NATUS MEDICAL INC
Form 10-Q
November 04, 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 September 30, 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 October 29, 2015 was 33,021,474.

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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)

	September 30, 2015	December 31, 2014
ASSETS		
Current assets:		
Cash and cash equivalents	$82,201	$66,558
Accounts receivable, net of allowance for doubtful accounts of $4,598 in 2015 and $4,324 in 2014	88,905	82,277
Inventories	46,108	40,051
Prepaid expenses and other current assets	18,861	17,408
Deferred income tax	11,448	11,511
Total current assets	247,523	217,805
Property and equipment, net	17,976	17,923
Intangible assets, net	87,187	92,761
Goodwill	108,401	96,316
Other assets	8,795	10,016
Total assets	$469,882	$434,821
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$24,199	$21,371
Accrued liabilities	39,193	36,024
Deferred revenue	10,191	11,745
Total current liabilities	73,583	69,140
Long-term liabilities:		
Other liabilities	6,883	4,859
Deferred income tax	8,655	8,107
Total liabilities	89,121	82,106
Stockholders' equity:		
Common Stock, $0.001 par value, 120,000,000 shares authorized; shares issued and outstanding 32,955,830 in 2015 and 32,649,158 in 2014	318,414	315,296
Preferred stock, $0.001 par value; 10,000,000 shares authorized; no shares issued and outstanding in 2015 and 2014	—	—
Retained earnings	98,270	68,890
Accumulated other comprehensive loss	(35,923)	(31,471)
Total stockholders' equity	380,761	352,715
Total liabilities and stockholders' equity	$469,882	$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 September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Revenue	$94,583	$89,876	$275,915	$261,824
Cost of revenue	35,520	33,180	104,468	102,659
Intangibles amortization	683	1,054	2,048	2,257
Gross profit	58,380	55,642	169,399	156,908
Operating expenses:				
Marketing and selling	22,495	20,123	65,345	62,815
Research and development	7,700	7,462	21,867	22,272
General and administrative	10,031	12,740	33,239	34,537
Intangibles amortization	2,036	(408)	5,165	1,374
Restructuring	42	2,848	358	3,701
Total operating expenses	42,304	42,765	125,974	124,699
Income from operations	16,076	12,877	43,425	32,209
Other income (expense), net	7	(1,447)	(1,203)	(340)
Income before provision for income tax	16,083	11,430	42,222	31,869
Provision for income tax expense	5,151	3,607	12,842	9,830
Net income	$10,932	$7,823	$29,380	$22,039
Foreign currency translation adjustment	(642)	(5,979)	(4,452)	(9,949)
Comprehensive income	$10,290	$1,844	$24,928	$12,090
Earnings per share:				
Basic	$0.34	$0.25	$0.91	$0.70
Diluted	$0.33	$0.24	$0.89	$0.68
Weighted average shares used in the calculation of earnings per share:				
Basic	32,432	31,584	32,279	31,358
Diluted	33,253	32,615	33,194	32,426

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)

	Nine Months Ended September 30,	
	2015	2014
Operating activities:		
Net income	$29,380	$22,039
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for losses on accounts receivable	945	561
Excess tax benefit on the exercise of stock options	(5,304)	(3,846)
Depreciation and amortization	11,346	8,567
Impairment of property and equipment	—	2,160
Warranty reserve	4,771	1,420
Share-based compensation	5,382	4,704
Changes in operating assets and liabilities:		
Accounts receivable	(6,681)	1,250
Inventories	(7,014)	(926)
Prepaid expenses and other assets	(1,049)	1,776
Accounts payable	3,237	(2,624)
Accrued liabilities	(3,596)	(5,851)
Deferred revenue	(2,049)	(1,026)
Deferred income tax	5,560	4,981
Net cash provided by operating activities	34,928	33,185
Investing activities:		
Acquisition of businesses, net of cash acquired	(11,559)	(4,925)
Purchases of property and equipment	(2,990)	(3,736)
Purchase of intangible assets	(1,158)	(964)
Net cash used in investing activities	(15,707)	(9,625)
Financing activities:		
Proceeds from stock option exercises and Employee Stock Purchase Program purchases	6,086	10,515
Excess tax benefit on the exercise of stock options	5,304	3,846
Repurchase of common stock	(9,352)	(3,407)
Taxes paid related to net share settlement of equity awards	(4,303)	(1,960)
Contingent consideration earn-out	(664)	—
Payments on borrowings	—	(30,017)
Net cash used in financing activities	(2,929)	(21,023)
Exchange rate changes effect on cash and cash equivalents	(649)	(837)
Net increase in cash and cash equivalents	15,643	1,700
Cash and cash equivalents, beginning of period	66,558	56,106
Cash and cash equivalents, end of period	$82,201	$57,806
Supplemental disclosure of cash flow information:		
Cash paid for interest	$—	$364
Cash paid for income taxes	$5,348	$4,737
Non-cash investing activities:		
Property and equipment included in accounts payable	$200	$274
Inventory transferred to property and equipment	$797	$754

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 nine months ended September 30, 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 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 may adopt the standard in either its first quarter of 2017 or 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 timing of its adoption and the impact of adopting the new revenue standard on its consolidated financial statements.

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 diagnostic electroencephalography (“EEG") and video electromyography ("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

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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. The purchase price allocation is considered preliminary, and final determination of the value of intangible assets and contingent consideration is expected during the fourth quarter of 2015 as we are in the process of finalizing the valuation of the acquired intangible assets. Final determination of the values may 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.

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. The asset purchase agreement included an earn-out condition contingent upon revenue earned in 2015. The Company estimates this earn-out to be $1.4 million. Pro forma financial information for the NicView acquisition is not presented as it is not considered material.

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 was contingent upon annual revenue growth through 2016. This earn-out, originally estimated at $0.8 million, was settled during the second quarter of 2015 for $0.7 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. Pro forma financial information for these two acquisitions 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,	
	2015	2014	2015	2014
Net income	$10,932	$7,823	$29,380	$22,039
Weighted average common shares	32,432	31,584	32,279	31,358
Dilutive effect of stock based awards	821	1,031	915	1,068
Diluted Shares	33,253	32,615	33,194	32,426
Basic earnings per share	$0.34	$0.25	$0.91	$0.70
Diluted earnings per share	$0.33	$0.24	$0.89	$0.68
Shares excluded from calculation of diluted EPS	—	245	—	238

4 - Inventories

Inventories consist of the following (in thousands):

	September 30, 2015	December 31, 2014
Raw materials and subassemblies	$17,917	$19,821
Work in process	1,755	1,808
Finished goods	33,287	26,037
Total inventories	52,959	47,666
Less: Non-current inventories	(6,851)	(7,615)
Inventories, current	$46,108	$40,051

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At September 30, 2015 and December 31, 2014, the Company has classified $6.9 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):

	September 30, 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 definite lives:								
Technology	$63,568	$ —	$ (30,734)	$32,834	$64,376	$ —	$ (28,195)	$36,181
Customer related	33,106	—	(13,629)	19,477	31,189	—	(11,786)	19,403
Trade names	32,068	(3,382)	(2,049)	26,637	32,443	(3,504)	—	28,939
Internally developed software	15,367	—	(7,653)	7,714	14,109	—	(6,511)	7,598
Patents	2,698	—	(2,173)	525	2,794	—	(2,154)	640
Backlog	718	—	(718)	—	719	—	(719)	—
Definite-lived intangible assets	$147,525	$ (3,382)	$ (56,956)	$87,187	$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, 7 years for trade names, and 13 years for patents.

Internally developed software consists of $13.2 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 September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Technology	$934	$1,057	$2,854	$2,985
Customer related	689	294	2,092	1,247
Trade names	1,024	—	2,048	—
Internally developed software	434	321	1,142	1,049
Patents	28	17	84	83
Total amortization	$3,109	$1,689	$8,220	$5,364

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

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Three months ending December 31, 2015	$3,097
2016	11,900
2017	11,616
2018	11,392
2019	10,270
2020	8,590
Thereafter	30,322
Total expected amortization expense	$87,187

During the second quarter of 2015 we initiated a strategy to increase the brand strength of Natus by replacing acquired product trade names with Natus branded products over time. The implementation of this strategy places definite expected future lives on our acquired trade names which previously had indefinite lives. We assigned these trade names lives of seven years based on the timeline of our branding strategy. We will continue to assess the lives of these assets based on the timing and execution of this strategy. Amortization expense for trade names is recorded as a component of operating expense. This change increased the Company's amortization expense and decreased pre-tax income by approximately $1.0 million, decreased net income by approximately $0.7 million, and decreased diluted earnings per share by $0.02 per share for the three months ended September 30, 2015. For the nine months ended September 30, 2015, this change increased the Company's amortization expense and decreased pre-tax income by approximately $2.0 million, decreased net income by approximately $1.4 million, and decreased diluted earnings per share by $0.04 per share.

6 – Goodwill

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

December 31, 2014	$96,316
Acquisitions	13,489
Foreign currency translation	(1,404)
September 30, 2015	$108,401

7 - Property and Equipment, net

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

	September 30, 2015	December 31, 2014
Land	$3,044	$3,092
Buildings	6,462	6,828
Leasehold improvements	2,419	2,118
Office furniture and equipment	14,156	12,839
Computer software and hardware	9,936	8,821
Demonstration and loaned equipment	11,166	10,929
	47,183	44,627
Accumulated depreciation	(29,207)	(26,704)
Total	$17,976	$17,923

Depreciation expense of property and equipment was approximately $1.0 million and $3.1 million for the three and nine months ended September 30, 2015, respectively, and approximately $1.0 million and $3.4 million for the three and nine months ended September 30, 2014, respectively.

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8 - Reserve for Product Warranties

We provide a warranty with our products that is generally one year in length and in some cases, regulations may require us to provide repair or remediation beyond our typical warranty period. We also sell extended service agreements on our medical device products that are generally over one year in length. If any of our products contain defects, we may be required to incur additional repair and remediation costs. 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.

A warranty reserve is included in accrued liabilities for the expected future costs of servicing products. Additions to the reserve are based on management’s best estimate of probable liability. We consider a combination of factors including material and labor costs, regulatory requirements, and other judgments in determining the amount of the reserve. The reserve is reduced as costs are incurred to honor existing warranty and regulatory obligations.

We expect to incur future costs to bring our NeoBLUE® phototherapy product into U.S. regulatory compliance. We are unable to estimate the cost of the compliance effort at this time.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Balance, beginning of period	$4,408	$2,688	$2,753	$3,142
Additions charged to expense	1,617	668	4,770	1,078
Reductions	(813)	(646)	(2,311)	(1,510)
Balance, end of period	$5,212	$2,710	$5,212	$2,710

9 - Share-Based Compensation

At September 30, 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 nine months ended September 30, 2015 and our methods for determining grant-date fair value of the awards are 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 September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Cost of revenue	$29	$32	$116	$110
Marketing and selling	287	261	972	531
Research and development	249	220	644	758
General and administrative	1,326	1,014	3,650	3,305
Total	$1,891	$1,527	$5,382	$4,704

As of September 30, 2015, unrecognized compensation expense related to the unvested portion of our stock options and other stock awards was approximately $9.2 million, which is expected to be recognized over a weighted average period of 1.7 years.

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10 - Other Income (Expense), net

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Interest income	$13	$(28)	$28	$108
Interest expense	—	(104)	—	(486)
Foreign currency gain (loss)	(80)	(785)	(1,571)	216
Other	74	(530)	340	(178)
Total other income (expense), net	$7	$(1,447)	$(1,203)	$(340)

11 - Income Taxes

Provision for Income Tax Expense

We recorded provisions for income tax of $5.2 million and $12.8 million for the three and nine months ended September 30, 2015, respectively. Our effective tax rate was 32.0% and 30.4% for the three and nine months ended September 30, 2015, respectively.

We recorded provisions for income tax of $3.6 million and $9.8 million for the three and nine months ended September 30, 2014, respectively. Our effective tax rate was 31.6% and 30.8% for the three and nine months ended September 30, 2014.

Our effective tax rate for the three and nine months ended September 30, 2015 differed from federal statutory tax rate primarily due to profits taxed in foreign jurisdictions with lower tax rates than the federal statutory rate. The changes in the effective tax rate for the three and nine months ended September 30, 2015 compared with the three and nine months ended September 30, 2014 are primarily attributable to forecasted shifts in the geographical mix of income.

We recorded $2.7 million net tax benefit of unrecognized tax benefits for the nine months ended September 30, 2015. Within the next twelve months, it is possible our uncertain tax benefit may change with a range of approximately zero to $0.5 million. Our tax returns remain open to examinations as follows: U.S. Federal, 2011 through 2014, U.S. States 2010 through 2013 and significant foreign jurisdictions 2010 through 2014.

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.

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 nine months ended September 30, 2015 is as follows (in thousands):

	Personnel Related	Facility Related	Total
Balance at December 31, 2014	$368	$—	$368
Additions	339	115	454
Reversals	(96)	—	(96)
Payments	(464)	(115)	(579)
Balance at September 30, 2015	$147	$—	$147

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13 - Segment, Customer and Geographic Information

We operate in one reportable segment in which we provide healthcare products and services 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 September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Consolidated Revenue:				
United States	$62,553	$56,678	$177,627	$157,481
Foreign countries	32,030	33,198	98,288	104,343
Totals	$94,583	$89,876	$275,915	$261,824

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Revenue by End Market:				
Neurology Products				
Devices and Systems	$41,993	$43,922	$123,086	$125,917
Supplies	15,286	14,746	45,603	45,059
Services	2,125	—	5,614	—
Total Neurology Revenue	59,404	58,668	174,303	170,976
Newborn Care Products				
Devices and Systems	17,598	16,516	53,916	49,064
Supplies	12,584	12,854	37,025	36,733
Services	4,997	1,838	10,671	5,051
Total Newborn Care Revenue	35,179	31,208	101,612	90,848
Total Revenue	$94,583	$89,876	$275,915	$261,824

	September 30, 2015	December 31, 2014
Property and equipment, net:		
United States	$6,367	$5,782
Canada	5,199	5,538
Argentina	3,271	3,692
Ireland	1,974	1,656
Other foreign countries	1,165	1,255
Totals	$17,976	$17,923

During the three and nine months ended September 30, 2015 and 2014, no single customer or foreign countr