration of shipments on order to support a build of a new product for the current customer. While our total revenue for the three months ended March 31, 2004 included non-recurring license fees of approximately \$0.5 million related to our license agreement with Micron Technology, Inc., we had no such revenue in the first quarter of this year. 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.

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 general, we do not anticipate making significant capital expenditures. In

## **Table of Contents**

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. In the future, as we launch new products or expand our operations, we may require additional funds to procure product mask sets, order elevated quantities of wafers from our foundry partners, perform qualification testing and assemble and test those 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 might 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.

We recognize revenue at the time of shipment to our customers and our international stocking sales representatives. Our revenue consists primarily of sales of our integrated circuits to networking OEMs and contract manufacturers. Initial sales of our products for a new design are usually made directly to networking OEMs. Once a design enters production, a networking OEM often outsources its manufacturing to contract manufacturers that purchase our products directly from us.

Since we purchase all wafers from suppliers with fabrication facilities and outsource the assembly and testing to third party vendors, a significant portion of our costs of revenue consists of payments to our third party vendors. We do not have long-term agreements with any of our suppliers and rely upon them to fulfill our orders.

Research and development expenses consist primarily of compensation and related costs for personnel as well as costs related to mask procurements and tape-outs, depreciation, software maintenance and facilities costs. All research and development costs are expensed in the period incurred. In order for us to remain competitive, we believe a significant portion of our operating expenses will continue to be related to research and development efforts. We also believe research and development headcount will increase in the future, and that research and development costs will increase in absolute dollars but decline as a percentage of revenue.

Selling expenses consist primarily of compensation and related costs for sales and marketing personnel, marketing programs, travel, facilities overhead and bonuses and commissions for independent sales representatives. General and administrative expenses consist primarily of compensation and related costs for finance and accounting, patent and corporate legal expenses, information technology and facilities overhead.

## **Critical Accounting Estimates**

The preparation of our condensed unaudited financial statements in conformity with accounting principles generally accepted in the United States of America requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. We based these estimates and assumptions on historical experience and evaluate them on an on-going basis to help ensure they remain reasonable under current conditions. Actual results could differ from those estimates. For a discussion of the critical accounting estimates, see Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations - Critical Accounting Policies in our Annual Report on Form 10-K for the year ended December 31, 2004.



**Table of Contents****Results of Operations*****Comparison of Three Months Ended March 31, 2005 to Three Months Ended March 31, 2004*****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 March 31, 2005 and the three months ended March 31, 2004 (in thousands, except percentage data):

	Three Months		Three Months		Year-to-Year Increase (Decrease)	Increase (Decrease) Percentage
	ended	Percentage	ended	Percentage		
	March 31,	of	March 31,	of		
	2005	Revenue	2004	Revenue	(Decrease)	Percentage
<b>Revenue:</b>						
Product revenue	\$ 21,802	100.0%	\$ 7,765	93.9%	\$ 14,037	180.8%
License and engineering service revenue			502	6.1%	(502)	-100.0%
<b>Total revenue</b>	<b>21,802</b>	<b>100.0%</b>	<b>8,267</b>	<b>100.0%</b>	<b>13,535</b>	<b>163.7%</b>
<b>Cost of revenue:</b>						
Cost of product revenue	9,484	43.5%	5,570	67.4%	3,914	70.3%
<b>Gross profit</b>	<b>\$ 12,318</b>	<b>56.5%</b>	<b>\$ 2,697</b>	<b>32.6%</b>	<b>\$ 9,621</b>	<b>356.7%</b>

*Revenue.* The increase in total revenue during the three months ended March 31, 2005 resulted from the growth in sales of our knowledge-based processors. During the three months ended March 31, 2005, the volume of knowledge-based processor shipments increased approximately 273% compared to that of the three months ended March 31, 2004. Revenue from sales to Cisco and its contract manufacturers represented 85% of total revenue for the three months ended March 31, 2005 compared to 64% during the three months ended March 31, 2004. The increase in sales of our knowledge-based processors was offset by the decrease in license and engineering service revenue during the three months ended March 31, 2005. The license and engineering service revenue generated during the three months ended March 31, 2004 represented the amount we received pursuant to a strategic agreement with Micron Technology Inc. ( Micron ) signed in December 2002. Under the current agreement, Micron is obligated to pay us fees totaling \$5.3 million, of which \$4.6 million has been recognized as license and engineering service revenue through March 31, 2005. The remaining \$0.7 million 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.

*Cost of Revenue.* The cost of revenue increased to \$9.5 million for the three months ended March 31, 2005 primarily due to the increased unit shipments of knowledge-based processors. We recorded a provision for excess and obsolete inventory reserve of \$0.4 million during the three months ended March 31, 2005 as we determined that a portion of inventory related to our previous generation products was unsalable. The cost of revenue during the three months ended March 31, 2005 was also impacted by additional provision of warranty reserve of \$0.2 million. Our



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

warranty accrual is estimated based on historical claims compared to historical revenue and assumes that we have to replace products subject to a claim.

*Gross Profit /Gross Margin.* Gross margin increased to 56.5% during the three months ended March 31, 2005 from 32.6% during the three months ended March 31, 2004. 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 \$1.0 million from the sale of products that had been fully reserved in prior periods and accordingly had no associated costs of revenue. This amount represented approximately 4.4% of the gross margin during the three months ended March 31, 2005. During the three months ended March 31, 2004, the gross margin of 32.6% was impacted adversely because we realized a zero margin on \$2.7 million of revenue from shipments of products to Cisco, which had been previously written down to their estimated market value. The license and engineering service revenue of \$0.5 million during the three months ended March 31, 2004 related to the agreement with Micron had no associated cost, and accordingly had 100% gross margin.

### Operating expenses

The table below sets forth operating expense data for the three months ended March 31, 2005 and the three months ended March 31, 2004 (in thousands, except percentage data):

	Three Months		Three Months		Year-to-Year Increase (Decrease)	Increase (Decrease) Percentage
	ended	Percentage	ended	Percentage		
	March 31, 2005	of Revenue	March 31, 2004	of Revenue		
Operating expenses:						
Research and development	\$ 3,838	17.6%	\$ 4,084	49.4%	\$ (246)	-6.0%
Selling, general and administrative	2,412	11.1%	1,544	18.7%	868	56.2%
Stock-based compensation	637	2.9%	2,253	27.3%	(1,616)	-71.7%
<b>Total operating expenses</b>	<b>\$ 6,887</b>	<b>31.6%</b>	<b>\$ 7,881</b>	<b>95.3%</b>	<b>\$ (994)</b>	<b>-12.6%</b>

**Table of Contents**

*Research and Development Expenses.* Research and development expenses decreased during the three months ended March 31, 2005, as compared to the same period in 2004, primarily due to the decrease in product development and qualification expenses of \$0.6 million. During the three months ended March 31, 2004, product development and qualification expenses were significantly higher as we began to ramp the production of knowledge-based processor products. Further, consulting expense decreased by \$0.1 million during the three months ended March 31, 2005 as we utilized more internal resources to conduct our research and development activities. The decreases in product development and qualification expenses and consulting expenses were offset by increases in software maintenance expense of \$0.1 million and rent and facilities expense of \$0.2 million. The increase in software maintenance expense was due to the purchase of additional software licenses to support our semiconductor design activities. The increase in rent and facilities expenses was the result of our moving to the new headquarters building in July 2004. 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 three months ended March 31, 2005, as compared to the same period in 2004, primarily due to the increases in directors and officers' insurance premium of \$0.2 million, payroll related costs of \$0.3 million, consulting expenses of \$0.3 million and sales commission of \$0.1 million. The increase in directors and officers' insurance premium was the result of the Company's becoming a publicly-traded company in July 2004. The increase in payroll related costs was due to the accrual of management bonus pursuant to an Incentive Bonus Plan, which was adopted for fiscal 2005, and the increase in headcount to support our growing operations. The increase in consulting expenses primarily related to our on-going effort to document, evaluate and test our system of internal controls over financial reporting as we prepare to comply with Section 404 of the Sarbanes-Oxley Act of 2002. The increase in commission expense was the result of a significant sales increase during the three months ended March 31, 2005. The remainder of the fluctuation in selling, general and administrative expenses was caused by individually minor items.

*Stock-based compensation.* Stock-based compensation expense represents amortization of deferred stock-based compensation that was recorded in connection with the 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 March 31, 2005 and the three months ended March 31, 2004 (in thousands, except percentage data):

	Three Months		Three Months		Year-to-Year	Change
	ended	Percentage	ended	Percentage		
	March 31,	of	March 31,	of	Change	Percentage
	2005	Revenue	2004	Revenue	Change	Percentage
Other income (expense), net:						
Interest income	\$ 228	1.0%	\$ 35	0.4%	\$ 193	551.43%
Interest expense	(67)	-0.3%	(208)	-2.5%	141	-67.79%
Other expense, net	(2)	0.0%	(48)	-0.6%	46	-95.83%
<b>Total interest and other income (expense), net</b>	<b>\$ 159</b>	<b>0.7%</b>	<b>\$ (221)</b>	<b>-2.7%</b>	<b>\$ 380</b>	<b>-171.95%</b>

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

*Interest and Other Income (Expenses), net.* The net interest and other income of \$0.2 million generated during the three months ended March 31, 2005 was primarily due to a higher average cash and investment balance during that period. The higher average cash and investment balance during the three months ended March 31, 2005 as compared to the three months ended March 31, 2004 was primarily due to the proceeds received in our initial public offering in July 2004 as well as \$4.9 million of cash generated from operating activities during the period. The higher interest expense during the three months ended March 31, 2004 was primarily related to the balances outstanding under the lines of credit and convertible promissory notes during that period. All outstanding amounts under the lines of credit and convertible promissory notes were paid off in July 2004.

### **Liquidity and Capital Resources**

At March 31, 2005, our principal sources of liquidity were our cash and cash equivalents which totaled \$46.3 million.

**Table of Contents**

We have a line of credit for \$14.5 million with a bank, which is available for general working capital purposes (the Working Capital Line). As of March 31, 2005, 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 (6.0% at March 31, 2005), 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, we are required to maintain a tangible net worth of at least \$40 million and a minimum Adjusted Quick Ratio of 2.0 (both as defined in the working capital line agreement) at all times. We had complied with these covenants as of March 31, 2005.

The table below (in thousands) sets forth the key components of cash flow for the three months ended March 31, 2005 and March 31, 2004:

	<b>Three Months ended March 31, 2005</b>	<b>Three Months ended March 31, 2004</b>
Net cash provided by (used in) operating activities	\$ 4,935	\$ (7,005)
Net cash provided by (used in) investing activities	\$ (199)	\$ 4,880
Net cash provided by financing activities	\$ 123	\$ 9,678

***Cash Flows during the Three Months Ended March 31, 2005***

During the three months ended March 31, 2005, our operating activities generated net cash of \$4.9 million. For cash provided by operating activities, our primary source of cash was a net income of \$5.4 million, which was adjusted for non-cash items of \$1.1 million primarily related to depreciation and amortization of stock-based compensation. Other sources of cash for operating activities during the three months ended March 31, 2005 included inventory, which decreased by \$0.6 million as the demand for our knowledge-based processors increased significantly during the period. Cash was also generated from the reduction in prepaid and other assets by \$0.4 million. The cash generated was primarily offset by the increase in accounts receivable of \$2.7 million from higher sales of our knowledge-based processor sales during the period.

Our investing activities used cash of \$0.2 million during the three months ended March 31, 2005. Cash was used to purchase computer equipment and research and development design tools to support our growing operations. We expect to make capital expenditures of approximately \$2.6 million for the remainder of fiscal 2005. 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 \$0.1 million for the three months ended March 31, 2005. The sources of cash were the proceeds from exercises of stock options and repayment of stockholder notes received during the period. Cash provided by activities was offset by repayment of capital lease obligations.

***Cash Flows during the Three Months Ended March 31, 2004***

Cash used in operating activities was \$7.0 million for the three months ended March 31, 2004. The primary use of cash during the period was the reported net loss of \$5.4 million, offset by non-cash charges of approximately \$3.0 million, which primarily consisted of stock-based compensation charges of approximately \$2.4 million. Cash flows from operations in the first three months of 2004 were negatively impacted by an increase in accounts receivable of \$2.8 million and \$3.5 million in inventories, as our business grew. Significant uses of cash during the quarter included an increase in accounts receivable primarily from increased product sales to Solectron. Also, we added inventory to meet increased customer demand for knowledge-based processors. Accounts payable grew as we incurred additional costs associated with procuring additional inventory to meet the demand for our knowledge-based processors from Solectron.

We generated net cash flows from investing activities of \$4.9 million for the three months ended March 31, 2004 due primarily to the decrease in our restricted cash balances when we renegotiated our bank facilities.

**Table of Contents**

Cash flows from financing activities during the three months ended March 31, 2004 were \$9.7 million consisting of proceeds received from the issuance of \$7.7 million in convertible promissory notes and warrants and a \$1.1 million increase in bank financing.

**Capital Resources**

We believe that our existing cash and cash equivalents balance of \$46.3 million, together with the Working Capital Line of \$14.5 million, will be sufficient to meet our anticipated cash needs for at least next 12 months. 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. We also might decide to raise additional capital at such times and upon such terms as management considers favorable and in the interests of the Company.

**Contractual obligations**

There were no material changes to our contractual obligations during the three months ended March 31, 2005, other than the changes due to our payments for previously disclosed obligations. As of March 31, 2005, 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	\$ 4,007	\$ 552	\$ 1,818	\$ 1,328	\$ 309
Capital lease obligations	825	824	1		
Wafer purchases	5,824	5,824			
Other	14	14			
<b>Total</b>	<b>\$ 10,670</b>	<b>\$ 7,214</b>	<b>\$ 1,819</b>	<b>\$ 1,328</b>	<b>\$ 309</b>

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 March 31, 2005, 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.

### **Risk Factors**

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

## **Table of Contents**

**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 95% and 77% of our total revenue during the three months ended March 31, 2005 and 2004, 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 three months ended March 31, 2005 and 2004, Cisco and its contract manufacturers accounted for 85% and 64% of our total revenue, respectively. 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:

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



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

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.

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

Although we reported net income of \$5.4 million during the three months ended March 31, 2005, we reported operating losses in each year since our inception in 1995. At March 31, 2005, we had an accumulated deficit of approximately \$93.8 million. To sustain profitability, we will have to continue 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 sustain profitability on a quarterly or annual basis.

## **Table of Contents**

### **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.

### **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 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.

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

We have recently experienced significant revenue growth. Specifically, our total revenue increased 163% to \$21.8 million during the three months ended March 31, 2005 from \$8.3 million during the three months ended March 31, 2004. In addition, our total revenue increased 253% to \$47.8 million during the year ended December 31, 2004 from \$13.5 million during the year ended December 31, 2003. We do not expect similar revenue growth rates in future periods. 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 86% and 65% of our total revenue for the three months ended March 31, 2005 and 2004, 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.

## **Table of Contents**

**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 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 convert the production of our integrated circuits to a new fabrication process and qualify the other 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.

**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, reliability 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, which may affect the quality or reliability of our products. We may incur substantial research and development expense for prototype or development stage products as we qualify the products for production.

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

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.

## **Table of Contents**

### **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 demands 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.

### **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.

### **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 non-competition agreements or term employment agreements with any of our executive officers, whom we generally employ at will. 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.

## **Table of Contents**

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.

**When the accounting treatment for employee stock option changes, we expect our earnings to be adversely affected by the new stock option accounting rule 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. In December 2004, the FASB issued SFAS No. 123 (revised 2004), Share-Based Payment. SFAS No. 123(R) would require the Company to measure all employee stock-based compensation awards using a fair value method and record such expense in its financial statements. In addition, the adoption of SFAS No. 123(R) will require additional accounting related to the income tax effects and additional disclosure regarding the cash flow effects resulting from share-based payment arrangements. We are required to adopt SFAS No. 123(R) beginning in the first quarter of fiscal 2006. Upon adoption of SFAS No. 123(R), our stock-based compensation expenses will be higher and our net income will be reduced or net losses will be increased compared to our current accounting. As a consequence, we may consider reducing future stock option grants which 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 17% of our total revenue during the three months ended March 31, 2005, and for 8% of our total revenue during the same period of 2004. 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:



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

foreign currency exchange fluctuations;

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.

## **Table of Contents**

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 of 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.

**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.

## **Table of Contents**

**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, for example, the periodic costs associated with the generation of mask sets for new products and product improvements and 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.**

We expect our business to be subject to the cyclical nature 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 also has 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 affected adversely. 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.

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.

## **Table of Contents**

**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 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

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

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.

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.

## **Table of Contents**

### **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 and 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. 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

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.

**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.

## **Table of Contents**

### **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 a significant portion 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.**

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.

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.

**The price of our stock could decrease as a result of shares being sold in the market, including sales by directors, officers and other significant stockholders.**

Sales of a substantial number of shares of common stock in the public market could adversely affect the prevailing market price of our common stock from time to time. The number of shares of our common stock available for sale in the public market is limited by restrictions under the Securities Act of 1933, as amended, but taking into account sales of stock made in accordance with the provisions of Rules 144(k), 144 and 701, substantially all the shares of our common stock currently outstanding are eligible for sale in the public market. We believe that as of April 1, 2005, approximately 7.3 million shares (including currently exercisable options) are held by our directors, officers and holders of 5% or more of our common stock.

## **Table of Contents**

Each of our executive officers has entered into a plan for selling a portion of his or her shares of common stock in the manner described under Rule 10b5-1 of the Securities Exchange Act of 1934. Each plan is non-discretionary and is administered by an independent brokerage firm. Each plan provides for aggregate sales of between 33,000 and 140,000 shares in blocks of at least 1,000 shares in specified months pursuant to limit orders at specified prices. The duration of each plan is through December 31, 2005. Pursuant to these plans, these executive officers may sell up to 547,360 shares of common stock combined during 2005. Sales of the shares are further subject to the volume restrictions set forth in SEC Rule 144(e). Each plan provides for termination upon the completion of the specified trading program, the instruction of the stockholder, or the occurrence of other specified events, whichever is earliest. All of the shares are sold through broker-dealers in ordinary market transactions. In addition, subject to compliance with applicable securities laws, each of these executive officers may sell shares of common stock outside of these plans. Pre-designated trading under these plans may cause unexpected declines in the market price of our common stock.

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

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 have 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**

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

**Table of Contents**

adverse material holdings related to the underlying financial solvency of the issuer. As of March 31, 2005, 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 March 31, 2005, 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.

**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 March 31, 2005 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. Unregistered Sale of Equity Securities and Use of Proceeds**

(a) Not applicable.

(b) Not applicable.

(c) We are furnishing the following information with respect to purchases made by us or on our behalf or on behalf of any affiliated purchaser (as defined in Rule 10b-18(a)(3) under the Securities Exchange Act of 1934) of shares of our common stock during each of the three months ended March 31, 2005:

<u>Period</u>	(a) Total Number of Shares (or Units) Purchased	(b) Average Price Paid per Share (or Unit)	(c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans	(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet
---------------	---	--	---	--

	<u>or Programs<sup>(2)</sup></u>	<u>Be Purchased</u>
		<u>Under the Plans or</u>
		<u>Programs<sup>(2)</sup></u>
Month #1 (January 1-31)		
Month #2 (February 1-28)		
Month #3 (March 1-31)	4,028	\$ 2.00
Total	4,028	\$ 2.00

(1) These shares had been purchased from us by one employee and one director pursuant to the exercise of stock options. We repurchased these shares from the individuals upon their termination of employment or service with us pursuant to our right to repurchase unvested shares at the original exercise price in accordance with our 2000 Stock Plan and the stock option agreements with the individuals.

(2) We do not have any publicly announced plans or programs to purchase our common stock.

#### Item 5. Other Information

On May 5, 2005, the compensation committee of our Board of Directors (the Committee ) adopted an Incentive Bonus Plan (the Plan ) to provide certain eligible employees, as defined in the Plan, an opportunity to participate in an annual incentive

**Table of Contents**

bonus program. On the same day, and pursuant to the Plan, the Committee approved target cash bonus awards for our executive officers for fiscal year 2005. The target cash bonuses range from approximately 10% to 42% of their base salaries, and in the aggregate total \$355,000.

In addition to the annual bonus program, on May 5, 2005 the Committee approved a sales incentive program for our vice president of sales, Marcia Zander. Under the approved incentive program, Ms. Zander is eligible to receive a commission of 0.13% on all product sales during each month of fiscal year 2005.

**Item 6. Exhibits**

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: May 9, 2005

By: /s/ RONALD JANKOV

---

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

Dated: May 9, 2005

By: /s/ DONALD WITMER

---

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

**Table of Contents**

**EXHIBIT INDEX**

10.10	NetLogic Microsystems, Inc. Incentive Bonus Plan Effective May 5, 2005
31.1	Rule 13a-14 certification
31.2	Rule 13a-14 certification
32	Section 1350 certification