NATUS MEDICAL INC
Form 10-Q
May 06, 2015
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2015

¨ 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: 000-33001

NATUS MEDICAL INCORPORATED
(Exact name of registrant as specified in its charter)

Delaware	77-0154833
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

6701 Koll Center Parkway, Suite 120, Pleasanton, CA 94566
(Address of principal executive offices) (Zip Code)
(925) 223-6700
(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 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 ý No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ý No ¨

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

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

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

The number of issued and outstanding shares of the registrant’s Common Stock, $0.001 par value, as of May 1, 2015 was 32,964,943.

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PART I. FINANCIAL INFORMATION
Item 1. Financial Statements
NATUS MEDICAL INCORPORATED AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS (unaudited)
(in thousands, except share and per share amounts)

	March 31, 2015	December 31, 2014
ASSETS		
Current assets:		
Cash and cash equivalents	$66,999	$66,558
Accounts receivable, net of allowance for doubtful accounts of $4,310 in 2015 and $4,324 in 2014	81,990	82,277
Inventories	41,371	40,051
Prepaid expenses and other current assets	16,394	17,408
Deferred income tax	11,485	11,511
Total current assets	218,239	217,805
Property and equipment, net	18,214	17,923
Intangible assets, net	89,431	92,761
Goodwill	109,327	96,316
Other assets	8,529	10,016
Total assets	$443,740	$434,821
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$22,253	$21,371
Accrued liabilities	37,122	36,024
Deferred revenue	12,014	11,745
Total current liabilities	71,389	69,140
Long-term liabilities:		
Other liabilities	5,149	4,859
Deferred income tax	8,637	8,107
Total liabilities	85,175	82,106
Stockholders' equity:		
Common Stock, $0.001 par value, 120,000,000 shares authorized; shares issued and outstanding 32,902,483 in 2015 and 32,649,158 in 2014	317,629	315,296
Preferred stock, $0.001 par value; 10,000,000 shares authorized; no shares issued and outstanding in 2015 and 2014	—	—
Retained earnings	77,486	68,890
Accumulated other comprehensive loss	(36,550)	(31,471)
Total stockholders' equity	$358,565	$352,715
Total liabilities and stockholders' equity	$443,740	$434,821

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

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NATUS MEDICAL INCORPORATED AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME
(unaudited)
(in thousands, except per share amounts)

	Three Months Ended March 31,	
	2015	2014
Revenue	$89,395	$85,624
Cost of revenue	35,105	33,981
Intangibles amortization	682	1,046
Gross profit	53,608	50,597
Operating expenses:		
Marketing and selling	20,742	20,630
Research and development	6,857	7,177
General and administrative	11,552	11,729
Intangibles amortization	955	1,136
Restructuring	156	538
Total operating expenses	40,262	41,210
Income from operations	13,346	9,387
Other income (expense), net	(829)	312
Income before provision for income tax	12,517	9,699
Provision for income tax expense	3,920	2,944
Net income	$8,597	$6,755
Foreign currency translation adjustment	(5,079)	(2,891)
Comprehensive income	$3,518	$3,864
Earnings per share:		
Basic	$0.27	$0.22
Diluted	$0.26	$0.21
Weighted average shares used in the calculation of earnings per share:		
Basic	32,127	31,062
Diluted	33,097	32,185

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

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NATUS MEDICAL INCORPORATED AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)
(in thousands)

	Three Months Ended March 31, 2015	2014
Operating activities:		
Net income	$8,597	$6,755
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for losses on accounts receivable	276	465
Excess tax benefit on the exercise of stock options	(1,054)	(2,194)
Depreciation and amortization	2,983	3,302
Warranty reserve	876	390
Share-based compensation	1,731	1,609
Changes in operating assets and liabilities:		
Accounts receivable	413	708
Inventories	(1,243)	926
Prepaid expenses and other assets	778	(1,936)
Accounts payable	1,079	(2,710)
Accrued liabilities	(2,492)	(2,761)
Deferred revenue	159	(714)
Deferred income tax	1,709	1,844
Net cash provided by operating activities	13,812	5,684
Investing activities:		
Acquisition of businesses, net of cash acquired	(12,078)	(4,925)
Purchases of property and equipment	(1,399)	(806)
Purchase of intangible assets	—	(35)
Net cash used in investing activities	(13,477)	(5,766)
Financing activities:		
Proceeds from stock option exercises and Employee Stock Purchase Program (“ESPP”) purchases	1,319	6,300
Excess tax benefit on the exercise of stock options	1,054	2,194
Repurchase of common stock	(1,312)	—
Tax payments to settle employee liability	(460)	—
Payments on borrowings	—	(5,079)
Net cash provided by financing activities	601	3,415
Exchange rate changes effect on cash and cash equivalents	(495)	150
Net increase in cash and cash equivalents	441	3,483
Cash and cash equivalents, beginning of period	66,558	56,106
Cash and cash equivalents, end of period	$66,999	$59,589
Supplemental disclosure of cash flow information:		
Cash paid for interest	$2	$186
Cash paid for income taxes	$149	$574
Non-cash investing activities:		
Property and equipment included in accounts payable	$172	$265
Inventory transferred to property and equipment	$377	$398

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

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NATUS MEDICAL INCORPORATED AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

1 - Basis of Presentation

The accompanying interim condensed consolidated financial statements of Natus Medical Incorporated (“Natus,” “we,” “us,” “our,” or the “Company”) have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”). The accounting policies followed in the preparation of the interim condensed consolidated financial statements are consistent in all material respects with those presented in Note 1 to the consolidated financial statements included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2014.

Interim financial reports are prepared in accordance with the rules and regulations of the Securities and Exchange Commission; accordingly, they do not include all of the information and notes required by GAAP for annual financial statements. The interim financial information is unaudited, and except for the prior period correction of errors disclosed below, reflects all normal adjustments that are, in the opinion of management, necessary for the fair presentation of our financial position, results of operations, and cash flows for the interim periods presented. The consolidated balance sheet as of December 31, 2014 was derived from audited financial statements, but does not include all disclosures required by GAAP. The accompanying financial statements should be read in conjunction with the financial statements included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2014. We have made certain reclassifications to the prior period to conform to current period presentation.

Operating results for the three months ended March 31, 2015 are not necessarily indicative of the results that may be expected for the year ending December 31, 2015. The accompanying condensed consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2014-09, Revenue from Contracts with Customers (Topic 606). ASU 2014-09 requires revenue recognition to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. ASU 2014-09 sets forth a new revenue recognition model that requires identifying the contract, identifying the performance obligations, determining the transaction price, allocating the transaction price to performance obligations and recognizing the revenue upon satisfaction of performance obligations. The Company is currently evaluating the impact of ASU 2014-09, which is effective for the Company in our fiscal year ending December 31, 2017.

2 - Business Combinations

Global Neuro-Diagnostics

The Company acquired Global Neuro-Diagnostics ("GND") through an equity purchase on January 23, 2015. GND's service offers patients a more convenient way to complete routine EEG and video EEG testing which can be performed at the home, hospital or physician's office. The service also provides comprehensive reporting and support to the physician. The cash consideration for GND was $11.4 million. The purchase agreement also included an earn-out condition which the Company estimates to be $3.3 million. This earn-out is contingent upon GND achieving certain revenue milestones from 2015 to 2017.

Valuing intangible assets required us to make significant estimates that will be adjusted in the future; consequently, the purchase price allocation is considered preliminary. Final determination of the value of intangible assets is expected during the second quarter of 2015 and will result in an adjustment to the preliminary purchase price allocation, with an offsetting adjustment to goodwill. Pro forma financial information for the GND acquisition is not presented as it is not considered material.

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NicView
On January 2, 2015, the Company purchased the assets of NicView for cash consideration of $1.1 million. NicView provides streaming video for families with babies in the neonatal intensive care unit.
Hearing Screening as a Service
In the first quarter of 2014, the Company entered into two asset purchase agreements for companies in the newborn hearing screening services market for cash consideration of $2.6 million. The purchase agreements also included an earn-out condition which is contingent upon annual revenue growth through 2016. This earn-out condition is currently estimated at $0.8 million. Both acquisitions support the Company's objective to enter this market that complements our newborn hearing screening device business. This hearing screening services business operates under the name Peloton.
3 - Earnings Per Share
The components of basic and diluted EPS are as follows (in thousands):

	Three Months Ended March 31,	
	2015	2014
Net income	$8,597	$6,755
Weighted average common shares	32,127	31,062
Dilutive effect of stock based awards	970	1,123
Diluted Shares	33,097	32,185
Basic earnings per share	$0.27	$0.22
Diluted earnings per share	$0.26	$0.21
Shares excluded from calculation of diluted EPS	—	230

4 - Inventories
Inventories consist of the following (in thousands):

	March 31, 2015	December 31, 2014
Raw materials and subassemblies	$21,438	$19,821
Work in process	1,864	1,808
Finished goods	24,320	26,037
Total inventories	47,622	47,666
Less: Non-current inventories	(6,251)	(7,615)
Inventories, current	$41,371	$40,051

At March 31, 2015 and December 31, 2014, the Company has classified $6.3 million and $7.6 million, respectively, of inventories as other assets. This inventory consists primarily of service components used to repair products pursuant to warranty obligations and extended service contracts, including service components for products we are not currently selling. Management believes that these inventories will be utilized for their intended purpose.

5 – Intangible Assets
The following table summarizes the components of gross and net intangible asset balances (in thousands):

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	March 31, 2015				December 31, 2014			
	Gross Carrying Amount	Accumulated Impairment	Accumulated Amortization	Net Book Value	Gross Carrying Amount	Accumulated Impairment	Accumulated Amortization	Net Book Value
Intangible assets with finite lives:								
Technology	$63,244	—	$ (28,714)	$34,530	$64,376	—	$ (28,195)	$36,181
Customer related	30,458	—	(12,076)	$18,382	31,189	—	(11,786)	19,403
Internally developed software	14,193	—	(6,864)	$7,329	14,109	—	(6,511)	7,598
Patents	2,655	—	(2,086)	$569	2,794	—	(2,154)	640
Backlog	717	—	(717)	$—	719	—	(719)	—
Definite-lived intangible assets	111,267		(50,457)	60,810	113,187	—	(49,365)	63,822
Intangible assets with indefinite lives:								
Trade names	31,950	(3,329)	—	$28,621	32,443	(3,504)	—	28,939
Total intangible assets	$143,217	$ (3,329)	$ (50,457)	$89,431	$145,630	$ (3,504)	$ (49,365)	$92,761

Finite-lived intangible assets are amortized over their weighted average lives of 17 years for technology, 13 years for customer related intangibles, 7 years for internally developed software, and 13 years for patents.

Internally developed software consists of $12.0 million relating to costs incurred for development of internal use computer software and $2.2 million for development of software to be sold.

Amortization expense related to intangible assets with definite lives was as follows (in thousands):

	Three Months Ended March 31,	
	2015	2014
Technology	$960	$1,096
Customer related	605	647
Internally developed software	354	288
Patents	28	30
Total amortization	$1,947	$2,061

Expected amortization expense related to amortizable intangible assets is as follows (in thousands):

Nine months ending December 31, 2015	$5,681
2016	6,917
2017	6,634
2018	6,410
2019	5,445
2020	4,531
Thereafter	25,192
Total expected amortization expense	$60,810

6 – Goodwill

The carrying amount of goodwill and the changes in those balances are as follows (in thousands):

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December 31, 2014	$96,316
Acquisitions	14,854
Foreign currency translation	(1,843)
March 31, 2015	$109,327

7 - Property and Equipment, net

Property and equipment, net consist of the following (in thousands):

	March 31, 2015	December 31, 2014
Land	$3,076	$3,092
Buildings	6,621	6,828
Leasehold improvements	2,276	2,118
Office furniture and equipment	13,325	12,839
Computer software and hardware	9,255	8,821
Demonstration and loaned equipment	10,813	10,929
	45,366	44,627
Accumulated depreciation	(27,152)	(26,704)
Total	$18,214	$17,923

Depreciation expense of property and equipment was approximately $1.0 million for the three months ended March 31, 2015 and approximately $1.2 million for the three months ended March 31, 2014.

8 - Reserve for Product Warranties

We provide a warranty on all medical device products that is generally one year in length. We also sell extended service agreements on our medical device products that are generally over one year in length. Service for domestic customers is provided by Company-owned service centers that perform all service, repair, and calibration services. Service for international customers is provided by a combination of Company-owned facilities and vendors on a contract basis.

We have accrued a warranty reserve, included in accrued liabilities on the accompanying condensed consolidated balance sheets, for the expected future costs of servicing products during the initial warranty period. We base the liability on actual warranty costs incurred to service those products. Additions to the reserve are based on a combination of factors including the percentage of service department labor applied to warranty repairs, as well as actual service department costs, and other judgments, such as the degree to which the product incorporates new technology. The reserve is reduced as costs are incurred to honor existing warranty obligations.

The details of activity in the warranty reserve are as follows (in thousands):

	Three Months Ended March 31,	
	2015	2014
Balance, beginning of period	$2,753	$3,143
Additions charged to expense	876	390
Reductions	(654)	(522)
Balance, end of period	$2,975	$3,011

9 - Share-Based Compensation

At March 31, 2015, we have two active share-based compensation plans, the 2011 Stock Awards Plan and the 2011 Employee Stock Purchase Plan. The terms of awards granted during the three months ended March 31, 2015

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and our methods for determining grant-date fair value of the awards were consistent with those described in the consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2014.

Detail of share-based compensation expense is as follows (in thousands):

	Three Months Ended March 31, 2015	2014
Cost of revenue	$51	$28
Marketing and selling	363	235
Research and development	217	146
General and administrative	1,100	1,200
Total	$1,731	$1,609

As of March 31, 2015, unrecognized compensation expense related to the unvested portion of our stock options and other stock awards was approximately $11.7 million, which is expected to be recognized over a weighted average period of 2.1 years.

10 - Other Income (Expense), net

Other income (expense), net consists of (in thousands):

	Three Months Ended March 31, 2015	2014
Interest income	$10	$145
Interest expense	(1)	(264)
Foreign currency gain (loss)	(989)	149
Other	151	282
Total other income (expense), net	$(829)	$312

11 - Income Taxes

Provision for Income Tax Expense

Our effective tax rate (ETR) (provision for income taxes divided by pretax income) for the three months ended March 31, 2015 and 2014 was 31.3% and 30.4%, respectively. Our year-to-date results reflect the projected fiscal year ETR, as adjusted for the impact of any discrete items. Our ETR for the three months ended March 31, 2015 includes the discrete tax impact of the forgiveness of an intercompany loan between the U.S. parent company and its Argentinian subsidiary which increased our ETR by 3.7%. The discrete item recognized during the three months ended March 31, 2014 was not material to the ETR. The decrease in our ETR excluding the impact of discrete items, is due to forecasted shifts in the geographical mix of income. Our ETR for the three months ended March 31, 2015 and 2014 differed from statutory tax rates primarily because of profits taxed in foreign jurisdictions with lower tax rates than the statutory rate.

We recorded a net tax expense of $143,000 of unrecognized tax benefits for the three months ended March 31, 2015. Within the next twelve months, it is possible our uncertain tax benefit may change within a range of approximately zero to $800,000.Our tax returns remain open to examination as follows: U.S. Federal, 2011 through 2013, U.S. States 2010 through 2013 and significant foreign jurisdictions, 2010 through 2013.

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12 - Restructuring Reserves

The Company has historically incurred an ongoing level of restructuring-type activities to maintain a competitive cost structure, including manufacturing and workforce optimization resulting from acquisitions.

During the third quarter of 2014, the Company adopted a restructuring plan to reduce operating costs and close one of its North American distribution centers. The activities under this restructuring plan are expected to be completed during the second quarter of 2015.

The balance of the restructuring reserve is included in accrued liabilities on the accompanying condensed consolidated balance sheets. Employee termination benefits are included as a part of restructuring expenses.

Activity in the restructuring reserves for the three months ended March 31, 2015 is as follows (in thousands):

	Personnel Related	Facility Related	Total
Balance at December 31, 2014	$368	$—	$368
Additions	129	27	156
Reversals	—	—	—
Payments	(116)	(27)	(143)
Balance at March 31, 2015	$381	$—	$381

13 - Segment, Customer and Geographic Information

We operate in one reportable segment in which we provide healthcare products used for the screening, detection, treatment, monitoring and tracking of common medical ailments.

Our end-user customer base includes hospitals, clinics, laboratories, physicians, nurses, audiologists, and governmental agencies. Most of our international sales are to distributors who resell our products to end users or sub-distributors.

Revenue and long-lived asset information are as follows (in thousands):

	Three Months Ended March 31,	
	2015	2014
Consolidated Revenue:		
United States	$54,564	$48,346
Foreign countries	34,831	37,278
Totals	$89,395	$85,624

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	Three Months Ended March 31,	
	2015	2014
Revenue by End Market:		
Neurology Products		
Devices and Systems	$40,115	$42,260
Supplies	14,878	14,226
Services	1,294	—