SEACHANGE INTERNATIONAL INC
Form 10-Q
December 11, 2006
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SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended October 31, 2006

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: 0-21393

SEACHANGE INTERNATIONAL, INC.

(Exact name of registrant as specified in its charter)

Delaware	**04-3197974**
(State or other jurisdiction of incorporation or organization)	**(IRS Employer Identification No.)**

50 Nagog Park, Acton, MA 01720

(Address of principal executive offices, including zip code)

Registrant s telephone number, including area code: (978) 897-0100

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 x NO ¨

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

Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act.): YES ¨ NO x

The number of shares outstanding of the registrant s Common Stock on December 7, 2006 was 29,207,227.

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PART I FINANCIAL INFORMATION

ITEM 1. Financial Statements

SEACHANGE INTERNATIONAL, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except share and per share data)

	October 31, 2006 (unaudited)	January 31, 2006
Assets		
Current assets:		
Cash and cash equivalents	$ 34,855	$ 21,594
Restricted cash		500
Marketable securities	4,196	14,596
Accounts receivable, net of allowance for doubtful accounts of $394 at October 31, 2006 and $405 at January 31, 2006	27,138	30,109
Unbilled receivables	5,105	4,363
Inventories, net	18,067	19,299
Income taxes receivable	2,780	2,781
Prepaid expenses and other current assets	3,802	4,594
Total current assets	95,943	97,836
Property and equipment, net	30,726	27,191
Marketable securities	15,967	24,689
Investments in affiliates	13,443	12,812
Intangible assets, net	14,480	18,904
Goodwill	23,319	20,379
Other assets	5,157	5,363
Total assets	$ 199,035	$ 207,174
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 10,104	$ 10,016
Income taxes payable	364	2,843
Accrued litigation reserve		7,986
Other accrued expenses	6,228	8,408
Customer deposits	5,078	2,170
Deferred revenues	18,533	20,045
Deferred tax liabilities	587	556
Total current liabilities	40,894	52,024
Deferred tax liabilities, long-term	991	1,353
Total liabilities	41,885	53,377
Commitments and contingencies (Note 11)		
Stockholders equity:		

Convertible preferred stock, $0.01 par value; 5,000,000 shares authorized, none issued or outstanding		
Common stock, $0.01 par value; 100,000,000 shares authorized; 29,063,217 and 28,451,930 shares issued and outstanding at October 31, 2006 and January 31, 2006, respectively	291	285
Additional paid-in capital	182,703	176,238
Accumulated deficit	(26,693)	(22,264)
Accumulated other comprehensive income (loss)	849	(462)
Total stockholders equity	157,150	153,797
Total liabilities and stockholders equity	$ 199,035	$ 207,174

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

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SEACHANGE INTERNATIONAL, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

	Three months ended		Nine months ended	
	October 31, 2006	October 31, 2005	October 31, 2006	October 31, 2005
	(unaudited)			
Revenues:				
Hardware, software and systems	$ 26,022	$ 22,049	$ 73,344	$ 56,564
Services	16,232	13,272	47,917	36,464
	42,254	35,321	121,261	93,028
Cost of revenues:				
Hardware, software and systems	12,916	13,791	35,727	35,538
Services	9,764	6,920	26,763	20,192
	22,680	20,711	62,490	55,730
Gross profit	19,574	14,610	58,771	37,298
Operating expenses:				
Research and development	9,773	8,797	30,667	25,136
Selling and marketing	5,703	4,927	16,833	14,518
General and administrative	4,864	3,710	14,261	9,829
Amortization of intangibles	1,410	800	4,230	1,161
Total operating expenses	21,750	18,234	65,991	50,644
Loss from operations	(2,176)	(3,624)	(7,220)	(13,346)
Interest income	337	467	1,026	1,564
Interest expense	(5)	(6)	(87)	(20)
Loss before income taxes and equity income in earnings of affiliates	(1,844)	(3,163)	(6,281)	(11,802)
Income tax benefit	358	1,150	1,079	2,275
Equity income (loss) in earnings of affiliates	453	(95)	773	283
Net loss	$ (1,033)	$ (2,108)	$ (4,429)	$ (9,244)
Basic loss per share	$ (0.04)	$ (0.07)	$ (0.15)	$ (0.33)
Diluted loss per share	$ (0.04)	$ (0.07)	$ (0.15)	$ (0.33)
Weighted average common shares outstanding:				
Basic	29,031	28,308	28,731	28,258
Diluted	29,031	28,308	28,731	28,258

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

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SEACHANGE INTERNATIONAL, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS

(in thousands)

	Nine months ended October 31, 2006 (unaudited)	Nine months ended October 31, 2005 (unaudited)
Cash flows from operating activities:		
Net loss	$ (4,429)	$ (9,244)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation	5,536	4,814
Amortization of intangibles and capitalized software	4,924	1,286
Inventory valuation charge	709	695
Allowance for (recovery of) doubtful accounts receivable	303	(190)
Amortization of premiums on marketable securities	28	234
Loss on disposal of property and equipment	3	
Equity income in earnings of affiliates	(773)	(283)
Stock-based compensation	2,644	
Changes in operating assets and liabilities:		
Accounts receivable	2,668	4,474
Unbilled receivables	(742)	(3,251)
Inventories	(2,585)	(4,089)
Income taxes receivable	1	131
Prepaid expenses and other assets	843	(5,551)
Accounts payable	88	(3,272)
Income taxes payable	(2,479)	(2,497)
Accrued expenses	624	3,107
Accrued litigation reserve	(7,986)	72
Customer deposits	2,908	2,672
Deferred revenues	(1,512)	(3,026)
Other	(414)	(22)
Net cash provided by (used) in operating activities	359	(13,940)
Cash flows from investing activities:		
Purchases of property and equipment	(5,826)	(11,468)
Purchases of marketable securities	(11,238)	(11,893)
Proceeds from sale and maturity of marketable securities	30,577	14,507
Acquisition of businesses	(3,045)	(31,260)
Investments in affiliates		(9,993)
Decrease in restricted cash	500	500
Net cash provided by (used in) investing activities	10,968	(49,607)
Cash flows from financing activities:		
Repayment of obligations under capital lease		(209)
Proceeds from issuance of common stock	1,532	868
Net cash provided by financing activities	1,532	659

Effect of exchange rate changes on cash:		402		
Net increase (decrease) in cash and cash equivalents		13,261		(62,888)
Cash and cash equivalents, beginning of period		21,594		93,561
Cash and cash equivalents, end of period	$	34,855	$	30,673
Supplemental disclosure of noncash activities:				
Transfer of items originally classified as equipment to inventories	$		$	11
Transfer of items originally classified as inventories to equipment	$	2,650	$	3,467
Issuance of equity for ODG contingent consideration	$	2,287	$	
Conversion of debt to equity related to Casa investment	$		$	750

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

SEACHANGE INTERNATIONAL, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements include the accounts of SeaChange International, Inc. and its wholly-owned subsidiaries (SeaChange or the Company). SeaChange believes that the unaudited condensed consolidated financial statements reflect all adjustments (consisting of only normal recurring adjustments), necessary for a fair statement of SeaChange s financial position, results of operations and cash flows at the dates and for the periods indicated. The results of operations for the periods presented are not necessarily indicative of results expected for the full fiscal year or any other future periods. The unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes for the year ended January 31, 2006, included in SeaChange s Annual Report on Form 10-K for such fiscal year. The balance sheet at January 31, 2006 was derived from audited financial statements but does not include all disclosures required by accounting principles generally accepted in the United States of America. Certain reclassifications have been made to conform the prior period amounts to the current period presentation, including, the reclassification of the value-added tax (VAT) payable balance against the VAT receivable balance on the Consolidated Balance Sheet at January 31, 2006 and the reclassification of amortization expense related to acquired intangible assets (previously presented as a part of the general and administrative, marketing and sales expense lines) to a separate line within operating expenses on the Condensed Consolidated Statements of Operations for the three and nine months ended October 31, 2005. The reclassifications had no impact on the Company s results of operations or financial position.

2. Critical Accounting Policies

Revenue Recognition and Allowance for Doubtful Accounts

Revenues from sales of hardware, software and systems that do not require significant modification or customization of the underlying software are recognized when title and risk of loss has passed to the customer, there is evidence of an arrangement, fees are fixed or determinable and collection of the related receivable is considered probable. Customers are billed for installation, training, project management and at least one year of product maintenance and technical support at the time of the product sale. Revenue from these activities are deferred at the time of the product sale and recognized ratably over the period these services are performed. Revenue from ongoing product maintenance and technical support agreements are recognized ratably over the period of the related agreements. Revenue from software development contracts that include significant modification or customization, including software product enhancements, is recognized based on the percentage of completion contract accounting method using labor efforts expended in relation to estimates of total labor efforts to complete the contract. For contracts, where some level of profit is assured but the Company is only able to estimate ranges of amounts of total contract revenue and total contract cost, the Company uses the lowest probable level of profits in accounting for the contract revenues and costs. Accounting for contract amendments and customer change orders are included in contract accounting when executed. Revenue from shipping and handling costs and other out-of-pocket expenses reimbursed by customers are included in revenues and cost of revenues. Our share of intercompany profits associated with sales and services provided to affiliated companies are eliminated in consolidation in proportion to our equity ownership.

SeaChange s transactions frequently involve the sales of hardware, software, systems and services in multiple element arrangements. Hardware, software and systems sales include at least one year of free technical support and maintenance services. Revenues under multiple element arrangements are recorded based on the residual method of accounting. Under this method, the total arrangement value is allocated first to undelivered elements, based on their fair values, with the remainder being allocated to the delivered elements. The amounts allocated to undelivered elements, which may include project management, training, installation, maintenance and technical support and certain hardware and software components, are based upon the price charged when these elements are sold separately and unaccompanied by the other elements. The amount allocated to installation, training and project management revenue is based upon standard hourly billing rates and the estimated time required to complete the service. These services are not essential to the functionality of systems as these services do not alter the equipment s capabilities, are available from other vendors and the systems are standard products. For multiple element arrangements that include software development with significant modification or customization and systems sales where vendor-specific objective evidence of the fair value does not exist for the undelivered elements of the arrangement (other than maintenance and technical support), percentage of completion accounting is applied for revenue recognition purposes to the entire arrangement with the exception of maintenance and technical support. For transactions in which consideration, including equity instruments, is given to a customer, SeaChange accounts for the value of this consideration as an adjustment to revenue in the Consolidated Statement of Operations.

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The Company maintains allowances for specific doubtful accounts and general categories of accounts based on estimates of losses resulting from the inability of the Company s customers to make required payments and records these allowances as a charge to general and administrative expenses. The Company monitors payments from customers and assesses any collection issues. The Company performs ongoing credit evaluations of customers financial condition but generally does not require collateral. For some international customers, the Company requires an irrevocable letter of credit to be issued by the customer before the purchase order is accepted. The Company bases its allowances for doubtful accounts on historical collections and write-off experience, current trends, credit assessments, and other analysis of specific customer situations.

Foreign Currency Translation

SeaChange has determined that the functional currency of all but one of its foreign subsidiaries is the U.S. dollar. Where the U.S. dollar is designated as the functional currency of an entity, SeaChange translates that entity s monetary assets and liabilities denominated in local currencies into U.S. dollars (the functional and reporting currency) at current exchange rates, as of each balance sheet date. Nonmonetary assets (e.g., inventories, property, plant, and equipment and intangible assets) and related income statement accounts (e.g., cost of sales, depreciation, amortization of intangible assets) are translated at historical exchange rates between the functional currency (the U.S. dollar) and the local currency. Revenue and other expense items are translated using average exchange rates during the fiscal period. Translation adjustments and transactions gains and losses on foreign currency transactions, and any unrealized gains and losses on short-term inter-company transactions are included in income.

For the single foreign subsidiary where the local currency is designated as the functional currency, SeaChange translates its assets and liabilities into U.S. dollars (the reporting currency) at current exchange rates as of each balance sheet date. Revenue and expense items are translated using average exchange rates during the period. Cumulative translation adjustments are presented as a separate component of stockholders equity. Exchange gains and losses on foreign currency transactions and unrealized gains and losses on short-term inter-company transactions are included in income.

3. Stock-Based Compensation and Stock Incentive Plans

Effective February 1, 2006, SeaChange adopted on a modified prospective basis the provisions of the Financial Accounting Standards Board s Statement of Financial Accounting Standards No. 123(R), Share-Based Payment (Revised 2004), (FAS No. 123(R)) which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors including employee stock options, restricted stock units and employee stock purchases related to SeaChange s Employee Stock Purchase Plan (ESPP) based on estimated fair values. Accordingly, stock-based compensation cost is measured at the grant date, based on the fair value of the award, and is recognized as expense on a straight-line basis over the employee s requisite service period. SeaChange has applied the provisions of Staff Accounting Bulletin No. 107, Share-Based Payment, (SAB 107) in its adoption of FAS No. 123(R).

Impact of the Adoption of FAS No. 123(R)

Under the modified prospective transition method, SeaChange recognized stock-based compensation expense during the three and nine months ended October 31, 2006 for: (a) ESPP awards from offering periods that began on December 1, 2005 and June 1, 2006 and ended May 31, 2006 and November 30, 2006, respectively, (b) stock options and restricted stock units granted prior to, but not yet vested as of February 1, 2006, based on the grant date fair value estimated in accordance with the disclosure provisions of FAS No. 123, and (c) stock options and restricted stock units granted subsequent to February 1, 2006, based on the grant date fair value, estimated in accordance with the provisions of FAS No. 123(R). Under the modified prospective transition method, results for prior periods are not restated. The adoption of FAS No. 123(R) did not affect the accounting for stock-based compensation expense related to restricted stock units. The fair value of a restricted stock unit is the market value of a share of the Company s common stock on the date of grant of the restricted stock unit. This fair value is amortized on a straight-line basis over the related vesting period of the restricted stock unit.

The estimated fair value of SeaChange s stock-based awards, less expected forfeitures, is amortized over the awards vesting period on a straight-line basis. The effect of recording stock-based compensation for the three and nine month periods ended October 31, 2006 was as follows:

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	For the Three Months Ended October 31, 2006	For the Nine Months Ended October 31, 2006
	(Amounts in thousands, except per share amounts)	
Stock-based compensation expense by type of award:		
Stock options	$ 573	$ 1,708
Restricted stock units	163	447
Performance-based restricted stock units	97	133
Employee Stock Purchase Plan	72	356
Total stock-based compensation	905	2,644
Less: Tax effect on stock-based compensation		
Net effect on net loss	$ 905	$ 2,644
Effect on net loss per share		
Basic	$ (0.03)	$ (0.09)
Diluted	$ (0.03)	$ (0.09)

The following table presents stock-based compensation expenses included in the Company s unaudited Condensed Consolidated Statements of Operations:

	For the Three Months Ended October 31, 2006	For the Nine Months Ended October 31, 2006
	(Amounts in thousands)	
Cost of product revenue	$ 33	$ 83
Cost of service revenue	58	169
Research and development expense	396	1,194
Sales and marketing expense	110	346
General and administrative expense	308	852
Income tax benefit		
Total effect related to stock-based compensation expense	$ 905	$ 2,644

SeaChange estimates the fair value of stock options, including purchases made pursuant to options granted under the ESPP, using the Black-Scholes valuation model. Key input assumptions used to estimate the fair value of stock options include the exercise price, the expected option term, the risk-free interest rate over the option s expected term, the expected annual dividend yield and the expected stock price volatility. The expected option term was determined using the simplified method for plain vanilla options as allowed by SAB 107. The expected stock price volatility was established using a blended volatility, which is an average of the historical volatility of SeaChange s common stock over a period of time equal to the expected term of the stock option, and the average volatility of SeaChange s common stock over the most recent one-year and two-year periods. For stock options granted and valued in the first half of fiscal year 2007, the historical stock price volatility excluded the Company s secondary offering, completed in January 2002, because a similar event is not anticipated during the expected term of the stock options granted. For stock options granted in the third quarter of fiscal 2007, the historical stock price volatility excluded the Company s secondary offering because the historical option term no longer included the period of the secondary offering. SeaChange believes that the valuation technique and the approach utilized to develop the underlying assumptions are appropriate in calculating the fair values of SeaChange s equity awards granted in the three and nine months ended October 31, 2006. Estimates of fair values are not intended to predict actual future events or the value ultimately realized by the persons who receive equity awards.

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The fair value of each option grant was estimated on the grant date using the Black-Scholes option-pricing model with the following assumptions:

	Three months ended October 31, 2006 Options			Nine months ended October 31, 2006 Options		
	Range	**Weighted Average**	**ESPP**	**Range**	**Weighted Average**	**ESPP**
Expected term (in years)	4 - 5	4.5	0.5	4 5	4.5	0.5
Expected volatility	54% - 57%	56%	47%	54% - 58%	57%	47%
Risk-free interest rate	4.5% - 4.8%	4.8%	5%	4.5% - 5.1%	4.8%	5%
Expected dividend yield	0%	0%	0%	0%	0%	0%

Pro Forma Information Under SFAS 123 and APB 25

Prior to February 1, 2006, SeaChange accounted for its stock plans under the provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations (APB 25) and provided pro forma disclosures as though the fair value method was reported in accordance with SFAS No. 123, Accounting for Stock-Based Compensation, (SFAS 123), as amended by SFAS No. 148, Accounting for Stock-Based Compensation-Transition and Disclosure, An Amendment of SFAS No. 123 .

The pro forma information for the three and nine months ended October 31, 2005 was as follows:

(Amounts in thousands, except share amounts)	**Three months ended October 31, 2005**	**Nine months ended October 31, 2005**
Net loss, as reported	$ (2,108)	$ (9,244)
Less: Stock-based employee compensation expense determined under fair value method for all awards, net of related tax effects	1,314	7,286
Pro forma net loss	$ (3,422)	$ (16,530)
Basic loss per share		
As reported	$ (0.07)	$ (0.33)
Pro forma	$ (0.12)	$ (0.58)
Diluted loss per share		
As reported	$ (0.07)	$ (0.33)
Pro forma	$ (0.12)	$ (0.58)

The fair value of SeaChange s stock-based awards granted during the three and nine month periods ended October 31, 2005 was estimated on the grant date using the Black-Scholes option pricing model with the following weighted-average assumptions:

	Three months ended October 31, 2005 Options	**Nine months ended October 31, 2005 Options**
Expected term (in years)	7.5	7.5
Expected volatility	80.0%	81.7%
Risk-free interest rate	4.1%	3.6%
Expected dividend yield	0%	0%

The expected term for options granted during fiscal year 2006 is higher than the expected term for options granted during fiscal year 2007 because of the shorter life of stock options granted under the 2005 Equity Compensation and Incentive Plan (the 2005 Plan) which replaced the Company s Amended and Restated 1995 Stock Option Plan (the 1995 Plan) in July 2005. Under the 2005 Plan, stock options vest over three years and expire seven years from the date of grant, while stock options granted under the 1995 Plan generally vested over a four year period and expired ten years from the date of grant. The expected volatility assumption is higher for options granted in fiscal year 2006 than in fiscal 2007 because the fiscal year 2006 volatility was only the historical volatility of SeaChange s common stock over a period of time equal to the expected term of the stock option (rather than a blended rate) and included the effects of the Company s secondary offering, completed in January 2002, but the fiscal 2007 volatility was a blended volatility rate and excluded the effects of the Company s secondary offering. Management believes that the fiscal 2007 calculation is more reflective of the Company s expected stock volatility.

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On January 26, 2006, the Company accelerated the vesting of certain unvested stock options with exercise prices equal to or greater than $9.00 per share that were previously awarded to its employees, including its executive officers and non-employee directors, under the Company s equity compensation plans. This decision was the principal reason for the lower stock-based compensation expense recorded in the three and nine month periods ending October 31, 2006 compared to the pro forma expense for the three and nine month periods ending October 31, 2005.

Stock Option Plans

The 2005 Plan provides for the grant of incentive stock options, nonqualified stock options, restricted stock, restricted stock units, and other non-stock option awards as determined by the plan administrator for the purchase of up to an aggregate of 1,500,000 shares of SeaChange s common stock (but not greater than two percent of the aggregate per fiscal year) by officers, employees, consultants and directors of SeaChange. The Board of Directors is responsible for administration of the 2005 Plan and determining the term of each award, award exercise price, number of shares for which each award is granted and the rate at which each award is exercisable.

Option awards may be granted to employees at an exercise price per share of not less than 100% of the fair market value per common share on the date of the grant (not less than 110% for an incentive stock option granted to a 10% or more stockholder). Incentive stock options may be granted only to those employees of SeaChange to the extent that the fair value of the options granted that become exercisable during any one calendar year plus previously granted incentive stock options that become exercisable in that period is less than $100,000. Restricted stock units and other equity-based non-stock option awards may be granted to any officer, employee, director or consultant at a purchase price per share as determined by SeaChange s Board of Directors. Awards granted under the 2005 Plan generally vest over three years and expire seven years from the date of the grant (five years for incentive stock options granted to holders of more than 10% of SeaChange s voting stock). As of October 31, 2006, there were 454,000 shares of SeaChange common stock available for future grant under the 2005 Plan.

Stock options granted under the Company s 1995 Plan generally vest ratably over four years and generally expire ten years from the date of the grant (five years for incentive stock options granted to holders of more than 10% of SeaChange s voting stock).

The following table summarizes the stock option activity as of and for the nine months ended October 31, 2006:

	Shares	Weighted average exercise price	Weighted average remaining contractual term (In years)	Aggregate Intrinsic Value
Outstanding at January 31, 2006	6,449,857	$ 14.91		
Granted	311,131	7.87		
Exercised	(147,627)	5.82		
Forfeited/expired/cancelled	(494,656)	15.08		
Outstanding at October 31, 2006	6,118,705	$ 14.76	6.28	$ 3,333,000
Options exercisable at October 31, 2006	5,177,827	$ 16.12	6.25	$ 2,238,000

The weighted-average grant date fair value of stock options granted during the three and nine months ended October 31, 2006 was $4.06 and $3.99, respectively. The weighted-average grant date fair value of stock options granted during the three and nine months ended October 31, 2005 was $4.75 and $6.90, respectively. As of October 31, 2006, the unrecognized stock-based compensation related to the unvested stock options was $1.8 million including estimated forfeitures. Total unrecognized compensation cost will be adjusted for any future changes in estimated changes in forfeitures. This cost will be recognized over an estimated weighted average amortization period of 1.0 year.

The total intrinsic value of options exercised during the three and nine months ended October 31, 2006 was $246,000 and $356,000, respectively, with intrinsic value defined as the difference between the market price on the date of exercise and the grant date price.

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The following table summarizes information about employee and director stock options outstanding and exercisable as of October 31, 2006:

	Options outstanding			Options exercisable	
	Number outstanding	Weighted average remaining Contractual term (years)	Weighted average exercise price	Number exercisable	Weighted average exercise price
Range of exercise prices					
$ 4.00 to 6.20	657,219	4.42	$ 5.58	629,546	$ 5.56
6.25 to 7.00	790,883	6.18	6.88	222,317	6.96
7.17 to 10.33	738,473	6.15	8.66	393,834	9.07
10.37 to 13.24	700,562	6.68	12.04	700,562	12.04
13.31 to 14.47	761,688	6.67	13.99	761,688	13.99
14.56 to 16.56	618,629	6.68	15.62	618,629	15.62
17.26 to 22.00	479,834	6.64	18.04	479,834	18.04
23.31 to 23.31	615,502	6.45	23.31	615,502	23.31
24.10 to 34.00	694,865	6.68	29.91	694,865	29.91
35.50 to 39.13	61,050	6.68	37.57	61,050	37.57
	6,118,705	6.28	$ 14.76	5,177,827	$ 16.12

Restricted Stock Units

Pursuant to the 2005 Plan, SeaChange may grant restricted stock units that entitle recipients to acquire shares of SeaChange s common stock. Of the 1,500,000 shares of SeaChange s common stock authorized for grant under the 2005 Plan, no more than twenty-five percent (375,000 shares) may be used for grants of restricted stock, restricted stock units or other non-stock option awards. Awards of restricted stock units vest in equal increments on each of the first three anniversaries of the grant of the award. Stock-based compensation expense associated with the restricted stock units is charged for the market value of the Company s stock on the date of grant, assuming nominal forfeitures, and is amortized over the awards vesting period on a straight-line basis. The Company recorded stock-based compensation expense related to restricted stock of $260,000 and $580,000 for the three and nine month periods ended October 31, 2006, respectively, and the Company had no stock-based compensation expense related to restricted stock for the three and nine month periods ended October 31, 2005 because no restricted stock units were granted prior to October 31, 2005. As of October 31, 2006, there were 137,000 shares of SeaChange common stock available for grants of restricted stock, restricted stock units or other non-option awards under the 2005 Plan.

The following table summarizes the restricted stock unit activity as of and for the nine months ended October 31, 2006:

	Shares	Weighted average grant date fair value
Nonvested at January 31, 2006	102,000	$ 8.01
Granted	136,000	8.36
Vested		
Forfeited/expired/cancelled		

Nonvested at October 31, 2006	238,000	$	8.21

As of January 31, 2006, the unrecognized stock-based compensation related to the unvested restricted stock units was $800,000. FAS 123(R) requires forfeitures to be estimated at the time of grant and revised in subsequent periods if actual forfeitures differ from those estimates.

As of October 31, 2006, the unrecognized stock-based compensation related to the unvested restricted stock units was $1.4 million. This cost will be recognized over an estimated weighted average amortization period of 2.2 years.

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Employee Stock Purchase Plan

The Company s Employee Stock Purchase Plan (ESPP) provides for the issuance of a maximum of 1,600,000 shares of common stock to participating employees who meet eligibility requirements. The authorized number of shares to be issued under the ESPP was increased from 1,100,000 to 1,600,000 by shareholder vote during the Company s annual shareholder meeting in July 2006. Employees of SeaChange who elect to participate in the Company s ESPP are able to purchase common stock at the lower of 85% of the fair market value of SeaChange s common stock on the first or last day of the applicable six-month offering period. In the most recent period under the ESPP ended May 31, 2006, employees purchased an aggregate of 122,510 shares at a discounted price of $5.50 per share. As of October 31, 2006, 490,000 shares of common stock were available for issuance under the ESPP.

4. Earnings (Loss) Per Share

Earnings (loss) per share is presented in accordance with SFAS No. 128, Earnings Per Share, (SFAS 128) which requires the presentation of basic earnings (loss) per share and diluted earnings (loss) per share. Basic earnings (loss) per share is computed by dividing earnings available to common shareholders by the weighted-average shares of common stock outstanding during the period. For the purposes of calculating diluted earnings (loss) per share, the denominator includes both the weighted average number of shares of common stock outstanding during the period and the weighted average number of shares of potential common stock, such as stock options, restricted stock units and warrants, calculated using the treasury stock method.

All options outstanding for the three and nine months ended October 31, 2006 and 2005 were antidilutive based on the Company s net losses. At October 31, 2006 and 2005, 6,356,705 and 5,965,000 stock options and non-vested restricted stock units were outstanding, respectively. For the three and nine months ended October 31, 2006, 283,000 and 223,000 shares would have been dilutive and would have been included in the calculation of stock options outstanding if the Company had net income for these periods. For the three and nine months ended October 31, 2005, 128,000 and 398,000 shares, respectively, would have been dilutive and would have been included in the calculation of stock options outstanding if the Company had net income in these periods.

Below is a summary of the shares used in calculating basic and diluted income (loss) per share for the periods indicated:

	Three months ended		Nine months ended	
	October 31, 2006	October 31, 2005	October 31, 2006	October 31, 2005
	(in thousands)			
Weighted average shares used in calculating earnings per share Basic	29,031	28,308	28,731	28,258
Dilutive common stock options				
Weighted average shares used in calculating earnings per share Diluted	29,031	28,308	28,731	28,258

5. Inventories, net

Inventories, net, consist of the following:

	October 31, 2006	January 31, 2006
	(in thousands)	
Components and assemblies	$ 9,623	$ 12,977
Finished products	8,444	6,322
	$ 18,067	$ 19,299

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6. Comprehensive Income (Loss)

SeaChange s comprehensive income (loss) is comprised of net loss and other comprehensive expense including foreign currency translation adjustment for our subsidiary where the functional currency is the local currency and for unrealized gains and losses on marketable securities, net of tax. Comprehensive income (loss) was calculated as follows:

	Three months ended		Nine months ended	
	October 31, 2006	October 31, 2005	October 31, 2006	October 31, 2005
	(in thousands)			
Net loss	$ (1,033)	$ (2,108)	$ (4,429)	$ (9,244)