REALNETWORKS INC
Form 10-Q
November 09, 2006

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

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

For the Quarterly Period Ended September 30, 2006

OR

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

Commission File Number 0-23137
REALNETWORKS, INC.
(Exact name of registrant as specified in its charter)

Washington	**91-1628146**
(State of incorporation)	**(I.R.S. Employer Identification Number)**
2601 Elliott Avenue, Suite 1000 **Seattle, Washington** **(Address of principal executive offices)**	**98121** **(Zip Code)**

(206) 674-2700
(Registrant s telephone number, including area code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See the definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer þ Accelerated filer o Non-accelerated filer o

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

The number of shares of the registrant s Common Stock outstanding as of October 31, 2006 was 161,595,952.

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RealNetworks, Inc.

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FOR THE QUARTER ENDED SEPTEMBER 30, 2006

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PART I. FINANCIAL INFORMATION
Item 1. Financial Statements

REALNETWORKS, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except per share data)

	September 30, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 693,057	$ 651,971
Short-term investments	151,745	129,356
Trade accounts receivable, net of allowances for doubtful accounts and sales returns	24,481	16,721
Deferred tax assets, net, current portion	7,046	54,204
Prepaid expenses and other current assets	11,488	11,933
Total current assets	887,817	864,185
Equipment, software and leasehold improvements, at cost:		
Equipment and software	65,551	56,402
Leasehold improvements	29,139	27,964
Total equipment, software and leasehold improvements	94,690	84,366
Less accumulated depreciation and amortization	60,235	51,228
Net equipment, software and leasehold improvements	34,455	33,138
Restricted cash equivalents	17,300	17,300
Equity investments	26,269	46,163
Other assets	4,177	2,397
Deferred tax assets, net, non-current portion	15,967	19,147
Goodwill	132,789	123,330
Other intangible assets, net	7,386	7,337
Total assets	$ 1,126,160	$ 1,112,997
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 14,905	$ 11,397
Accrued and other liabilities	72,105	112,340
Deferred revenue, current portion	25,469	25,021
Accrued loss on excess office facilities, current portion	4,053	4,623
Total current liabilities	116,532	153,381

Deferred revenue, non-current portion	340	276
Accrued loss on excess office facilities, non-current portion	11,323	13,393
Deferred rent	4,472	4,018
Convertible debt	100,000	100,000
Other long-term liabilities	1,679	196
Total liabilities	234,346	271,264
Shareholders equity:		
Preferred stock, $0.001 par value, no shares issued and outstanding		
Series A: authorized 200 shares		
Undesignated series: authorized 59,800 shares		
Common stock, $0.001 par value Authorized 1,000,000 shares; issued and outstanding 161,108 shares in 2006 and 166,037 shares in 2005	161	166
Additional paid-in capital	760,347	805,067
Deferred stock compensation		(19)
Accumulated other comprehensive income	15,597	26,724
Retained earnings	115,709	9,795
Total shareholders equity	891,814	841,733
Total liabilities and shareholders equity	$ 1,126,160	$ 1,112,997

See accompanying notes to unaudited condensed consolidated financial statements

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REALNETWORKS, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME
(In thousands, except per share data)

	Quarters ended September 30,		Nine Months ended September 30,	
	2006	2005	2006	2005
Net revenue (A)	$ 93,676	$ 82,233	$ 269,687	$ 241,491
Cost of revenue (B)	28,389	24,695	81,788	74,273
Gross profit	65,287	57,538	187,899	167,218
Operating expenses:				
Research and development	18,344	16,354	55,127	45,381
Sales and marketing	37,560	30,745	111,604	93,809
General and administrative	14,043	7,037	41,586	21,120
Loss on excess office facilities			738	
Subtotal operating expenses	69,947	54,136	209,055	160,310
Antitrust litigation expenses (benefit), net	(61,861)	3,531	(159,554)	11,925
Total operating expenses, net	8,086	57,667	49,501	172,235
Operating income (loss)	57,201	(129)	138,398	(5,017)
Other income (expense), net:				
Interest income, net	10,618	2,904	27,978	7,499
Equity in net loss of MusicNet				(1,068)
Gain on sale of equity investments		11,740	2,286	19,330
Other, net	242	124	432	(276)
Other income, net	10,860	14,768	30,696	25,485
Net income before income taxes	68,061	14,639	169,094	20,468
Income tax provision	(25,908)	(3,457)	(63,180)	(3,763)
Net income	$ 42,153	$ 11,182	$ 105,914	$ 16,705
Basic net income per share	$ 0.26	$ 0.07	$ 0.66	$ 0.10
Diluted net income per share	$ 0.24	$ 0.06	$ 0.59	$ 0.09
Shares used to compute basic net income per share	160,578	170,797	160,466	170,761
Shares used to compute diluted net income per share	178,913	184,180	178,551	184,276
Comprehensive income:				
Net income	$ 42,153	$ 11,182	$ 105,914	$ 16,705
Unrealized holding gains (losses) on investments, net of tax	28	16,321	(12,887)	21,831
Adjustments for gains reclassified to net income		(4,052)		(4,052)

Foreign currency translation gains (losses)	388	(109)	1,760	(1,400)
Comprehensive income	$ 42,569	$ 23,342	$ 94,787	$ 33,084

(A) Components of net revenue:				
License fees	$ 22,528	$ 19,596	$ 68,014	$ 60,605
Service revenue	71,148	62,637	201,673	180,886
	$ 93,676	$ 82,233	$ 269,687	$ 241,491
(B) Components of cost of revenue:				
License fees	$ 9,675	$ 8,666	$ 28,865	$ 24,888
Service revenue	18,714	16,029	52,923	49,385
	$ 28,389	$ 24,695	$ 81,788	$ 74,273

See accompanying notes to unaudited condensed consolidated financial statements

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REALNETWORKS, INC. AND SUBSIDIARIES
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Nine Months Ended September 30,	
	2006	**2005**
Cash flows from operating activities:		
Net income	$ 105,914	$ 16,705
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	12,480	11,869
Stock-based compensation	12,332	109
Equity in net losses of MusicNet		1,068
Changes in accrued loss on excess office facilities and content agreement	(2,640)	(6,230)
Loss on disposal of equipment	76	250
Gain on sale of equity investments	(2,286)	(19,330)
Deferred income taxes	56,508	3,324
Other	73	48
Net change in certain operating assets and liabilities, net of balances acquired	(48,496)	6,127
Net cash provided by operating activities	133,961	13,940
Cash flows from investing activities:		
Purchases of equipment and leasehold improvements	(9,316)	(10,728)
Purchases of intangible assets		(1,000)
Purchases of short-term investments	(177,868)	(121,540)
Proceeds from sales and maturities of short-term investments	156,006	127,790
Decrease in restricted cash equivalents		2,095
Proceeds from sale of equity investments	2,286	19,530
Purchases of cost based investments	(834)	(647)
Payment of acquisition costs, net of cash acquired	(7,086)	(14,705)
Net cash provided by (used in) investing activities	(36,812)	795
Cash flows from financing activities:		
Net proceeds from sale of common stock under employee stock purchase plan and exercise of stock options	41,976	4,926
Repayment of long-term note payable		(648)
Repurchase of common stock	(98,869)	(29,275)
Net cash used in financing activities	(56,893)	(24,997)
Effect of exchange rate changes on cash and cash equivalents	830	(492)
Net increase (decrease) in cash and cash equivalents	41,086	(10,754)
Cash and cash equivalents at beginning of period	651,971	219,426

Cash and cash equivalents at end of period	$ 693,057	$ 208,672
Supplemental disclosure of non-cash investing and financing activities:		
Cash paid for income taxes	$ 14,181	$
Non-cash consideration in business combinations:		
Accrued acquisition payments	$ 2,079	$
Accrued acquisition costs	$	$ 1
Long-term notes payable acquired in business combination	$	$ 863

See accompanying notes to unaudited condensed consolidated financial statements

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REALNETWORKS, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) Description of Business

RealNetworks, Inc. and subsidiaries (RealNetworks or Company) is a leading creator of digital media services and software, such as Rhapsody, RealArcade and RealPlayer. Consumers use the Company s services and software to find, play, purchase and manage free and premium digital content, including music, games and video. Broadcasters, network operators, media companies and enterprises use the Company s products and services to create, secure and deliver digital media to PCs, mobile phones and other consumer electronics devices.

Inherent in the Company s business are various risks and uncertainties, including the limited history of certain of its product and service offerings and its limited history of offering premium subscription services on the Internet. The Company s success will depend on, among other things, the acceptance of the Company s technology, products and services and the ability to generate related revenue.

(b) Basis of Presentation

The accompanying unaudited condensed consolidated financial statements include the accounts of the Company, its wholly-owned subsidiaries, and an entity in which the Company has a variable interest (see item (d) below for a further discussion of the variable interest entity). All significant intercompany balances and transactions have been eliminated in consolidation.

These financial statements reflect all adjustments, consisting only of normal, recurring adjustments that, in the opinion of the Company s management, are necessary for a fair presentation of the results of operations for the periods presented. Operating results for the quarter and nine months ended September 30, 2006 are not necessarily indicative of the results that may be expected for any subsequent quarter or for the year ending December 31, 2006. Certain information and disclosures normally included in financial statements prepared in conformity with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission (SEC).

These unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and related notes included in the Company s Annual Report on Form 10-K for the year ended December 31, 2005.

(c) Cash, Cash Equivalents and Short-Term Investments

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

	September 30, 2006	December 31, 2005
Cash and cash equivalents	$ 693,057	$ 651,971
Short-term investments	151,745	129,356
Total cash, cash equivalents and short-term investments	$ 844,802	$ 781,327
Restricted cash equivalents	$ 17,300	$ 17,300

Restricted cash equivalents at September 30, 2006 represent (a) cash equivalents pledged as collateral against a $10.0 million letter of credit in connection with a lease agreement for the Company s corporate headquarters, and (b) cash equivalents pledged as collateral against a $7.3 million letter of credit with a bank which represents collateral on the lease of a building located near the Company s corporate headquarters.

The majority of short-term investments mature within twelve months from the date of purchase. Investments with maturities beyond one year may be classified as short-term based on their highly liquid nature and because such marketable securities represent the investment of cash that is available for current operations.

The Company has classified as available-for-sale all marketable debt and equity securities for which there is a determinable fair market value and on which the Company has no restrictions to sell within the next 12 months.

Available-for-sale securities are carried at fair value, with unrealized gains and losses reported as a component of shareholders equity, net of applicable income taxes. Realized gains and losses and declines in value judged to be other-than-temporary on available-for-sale securities are included in other

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income (expense), net. The cost basis for determining realized gains and losses on available-for-sale securities is determined using the specific identification method.

(d) Equity Investments

The Company has certain equity investments that are accounted for under the cost method of accounting. The cost method is used to account for equity investments in companies in which the Company holds less than a 20 percent voting interest, does not exercise significant influence and for which the related securities do not have a quoted market price.

The Company has certain equity investments in which the Company holds less than a 20 percent voting interest in companies that are publicly traded. The investments are accounted for at market value. Changes in the market value of the investments are recognized as unrealized gains (losses), net of tax and are recorded in the accompanying unaudited condensed consolidated balance sheets as a component of Accumulated Other Comprehensive Income.

The Company s equity investment in MusicNet, Inc. (MusicNet) was accounted for under the equity method of accounting. Under the equity method of accounting, the Company s share of the investee s earnings or loss was included in the Company s consolidated operating results. In certain cases where the Company had loaned the investee funds, the Company may have recorded more than its relative equity share of the investee s losses. During the quarter ended June 30, 2005, the Company disposed of all of its preferred shares and convertible notes in MusicNet to a private equity firm, Baker Capital, in connection with the sale of all of the capital stock of MusicNet. There was no investment in MusicNet during 2006.

During the quarter ended March 31, 2006, the Company established Beijing RealNetworks Technology Co., Ltd, a Wholly Owned Foreign Entity (WOFE) which operates an Internet retail website in the People s Republic of China (PRC) in cooperation with a PRC affiliate. The results of operations of the WOFE have been included in the Company s consolidated results since the establishment date of the WOFE. The PRC regulates the WOFE s business through regulations and license requirements restricting: (i) the scope of foreign investment in the Internet, retail and delivery sectors; (ii) Internet content; and (iii) the sale of certain media products. In order to meet the PRC local ownership and regulatory licensing requirements, the WOFE s business is operated through a PRC affiliate which is owned by nominee shareholders who are PRC nationals and are RealNetworks employees. The WOFE does not own any capital stock of the PRC affiliate, but is the primary beneficiary of future losses or profits through contractual rights. As a result, the Company consolidates the results of the PRC affiliate in accordance with Financial Accounting Standards Board Interpretation No. 46R, Consolidation of Variable Interest Entities (FIN 46R). The net assets and operating results for the PRC affiliate were not significant during the quarter and nine months ended September 30, 2006.

(e) Other Assets

Other assets primarily consist of offering costs and other long-term deposits. The Company incurred the offering costs as a result of its convertible debt offering in 2003. These costs are deferred and are being amortized using the straight-line method, which approximates the effective interest method, over a 5-year period.

(f) Goodwill and Other Intangible Assets, net

Goodwill represents the excess of the purchase price over the fair value of identifiable tangible and intangible assets acquired and liabilities assumed in business combinations accounted for under the purchase method. Goodwill and intangible assets not subject to amortization are tested annually for impairment, and are tested for impairment more frequently if events and circumstances indicate that the asset might be impaired. Other intangible assets, net primarily consist of trade names, technology and patents that were acquired through certain of the Company s acquisitions, as well as other purchased technology. The intangible assets are amortized using the straight-line method over their estimated period of benefit, ranging from one to five years. The Company evaluates the recoverability of intangible assets periodically and takes into account events or circumstances that warrant revised estimates of useful lives or that may indicate that impairment exists. All of the Company s intangible assets are subject to amortization. No impairments of intangible assets have been identified during any of the periods presented.

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(g) Revenue Recognition

The Company recognizes revenue in accordance with the following authoritative literature: SEC Staff Accounting Bulletin No. 104, Revenue Recognition in Financial Statements (SAB 104); Emerging Issues Task Force (EITF) 00-21 Revenue Arrangements with Multiple Deliverables (EITF 00-21); Statement of Position (SOP) 97-2, Software Revenue Recognition (SOP 97-2); SOP 98-9 Software Revenue Recognition with Respect to Certain Arrangements (SOP 98-9); SOP 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts (SOP 81-1); and EITF 99-19 Reporting Revenue Gross as a Principal versus Net as an Agent (EITF 99-19). In general, the Company recognizes revenue when there is persuasive evidence of an arrangement, the fee is fixed or determinable, the product or services have been delivered and collectibility of the resulting receivable is reasonably assured.

Consumer subscription products are paid in advance, typically for monthly, quarterly or annual periods. Subscription revenue is recognized ratably over the related subscription period. Revenue from sales of downloaded individual tracks, albums and games are recognized at the time the music or game is made available, digitally, to the end user.

The Company has arrangements whereby customers pay one price for multiple products and services. In some cases, these arrangements involve a combination of products and services. For arrangements with multiple deliverables, revenue is recognized upon the delivery of the separate units in accordance with EITF 00-21. In the event that there is no objective and reliable evidence of fair value of the delivered items, the revenue recognized upon delivery is the total arrangement consideration less the fair value of the undelivered items. The Company applies significant judgment in establishing the fair value of multiple elements within revenue arrangements.

The Company recognizes revenue on a gross or net basis, in accordance with EITF 99-19. In most arrangements, the Company contracts directly with its end user customers, is the primary obligor and carries all collectibility risk. Revenue in these arrangements is recorded on a gross basis. In some cases, the Company utilizes third party distributors to sell products or services directly to end user customers and carries no collectibility risk. In those instances, in accordance with EITF 99-19, the Company reports the revenue on a net basis.

The Company recognizes revenue in connection with its software products pursuant to the requirements of SOP 97-2, as amended by SOP 98-9. If the Company provides consulting services that are considered essential to the functionality of the software products, both the software product revenue and services revenue are recognized under contract accounting in accordance with the provisions of SOP 81-1. Revenue from these arrangements is recognized under the percentage of completion method based on the ratio of direct labor hours incurred to total projected labor hours. Revenue from software license agreements with original equipment manufacturers (OEM) is recognized when the OEM delivers its product incorporating the Company s software to the end user.

Revenue generated from advertising appearing on the Company s websites and from advertising included in its products is recognized as revenue as the delivery of the advertising occurs.

(h) Net Income Per Share

Basic net income per share is computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted net income per share is computed by dividing net income by the weighted average number of common and dilutive potential common shares outstanding during the period.

The share count used to compute basic and diluted net income per share is calculated as follows (in thousands):

	Quarters Ended September 30,		**Nine Months Ended September 30,**	
	2006	**2005**	**2006**	**2005**
Weighted average common shares outstanding	160,578	170,797	160,466	170,761
Shares used to compute basic net income per share	160,578	170,797	160,466	170,761
Dilutive potential common shares				
Stock options	7,585	2,633	7,335	2,765
Convertible debt	10,750	10,750	10,750	10,750

Shares used to compute diluted net income per share	178,913	184,180	178,551	184,276

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Approximately 9.2 million and 7.6 million shares of common stock potentially issuable from stock options for the quarter and nine months ended September 30, 2006, respectively, and 24.1 million shares of common stock for both the quarter and nine months ended September 30, 2005, respectively, are excluded from the calculation of diluted net income per share because the exercise price per share was greater than the average per share market price of the common stock for the respective period.

(i) Derivative Financial Instruments

During the quarter ended September 30, 2006, the Company entered into foreign currency forward contracts to manage the foreign currency risk of certain intercompany balances denominated in a foreign currency. Although these instruments are effective as a hedge from an economic perspective, they do not meet the criteria for hedge accounting under Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS 133), as amended.

At September 30, 2006, the following foreign currency contracts were outstanding and recorded at fair value (in thousands):

	Contract Amount (Local Currency)	Contract Amount (US Dollars)	Fair Value
Japanese Yen (YEN) (contracts to pay YEN/receive US$)	(YEN) 151,300	$ 1,293	$ 3

At December 31, 2005, the following foreign currency contracts were outstanding and recorded at fair value (in thousands):

	Contract Amount (Local Currency)	Contract Amount (US Dollars)	Fair Value
British Pounds (GBP) (contracts to receive GBP/pay US$)	(GBP) 1,000	$ 1,736	$ (15)
Euro (EUR) (contracts to pay EUR/receive US$)	(EUR) 1,260	$ 1,514	$ 23
Japanese Yen (YEN) (contracts to receive YEN/pay US$)	(YEN) 30,000	$ 251	$ 4

No derivative instruments designated as hedges for accounting purposes were outstanding at September 30, 2006 or December 31, 2005.

(j) Accumulated Other Comprehensive Income

The Company s accumulated other comprehensive income at September 30, 2006 and December 31, 2005 consisted of net unrealized gains on investments and the net amount of foreign currency translation adjustments. The tax effect of the foreign currency translation adjustments and unrealized gains and losses on investments has been taken into account if applicable. The components of accumulated other comprehensive income are as follows (in thousands):

	September 30, 2006	December 31, 2005
Unrealized gains on investments, net of taxes of $6,278 in 2006 and $13,592 in 2005	$ 15,829	$ 28,717
Foreign currency translation adjustments	(232)	(1,993)
Total accumulated other comprehensive income	$ 15,597	$ 26,724

(k) Stock-Based Compensation

On January 1, 2006, the Company adopted the provisions of, and began accounting for stock-based compensation in accordance with, the Financial Accounting Standards Board s (FASB) Statement of Financial Accounting Standards

No. 123 revised 2004, Share Based Payment (SFAS 123R), which replaced SFAS No. 123, Accounting for Stock-Based Compensation (SFAS 123) and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees (APB 25). Under the fair value provisions of this statement, stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense over the requisite service period, which is the vesting period. The Company uses the Black-Scholes option-pricing model to determine the fair-value of stock-based awards under SFAS 123R, consistent with that used for pro forma disclosures under SFAS 123. The Company utilized the modified prospective transition method, which requires that stock-based compensation expense be recorded for all new and unvested stock options and employee stock purchase plan shares that are ultimately expected to vest as the requisite service is rendered beginning on January 1, 2006, the first day of the Company s 2006 fiscal year. Stock-based compensation expense for awards granted prior to January 1, 2006 is based on the grant date fair-value as determined under the pro forma provisions of SFAS 123.

The expected term of the options represents the estimated period of time until exer