NATUS MEDICAL INC
Form 10-Q
November 03, 2016
Table of Contents

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 September 30, 2016

¨ 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 October 28, 2016 was 32,911,604.

Table of Contents

NATUS MEDICAL INCORPORATED
TABLE OF CONTENTS

Table of Contents

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)

	September 30, 2016	December 31, 2015
ASSETS		
Current assets:		
Cash and cash equivalents	$81,073	$82,469
Short-term investments	25,429	—
Accounts receivable, net of allowance for doubtful accounts of $4,706 in 2016 and $4,686 in 2015	84,870	99,080
Inventories	51,654	48,572
Prepaid expenses and other current assets	22,939	11,235
Total current assets	265,965	241,356
Property and equipment, net	18,127	16,967
Intangible assets, net	82,775	86,536
Goodwill	111,918	107,466
Deferred income tax	12,694	12,782
Other assets	19,236	14,389
Total assets	$510,715	$479,496
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$17,107	$23,660
Accrued liabilities	38,711	42,137
Deferred revenue	33,334	11,311
Total current liabilities	89,152	77,108
Long-term liabilities:		
Other liabilities	8,359	7,781
Deferred income tax	3,819	3,897
Total liabilities	101,330	88,786
Stockholders' equity:		
Common Stock, $0.001 par value, 120,000,000 shares authorized; shares issued and outstanding 32,888,068 in 2016 and 33,153,500 in 2015	311,058	323,745
Preferred stock, $0.001 par value; 10,000,000 shares authorized; no shares issued and outstanding in 2016 and 2015	—	—
Retained earnings	139,176	106,814
Accumulated other comprehensive loss	(40,849)	(39,849)
Total stockholders' equity	409,385	390,710
Total liabilities and stockholders' equity	$510,715	$479,496

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

Table of Contents

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Revenue	$90,906	$94,583	$274,193	$275,915
Cost of revenue	32,194	35,520	102,542	104,468
Intangibles amortization	612	683	1,818	2,048
Gross profit	58,100	58,380	169,833	169,399
Operating expenses:				
Marketing and selling	19,746	22,495	61,578	65,345
Research and development	7,689	7,700	22,596	21,867
General and administrative	12,821	10,031	37,225	33,239
Intangibles amortization	2,409	2,036	6,741	5,165
Restructuring	197	42	1,315	358
Total operating expenses	42,862	42,304	129,455	125,974
Income from operations	15,238	16,076	40,378	43,425
Other income (expense), net	(893)	7	(412)	(1,203)
Income before provision for income tax	14,345	16,083	39,966	42,222
Provision for income tax expense	1,032	5,151	7,605	12,842
Net income	$13,313	$10,932	$32,361	$29,380
Foreign currency translation adjustment	424	(642)	(999)	(4,452)
Comprehensive income	$13,737	$10,290	$31,362	$24,928
Earnings per share:				
Basic	$0.41	$0.34	$1.00	$0.91
Diluted	$0.40	$0.33	$0.98	$0.89
Weighted average shares used in the calculation of earnings per share:				
Basic	32,388	32,432	32,476	32,279
Diluted	32,981	33,253	33,077	33,194

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

Table of Contents

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

	Nine Months Ended September 30,	
	2016	2015
Operating activities:		
Net income	$32,361	$29,380
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for losses on accounts receivable	940	945
Excess tax benefit on the exercise of stock options	—	(5,304)
Depreciation and amortization	12,820	11,346
Gain on disposal of property and equipment	(21)	—
Warranty reserve	3,273	4,771
Share-based compensation	6,957	5,382
Changes in operating assets and liabilities:		
Accounts receivable	19,299	(6,681)
Inventories	(6,353)	(7,014)
Prepaid expenses and other assets	(13,261)	(1,049)
Accounts payable	(6,062)	3,237
Accrued liabilities	(6,488)	(3,596)
Deferred revenue	24,994	(2,049)
Deferred income tax	43	5,560
Net cash provided by operating activities	68,502	34,928
Investing activities:		
Acquisition of businesses, net of cash acquired	(15,849)	(11,559)
Purchases of property and equipment	(2,176)	(2,990)
Purchase of intangible assets	(210)	(1,158)
Purchases of short-term investments	(25,429)	—
Net cash used in investing activities	(43,664)	(15,707)
Financing activities:		
Proceeds from stock option exercises and Employee Stock Purchase Program purchases	2,550	6,086
Excess tax benefit on the exercise of stock options	—	5,304
Repurchase of common stock	(18,257)	(9,352)
Taxes paid related to net share settlement of equity awards	(3,937)	(4,303)
Contingent consideration	(1,284)	(664)
Proceeds from short-term borrowings	16,000	—
Deferred debt issuance costs	(533)	—
Payments on borrowings	(16,000)	—
Net cash used in financing activities	(21,461)	(2,929)
Exchange rate changes effect on cash and cash equivalents	(4,773)	(649)
Net increase in cash and cash equivalents	(1,396)	15,643
Cash and cash equivalents, beginning of period	82,469	66,558
Cash and cash equivalents, end of period	$81,073	$82,201
Supplemental disclosure of cash flow information:		
Cash paid for interest	$41	$—
Cash paid for income taxes	$8,024	$5,348
Non-cash investing activities:		

Property and equipment included in accounts payable	$159	$200
Inventory transferred to property and equipment	$1,240	$797

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

Table of Contents

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, 2015.

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 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, 2015 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, 2015. We have made certain reclassifications to the prior period to conform to current period presentation.

Operating results for the nine months ended September 30, 2016 are not necessarily indicative of the results that may be expected for the year ending December 31, 2016. 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 original effective date for ASU 2014-09 would have required the Company to adopt beginning in its first quarter of 2017. In July 2015, the FASB voted to amend ASU 2014-09 by approving a one-year deferral of the effective date as well as providing the option to early adopt the standard on the original effective date. Accordingly, the Company will adopt the standard in its first quarter of 2018. The new revenue standard may be applied retrospectively to each prior period presented or retrospectively with the cumulative effect recognized as of the date of adoption. The Company is currently evaluating the impact of adopting the new revenue standard on its consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842). This standard requires a lessee to recognize the lease assets and lease liabilities arising from operating leases in the statement of financial position. Qualitative along with specific quantitative disclosures are required by lessees and lessors to meet the objective of enabling users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. ASU 2016-02 is effective for fiscal years beginning after December 15, 2018 including interim periods within those fiscal years. The Company is currently evaluating the impact that will result from adopting ASU 2016-02.

In March 2016, the FASB issued ASU 2016-09, Compensation - Stock Compensation (Topic 718): Improvement to Employee Share-Based Payment Accounting. The new standard contains several amendments that simplifies the accounting for employee share-based payment transactions, including the accounting for income

taxes, forfeitures, statutory tax withholding requirements, classification of awards as either equity or liabilities, and classification on the statement of cash flows. The changes in the new standard eliminate the accounting for excess tax benefits to be recognized in additional paid-in capital and tax deficiencies recognized either in the income tax provision or in additional paid-in capital. The Company elected early adoption of ASU 2016-09 in the first quarter of 2016 which was applied using a modified retrospective approach. For the nine months ended September 30, 2016, we recognized all excess tax benefits and tax deficiencies as income tax expense or benefit as a discrete event. An income tax benefit of approximately $1.9 million was recognized in the period ended September 30, 2016 as a result of the adoption of ASU 2016-09. There was no change to retained earnings with respect to excess tax benefits, as this is not applicable to the Company. The treatment of forfeitures has not changed as we are electing to continue our current process of estimating the number of forfeitures. As such, this has no cumulative effect on retained earnings. With the early adoption of 2016-09, we have elected to present the cash flow statement on a prospective transition method and no prior periods have been adjusted.

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments. This standard provides guidance for eight cash flow classification issues in current GAAP. ASU 2016-15 is effective for fiscal years beginning after December 15, 2017 and interim periods within those fiscal years. The Company elected early adoption of ASU 2016-15 in the first quarter of 2016 relating to Contingent Consideration Payments Made after a Business Combination. For the nine months ended September 30, 2016, the Company recognized $1.0 million as a cash outflow for investing activities on the Statement of Cash Flows. This payment was made soon after the acquisition date of a business combination to settle the contingent consideration from the Monarch acquisition.

2 - Business Combinations

RetCam

On July 6, 2016, we acquired the portfolio of RetCam Imaging Systems ("RetCam") from Clarity Medical Systems, Inc. for $10.6 million in cash. RetCam is an imaging system used to diagnose and monitor a range of ophthalmic maladies in premature infants. The purchase agreement also included a holdback of $2.0 million which is contingent upon completion of certain modifications to RetCam 3 no later than March 31, 2017. Subsequent to the acquisition, an additional $1.1 million was paid by the Company to Clarity Medical Systems as a result of a working capital adjustment. Results of operations for RetCam will be included in our consolidated financial statements from the date of acquisition. The total purchase price was allocated $7.7 million to tangible assets, $5.0 million to intangible assets with an assigned weighted average life of 5 years being amortized on the straight line method, and $1.0 million to goodwill, offset by $2.0 million to net liabilities. Purchase price allocation is considered preliminary at this time although no material adjustments are anticipated. Pro forma financial information for the RetCam acquisition is not presented as it is not considered material.

NeuroQuest

On March 2, 2016, we acquired NeuroQuest, LLC (“NeuroQuest”) through an asset purchase. NeuroQuest complements our Global Neuro-Diagnostics ("GND") and Monarch Medical Diagnostics, LLC ("Monarch") acquisitions which offer patients a convenient way to complete routine-electroencephalography ("EEG") and extended video electronencephalography ("VEEG") testing. The cash consideration for NeuroQuest was $4.6 million. The purchase agreement also included an asset consideration holdback of $0.5 million. The total purchase price was allocated to $0.5 million of tangible assets, $1.3 million of intangible assets with an assigned weighted average life of 5 years being amortized on the straight line method, and $3.5 million of goodwill, offset by $0.1 million of net liabilities. Purchase price allocation is considered preliminary at this time. Pro forma financial information for the NeuroQuest acquisition is not presented as it is not considered material.

Monarch

Table of Contents

We acquired Monarch Medical Diagnostics, LLC ("Monarch") through an asset purchase on November 13, 2015. Monarch's service compliments our GND acquisition which offers patients a convenient way to complete routine and extended video EEG diagnostic testing. The service also provides comprehensive reporting and support to the physician. The cash consideration for Monarch was $2.7 million. The purchase agreement also included a contingent consideration holdback of $1.0 million which we paid on January 11, 2016. The total purchase price was allocated to $1.2 million of tangible assets, $1.2 million of intangible assets with an assigned weighted average life of 5 years being amortized on the straight line method, and $2.4 million of goodwill. Pro forma financial information for the Monarch acquisition is not presented as it is not considered material.

Global Neuro-Diagnostics

We acquired GND Operating LLC, and Braincare, LLC (collectively "GND") through an equity purchase on January 23, 2015. GND's service offers patients a convenient way to complete routine and extended video EEG diagnostic 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, which consists primarily of $1.5 million of tangible assets, $4.8 million of intangible assets with an assigned weighted average life of 5 years being amortized on the straight line method, and $8.9 million of goodwill, offset by $0.5 million of net liabilities. The purchase agreement also included an earn-out provision contingent upon GND achieving certain revenue milestones from 2015 to 2017. At acquisition we estimated the earn-out to be $3.2 million. Each quarter we evaluate expected future revenue and adjust our estimate accordingly. We currently estimate this earn-out to be $0.5 million, which was a reduction of $2.8 million in the current quarter, as we expect lower revenues for 2016 and 2017 than anticipated. Pro forma financial information for the GND acquisition is not presented as it is not considered material.

NicView

On January 2, 2015, we purchased the assets of Health Observation Systems, LLC ("NicView") for cash consideration of $1.1 million, of which $0.3 million was allocated to tangible assets and $2.7 million to goodwill, offset by $0.6 million allocated to net liabilities. NicView provides streaming video for families with babies in the neonatal intensive care unit. The asset purchase agreement included an earn-out condition of $1.3 million that was contingent upon orders received and installed by February 28, 2016. The earn-out was paid on March 28, 2016. Pro forma financial information for the NicView acquisition is not presented as it is not considered material.

3 - Earnings Per Share

The components of basic and diluted EPS are as follows (in thousands, except per share amounts):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net income	$13,313	$10,932	$32,361	$29,380
Weighted average common shares	32,388	32,432	32,476	32,279
Dilutive effect of stock based awards	593	821	601	915
Diluted Shares	32,981	33,253	33,077	33,194
Basic earnings per share	$0.41	$0.34	$1.00	$0.91
Diluted earnings per share	$0.40	$0.33	$0.98	$0.89
Shares excluded from calculation of diluted EPS	—	—	138	—

4 - Cash, Cash Equivalents, and Short-Term Investments

The Company has invested its excess cash in highly liquid marketable securities such as corporate debt instruments, U.S. government agency securities and asset-backed securities. Investments with maturities greater

Table of Contents

than one year are classified as current because management considers all investments to be available for current operations.

The Company's investments are designed to provide liquidity, preserve capital and maximize total return on invested assets with a focus on high credit-quality securities.

The Company's investments have been classified and accounted for as available-for-sale. Such investments are recorded at fair value and unrealized holding gains and losses are reported as a separate component of accumulated other comprehensive income (loss) in the stockholders' equity until realized. Realized gains and losses on sales of investments, if any, are determined on the specific identification method and are reclassified from accumulated other comprehensive income (loss) to results of operations as other income (expense).

The Company, to date, has not determined that any of the unrealized losses on its investments are considered to be other-than-temporary. The Company reviews its investment portfolio to determine if any security is other-than-temporarily impaired, which would require the Company to record an impairment charge in the period any such determination is made. In making this judgment, the Company evaluates, among other things: the duration and extent to which the fair value of a security is less than its cost; the financial condition of the issuer and any changes thereto; and the Company's intent and ability to hold its investment for a period of time sufficient to allow for any anticipated recovery in market value, or whether the Company will more likely than not be required to sell the security before recovery of its aggregated cost basis. The Company has evaluated its investments as of September 30, 2016 and has determined that no investments with unrealized losses are other-than-temporarily impaired. No investments have been in a continuous loss position greater than one year.

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

	September 30, 2016	December 31, 2015
Cash and cash equivalents:		
Cash	74,072	82,469
U.S. Treasury Bills	7,001	—
Total cash and cash equivalents	81,073	82,469
Short-term investments:		
U.S. investment grade bonds	16,865	—
Developed investment grade bonds	8,564	—
Total short-term investments	25,429	—
Total cash, cash equivalents and short-term investments	106,502	82,469

Short-term Investments by investment type are as follows (in thousands):

	September 30, 2016				December 31, 2015			
	Aggregated Cost Basis	Gross Unrealized Gains	Gross Unrealized Losses	Aggregated Fair Value	Aggregated Cost Basis	Gross Unrealized Gains	Gross Unrealized Losses	Aggregated Fair Value
U.S. investment grade bonds	16,890	1	(26)	16,865	—	—	—	—
Developed investment grade bonds	8,579	—	(15)	8,564	—	—	—	—
Total short-term investments	$25,469	$ 1	$ (41)	$ 25,429	$ —	$ —	$ —	$ —

Short-term investments by contractual maturity are as follows (in thousands):

Table of Contents

	September 30, 2016 Investments	December 31, 2015 Investments
Due in one year or less	$ 7,342	$ —
Due after one year through five years	18,087	—
Total short-term investment	$ 25,429	$ —

5 - Inventories

Inventories consist of the following (in thousands):

	September 30, 2016	December 31, 2015
Raw materials and subassemblies	$ 26,944	$ 19,041
Work in process	2,030	1,343
Finished goods	35,895	36,149
Total inventories	64,869	56,533
Less: Non-current inventories	(13,215)	(7,961)
Inventories, current	$ 51,654	$ 48,572

At September 30, 2016 and December 31, 2015, we have classified $13.2 million and $8.0 million, respectively, of inventories as other assets. We expect that we will not use this inventory within the next twelve months. This inventory consists primarily of last time buy items from our suppliers, service components used to repair products pursuant to warranty obligations and extended service contracts, including service components for products we are not currently selling and inventory that we purchased in bulk quantities. Management believes that these inventories will be utilized for their intended purpose.

6 – Intangible Assets

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

	September 30, 2016				December 31, 2015			
	Gross Carrying Amount	Accumulated Impairment	Accumulated Amortization	Net Book Value	Gross Carrying Amount	Accumulated Impairment	Accumulated Amortization	Net Book Value
Intangible assets with definite lives:								
Technology	$ 63,264	$ —	$ (34,140)	$ 29,124	$ 63,668	$ —	$ (31,600)	$ 32,068
Customer related	37,283	—	(16,863)	20,420	35,529	—	(14,352)	21,177
Trade names	34,478	(3,379)	(6,232)	24,867	31,837	(3,340)	(3,052)	25,445
Internally developed software	17,722	—	(9,769)	7,953	15,513	—	(8,155)	7,358
Patents	2,694	—	(2,283)	411	2,663	—	(2,175)	488
Definite-lived intangible assets	$ 155,441	$ (3,379)	$ (69,287)	$ 82,775	$ 149,210	$ (3,340)	$ (59,334)	$ 86,536

Finite-lived intangible assets are amortized over their useful lives, which are 5 to 20 years for technology, 4 to 16 years for customer related intangibles, 4 to 10 years for internally developed software, 5 to 7