

NETLOGIC MICROSYSTEMS INC  
Form 10-K  
March 02, 2007  
Table of Contents

---

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
WASHINGTON, D.C. 20549  
**FORM 10-K**

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the fiscal year ended December 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: 000-50838

---

**NETLOGIC MICROSYSTEMS, INC.**

(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of incorporation or organization)

77-0455244  
(I.R.S. Employer Identification No.)

1875 Charleston Road, Mountain View, California  
(Address of principal executive offices)

94043  
(Zip Code)

(650) 961-6676

(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class  
Common Stock

Name of each exchange on which registered  
Global Select Market of the NASDAQ Stock Market LLC

Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-K

Securities registered pursuant to Section 12(g) of the Act:

Title of each class	Name of each exchange on which registered
Series AA Junior Participating Preferred Stock, \$0.01 par value per share	None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes  No

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  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. Large accelerated filer  Accelerated filer  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

As of June 30, 2006, the aggregate market value of the registrant's common stock held by non-affiliates of the registrant was approximately \$653,772,000 based on the closing sale price as reported on the National Association of Securities Dealers Automated Quotation System National Market System.

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Outstanding at February 9, 2007
Common Stock, \$0.01 par value per share	20,499,919 shares

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the registrant's proxy statement to be delivered to stockholders in connection with the registrant's 2007 Annual Meeting of Stockholders to be held on or about May 18, 2007 are incorporated by reference into Part III of this Form 10-K. The registrant intends to file its proxy statement within 120 days after its fiscal year end.

---

**Table of Contents**

**NETLOGIC MICROSYSTEMS, INC.**

**FISCAL 2006 FORM 10-K**

**TABLE OF CONTENTS**

	<b>Page</b>
	<b><u>      </u></b>
<b><u>PART I</u></b>	
Item 1. <u>Business</u>	3
Item 1A. <u>Risk Factors</u>	20
Item 1B. <u>Unresolved Staff Comments</u>	35
Item 2. <u>Properties</u>	36
Item 3. <u>Legal Proceedings</u>	36
Item 4. <u>Submission of Matters to a Vote of Security Holders</u>	36
<b><u>PART II</u></b>	
Item 5. <u>Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	37
Item 6. <u>Selected Financial Data</u>	40
Item 7. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	41
Item 7A. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	53
Item 8. <u>Financial Statements and Supplementary Data</u>	54
Item 9. <u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	84
Item 9A. <u>Controls and Procedures</u>	84
Item 9B. <u>Other Information</u>	84
<b><u>PART III</u></b>	
Item 10. <u>Directors, Executive Officers and Corporate Governance</u>	85
Item 11. <u>Executive Compensation</u>	85
Item 12. <u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	85
Item 13. <u>Certain Relationships and Related Transactions and Director Independence</u>	85
Item 14. <u>Principal Accounting Fees and Services</u>	85
<b><u>PART IV</u></b>	
Item 15. <u>Exhibits and Financial Statement Schedules</u>	86
<u>Signatures</u>	89

---

**Table of Contents**

**PART I**

**Forward-looking Statements**

*This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, which include, without limitation, statements about the market for our technology, our strategy and competition. Such statements are based upon current expectations that involve risks and uncertainties. Any statements contained herein that are not statements of historical fact may be deemed forward-looking statements. For example, the words believes, anticipates, plans, expects, intends and similar expressions are intended to identify forward-looking statements. Our actual results and the timing of certain events may differ significantly from the results discussed in the forward-looking statements. Factors that might cause such a discrepancy include, but are not limited to, those discussed in Business, Risks Factors, Management's Discussion and Analysis of Financial Condition and Results of Operations and Qualitative and Quantitative Disclosures About Market Risk below. All forward-looking statements in this report are based on information available to us as of the date of this report, and we assume no obligation to update any such forward-looking statements. The information contained in this report should be read in conjunction with our condensed financial statements and the accompanying notes contained in this report. Unless expressly stated or the context otherwise requires, the terms we, our, us and NetLogic Microsystems refer to NetLogic Microsystems, Inc.*

**ITEM 1. BUSINESS.**

**Overview**

We are a semiconductor company that designs, develops and markets high performance knowledge-based processors for a variety of advanced wireline and wireless networking systems, such as routers, switches, wireless infrastructure equipment, network security appliances, network access equipment and networked storage devices. Our knowledge-based processors accelerate a wide variety of complex functions to enable emerging quad-play networks and services, or the convergence of voice, video, data and mobility over a single unified Internet Protocol infrastructure.

Knowledge-based processors are integrated circuits that employ an advanced processor architecture and a large knowledge or signature database containing information on the network, as well as applications and content that run on the network to make complex decisions about individual packets of information traveling through the network. Our knowledge-based processors significantly enhance the ability of networking original equipment manufacturers, or OEMs, to supply network service providers with systems offering more advanced functionality for the Internet, such as high-definition video delivery over the Internet, or IPTV, voice transmission over the Internet, or VoIP, unified threat management, or UTM, virtual private networks, or VPNs, rich content delivery over mobile wireless networks, and streaming video and audio.

Our knowledge-based processors incorporate advanced technologies that enable rapid processing, such as a superscalar architecture, which uses parallel-processing techniques, and deep pipelining, which segments processing tasks into smaller sub-tasks, for higher decision throughput. These technologies enable wireline and wireless networking systems to perform a broad range of network-aware and content-aware processing functions, such as application-based routing, UTM network security, intrusion detection and prevention, virus inspection, access control for network security, prioritization of traffic flow to maintain quality of service, or QoS, and statistical measurement of Internet traffic for transaction billing.

We design our products at the transistor level and use a full-custom layout flow to define how circuits are constructed in silicon. This allows us to optimize circuit design, minimize chip size and reduce power dissipation of our integrated circuits. By minimizing chip size, we are able to optimize the cost of our knowledge-based processors and facilitate the design of our customers' products within smaller enclosures, or form factors.

We provide complete, systems-level solutions that include interface designs and firmware, device driver, packet-processing and knowledge database management application software, design tools and environments and

## Table of Contents

reference designs. By providing a comprehensive systems-level solution, we help networking OEMs reliably introduce next generation networking systems and significantly enhance their time-to-market. These systems-level solutions are provided free-of-charge to our OEM customers to encourage sales of our products.

Our products are designed into systems offered by leading networking OEMs, including AlaxalA Networks Corporation, Alcatel-Lucent, ARRIS Group, Inc., Cisco Systems, Inc., Extreme Networks, Inc., Foundry Networks, Inc., Force10 Networks, Inc., Fujitsu Limited, Hitachi, Ltd., Huawei Technologies Co., Ltd., and Juniper Networks, Inc. We organized our business in 1995 as a California limited liability company and, incorporated in Delaware in 2000.

The packet processing requirements of new quad-play internet traffic, driven by the convergence of voice, video, data and mobility, continue to increase, and we made a number of significant product announcements in 2006 to support our continued focus on enabling quad-play networks and services. In our core business of Layer 3-4 knowledge-based processing, we announced the availability of our NL6000XS, which is the high-speed, 500MHz version of our previously announced NL6000 processor family. In October of 2006, we also announced the NL71024, the first member of our NL7000 family of processors and the first knowledge-based processor in the industry to support over one million Internet Protocol version 4, or IPv4 entries. This product also incorporates a new circuit design and architecture for advanced dynamic power management, delivering to our customers a new level of performance per Watt. The NL7000 family of knowledge-based processors also incorporates new functionality for the acceleration of Internet Protocol Version 6 (IPv6) traffic. This new feature is particularly important as quad-play functionality, and especially IP-over-mobile, is poised to drive a dramatic increase in the amount of IPv6 traffic over the next several years.

We also made initial sample deliveries of our newest knowledge-based processor, the NL8000, and we secured two design wins for this product with our largest customer. Both the NL7000 and NL8000 processors are multi-hundred million transistor designs with a large amount of complexity due to the advanced pipeline architecture and performance optimization, the new features sets and functionality, the dynamic power management implementation, and the new interface technology necessary to achieve the 40-50 Gigabits per second throughput required of these devices. Despite this complexity, the NL8000 achieved 100% of its performance and functionality targets with first silicon.

In January 2006, we announced the launch of our NETL7 family of Layer 7 knowledge-based processors that accelerate content processing and signature recognition tasks for enterprise and carrier-class networks, and are used to perform wire-speed content inspection of packets traveling through the network. This family of products extends the processing capabilities of our knowledge-based processors into the packet payload, thereby enabling the design and deployment of next-generation networking systems that can make packet processing decisions based on an awareness of the packet content.

We also introduced in 2006 two new products to our entry-level NETLite processor product line. The first, the NL3280GLQ, brings a new level of performance and functionality to merchant network processors using the network processor forum LA-1 standard bus interface, which is a widely adopted interface in entry-level switches and routers. The NL3280GLQ processor is a turnkey project designed by the company's rapidly growing India Design Center (IDC) located in Bangalore, India. In November 2006, we introduced a new low-power version of the NL3140 NETLite processor, which is specifically designed for cost-sensitive, high-volume applications, and we successfully penetrated our largest customer, Cisco Systems, with this new product family.

On February 15, 2006, we completed the acquisition of Cypress Semiconductor Corporation's (Cypress) Network Search Engine (NSE) products pursuant to an Agreement for the Purchase and Sale of Assets entered into on January 25, 2006, as amended. Upon closing the transaction, we acquired assets relating to Cypress' NSE business, including all intellectual property related primarily to the acquired NSE business (including all intellectual property related to the Sahasra algorithmic technology), the NSE70000 and Ayama product families and all inventory and fixed assets for those product families. We did not acquire any of Cypress' TCAM1,

## **Table of Contents**

TCAM2, TCAM2-CR, TurboCAM or Toy Cam products and inventory. The Sahasra algorithmic technology complements our Layer 7 processing initiative and is a beneficial building block in driving towards low-cost Layer 7 applications acceleration and security processing solutions. In addition, the Ayama 10000 and Ayama 20000 expanded our product offerings in the high-volume, entry-level Layer 3 switch market.

## **Industry Overview**

### *Networking Market Overview*

The Internet continues to grow and evolve to accommodate the continued increase in the amount of digital media content available and to provide converged support for the quad-play applications of voice, data, video and mobility over a single unified Internet Protocol, or IP, infrastructure. These applications include:

Voice transmission over the Internet, or VoIP;

Video on demand, or VoD, including television programming, movies and other media interactively streamed into homes and businesses over the Internet, known as Internet Protocol television, or IPTV;

On-line gaming;

Filtering of malware (e.g., virus, spyware and spam) and intrusion attempts;

Music, picture and video file downloading and sharing;

Email communications;

E-commerce;

Music, picture and video file downloading and sharing to mobile devices such as cell phones and portable music/video devices; and

Internet Web-surfing and video portal viewing, such as You-Tube, delivered over the IP infrastructure to cell phones and other mobile devices.

Due to the rapid growth and demands to support quad-play applications, there has been significant expansion of the global networking infrastructure using advanced packet-switching protocols, which are the data formats that enable communication among the systems within the network. These networking systems, based upon packet-switching protocols, transport packets of information through the network. The most common packet-switching protocol is the Internet Protocol.

The Internet infrastructure consists of various networking systems that handle the processing of IP packets. These systems include routers, switches, application acceleration equipment, network security appliances, network access equipment and networked storage devices. An IP packet that is sent from one user's device to another typically travels through a variety of networks that comprise the Internet infrastructure. These types of networks include:

Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-K

core networks, for long-distance city-to-city communications which may span hundreds or thousands of miles;

enterprise networks, for internal corporate communications, including access to storage environments;

metro networks, for intra-city communications which may span several miles;

edge networks, which link core, metro, enterprise and access networks; and

access networks, which connect individual users to the edge network.

**Table of Contents**

The following diagram depicts typical network connections within the Internet infrastructure:

IP packets are transferred from one networking system to another through these network connections. Each system within the network and each connected end-user device, such as a computer, mobile personal digital assistant or PDA, mobile phone, portable media player or wireless gaming console, is assigned a unique identifier, known as an IP address, which allows these systems and devices to communicate with each other.

For networking infrastructure that supports Layer 2-4 routing, decisions on how to handle IP packets are made using the data that is contained in the packet header. Layers 2, 3 and 4 refer to the data link, data and transport layers, respectively, of the Open Systems Interconnection or OSI, reference model, which is a layered abstract description for communications and computer network protocol design developed as part of the Open Systems Interconnection initiative. The packet header information consists of key data regarding the packet, including the IP address of the system that generated the packet, referred to as the source IP address, and the IP address of the device to which the packet is to be transmitted, referred to as the destination IP address.

For networking infrastructure that supports Layer 7 routing, decisions on how to handle IP packets are made using the information that is contained in the packet payload or packet content. The packet content contains the



## Table of Contents

actual data being transmitted between applications using the network. Layer 7 of the OSI model reference model, known as the application layer, facilitates communication between software applications and lower-layer network services.

When a packet arrives at a networking system such as a switch or a router, the packet is processed and decisions about the packet are made by examining the packet header content and/or the packet payload content. A decision may be made on where in the networking system the packet should be forwarded to in order to move the packet one step closer to its final destination. For example, an IP packet traveling from New York to San Francisco might travel through as many as 15 routers or switches and be processed a number of times by each router or switch. For many networking applications, packet processing must be performed without slowing down the overall flow of communication. Keeping pace with the rate of communication flow is referred to as wire-speed performance.

Due to the increased usage of the Internet, as well as the greater complexity of Internet-based applications, the amount of processing required for packets is increasing significantly. These more complex applications require multiple classes of packet processing that depend on both the type of content being transported and the information, or knowledge, of the overall network.

### *Trend Towards Network-aware and Content-aware Processing*

Rapid growth of voice, video and data traffic, as well as the greater complexity created by the convergence of these types of traffic, increasingly challenge OEMs to offer systems that enable network service providers to introduce new services over the Internet, such as Layer 7 networking, VoIP, VPNs, UTM network security, video on demand, streaming video and audio, music file downloading and filtering of computer viruses and intrusion attempts. In particular, networking OEM systems must increasingly make complex decisions about individual packets of information using knowledge about the overall network, which includes the method and manner in which networking systems are interconnected, as well as traffic patterns and congestion points, connection availability, user-based privileges, priorities and other attributes, as well as knowledge about the content carried by or applications that use the network. Using this knowledge of the network to make complex decisions about individual packets of information involves network awareness, while using knowledge of packet content to make complex decisions about individual packets of information involves content awareness. Network awareness and content awareness include the following:

Preferential transmission of packets based upon assigned priority;

Restrictions on access based upon security designations;

Changes to packet forwarding destinations based upon traffic patterns and bandwidth availability, or packet content; and

Addition or deletion of information about networks and users and applications.

Network and content awareness in advanced systems requires multiple classes of packet processing, in addition to forwarding. These additional classes of processing include access control for network security, prioritization of packets to maintain QoS and statistical measurement of Internet traffic for transaction billing. Compared to the basic processing task of forwarding, these additional classes of packet processing require a significantly higher degree of processing of IP packets to enable network and content awareness, or network-aware and content-aware processing. To maintain wire-speed performance in a network-aware environment, major networking OEMs require hundreds of millions of packet decisions each second, while also updating the knowledge database up to 100,000 times per second.

Several powerful trends are driving greater demand for network-aware and content-aware processing:

*Increasing Internet traffic drives the need for higher bandwidth.* New quad-play applications continue to emerge, including applications for MP3 audio file sharing and downloading peer-to-peer voice and video communications, and broadband video streaming, such as IPTV, to computers, mobile phones,

---

**Table of Contents**

portable media players, and other devices. These new applications require greater speed for effective transmission, which is driving the need for higher bandwidth. To satisfy these needs, routers, switches and other networking systems must have the ability to make rapid forwarding decisions that determine what further processing should be done for the packet, identify where the packet should be sent to next and rapidly transport the packet to the destination port. For example, edge and metro networking speeds have evolved from 1 Gigabit per second, or 1 Gb/s, to 2.5 Gb/s and 10 Gb/s, with 10Gb/s currently representing the fastest growing segment. We expect that as home and enterprise networks upgrade from Fast Ethernet (100 Mb/s) to Gigabit Ethernet (1Gb/s), and as wireless fidelity, or Wi-Fi, connections migrate from 802.11b (11Mb/s) to 802.11n (540Mb/s) specifications developed by the Institute of Electrical and Electronic Engineers, or IEEE, this will further drive the switch and router market to 10Gb/s to more effectively aggregate these IP nodes that feed into the network.

*Increasing network security requires additional packet inspection.* In order to make IP networks more secure, security technologies are being deployed at various points within the global networking infrastructure. For example, in the enterprise network, features are being added to secure specific links using VPNs, intrusion prevention systems, anti-virus gateways and access control lists. VPNs prevent eavesdropping on a secured communications link that is established between two devices and access control lists enable network service providers to permit or deny access to certain destinations. Intrusion prevention systems and anti-virus gateways scan the contents of IP traffic to search for, identify and block malicious attacks on the network and end-user devices. To implement these features, additional packet inspection is needed, which is typically more complex than the basic processing for forwarding decisions. These features require more information to be stored in the knowledge database and to be subsequently extracted for processing. Additionally, increasing and improving levels of security drives a need for greater processing of the packet payload thereby increasing required processing speeds.

*Convergence of voice, video, data and mobility requires enhanced QoS.* Convergence of voice, video, data and mobility requires enhancement of the IP network infrastructure, as these new services have more stringent performance requirements than traditional packet data. For example, delay in the transmission of a packet, or latency, would significantly degrade the quality of voice and video communications. To support more advanced communications, the network needs to treat packets of data in the IP network differently by assigning them a specified QoS level. For example, packets that require time-critical delivery can be assigned a higher priority for transmission, thereby reducing latency.

*Proliferation of Internet-connected devices requires more complex processing capabilities and larger knowledge databases.* Each Internet-connected device, including computers, handheld personal digital assistants and data and video-enabled mobile phones, is assigned an IP address. The significant increase in the number of such devices has led to a corresponding increase in the number of devices that networking systems need to support, requiring larger knowledge databases. In addition, in an effort to accommodate the connection of more devices to the Internet, the networking industry is moving to Internet Protocol version 6, or IPv6, which will increase the length of each IP address, requiring significantly more complex network-aware and content-aware processing to support larger knowledge databases.

The multiplicative effect of these trends leads to a significantly greater need for advanced processing that utilizes overall knowledge of the network to enable network and content awareness within switches, routers and other networking systems. Higher levels of performance are required to enable advanced processing for a greater variety of packet processing, such as content inspection for network security, application-based routing, access control for network security, prioritization of packets to maintain QoS and statistical measurement of Internet traffic for transaction billing, in addition to the forwarding functions.

As the demand for bandwidth and the need to support more advanced Internet applications increases, conventional approaches are increasingly unable to scale at the pace demanded by advanced applications because of their slower and less efficient processing capability. This creates a bottleneck in the information flow and limits overall system performance. Further, in designing high performance systems, networking OEMs need to address other performance issues, such as power dissipation. Minimizing the power dissipated by integrated

## **Table of Contents**

circuits is becoming more important for networking systems such as routers and switches, which are increasingly designed in smaller form factors. As a result, networking OEMs increasingly seek third party providers of advanced processing solutions that complement their core competencies to enable network and content awareness within their systems and meet their escalating performance requirements for rapid processing speeds, complex decision-processing capabilities, low power dissipation, small form factor and rapid time-to-market.

We continue to benefit from these trends as our total revenue for the fiscal year ended December 31, 2006 was \$96.8 million, which increased 18% over fiscal 2005, and our cash for the fiscal year ended December 31, 2006 was \$89.9 million, which increased 37% over fiscal 2005. Based on information available to us, we believe that our 2006 revenue represented approximately 30% of the total available Layer 2-4 market for knowledge-based processors and NETLite processors.

We expect the trends towards networks-aware and content-aware processing to continue to create significant opportunities for us. For example, we closed a record number of 34 new design wins in 2006, entered the Layer 7 market, broadened our presence in VoIP, and enhanced our presence in the IPTV market by having Motorola and Ericsson as customers. To take advantage of, and effectively compete for new opportunities, we pursue an aggressive product development strategy to improve the features, functions, performance, quality, reliability and manufacturability of our product solutions. For example, in 2006, we brought to market four significant new products: our NL6000XS, NL7000, NL8000 and NETL7 Layer 7 knowledge-based processor families.

Quad-play applications are the converged support for voice, data, video and mobility over a single unified IP infrastructure. Examples are voice-over-IP for cable, IPTV delivered over fiber or VDSL and video delivered over wireless networks to mobile devices. We continue to see increasing demand from the carrier space with the deployment of more sophisticated network infrastructure to support the delivery of these quad-play applications. To support quad-play applications, this new infrastructure requires more complex routing intelligence and significantly more quality of service and security functionality. The combination of these features is driving increasing content of knowledge-based processors into the edge and metro Ethernet markets, and is even driving the deployment of our products into IP aggregation and IP access equipment.

The fourth leg of quad-play is support of mobile devices, such as cell phones, over the IP infrastructure. With the advent of 3G, 3.5G and Super 3G, cell phones now have the ability to receive streaming audio and video, as well as music, movie and TV downloads and high-speed access to the Internet.

The higher data rates and richer feature sets demanded by quad-play applications are driving increasing knowledge-based processor content into the mobile wireless infrastructure space. We expect the second generation advanced 3.5G and Super 3G deployments to push advanced data networking equipment with knowledge-based processor content closer to the subscriber, increasing the volume and addressable market for our products.

In addition, research and development for 4G wireless indicate potential growth in demand for our products through innovations such as all-IPv6 networks and the use of Voice-over-IP for voice traffic. We expect this all-IP network, coupled with even higher data rates, to result in a large deployment of 10Gbps wireless edge routers. Due to the larger record sizes of IPv6 route tables, there will be more knowledge-based processor content in these new wireless edge routers. Also, with 4G wireless, integrated network security will become increasingly important, we expect most carriers to implement widespread malware protection and intrusion prevention in their 4G access networks.

## **Our Strategy**

Our objectives are to be the leading provider of network-aware and content-aware processing solutions to networking OEMs and to expand into new markets and applications. To achieve these goals, we are pursuing the following strategies:

*Maintain and Extend our Market and Technology Leadership Positions.* We were the first supplier of knowledge-based processors with approximately 256 IPv6 database entries and 1 million IPv4 data entries, the

## **Table of Contents**

first supplier to achieve 1.0 Volt operation of knowledge-based processors for lower power dissipation, and the first supplier to achieve operating frequencies of up to 500 MHz. We are the first supplier of content processors that are capable of processing application networking and security functions with a single 10 Gigabit-per-second engine. We intend to expand our market and technology leadership positions by continuing to invest in the development of successive generations of our knowledge-based processors to meet the increasingly high performance needs of networking OEMs, and acquire such capabilities through strategic partnerships and purchases of other businesses when we encounter favorable opportunities. We intend to leverage our engineering capabilities and continue to invest significant resources in recruiting and developing additional expertise in the area of high performance circuit design, custom circuit layout, high performance I/O interfaces, and applications engineering. By utilizing our proprietary design methodologies, we intend to continue to target the most demanding, advanced applications for our processors.

*Focus on Long-Term Relationships with Industry-Leading OEM Customers.* The design and product life cycles of our OEM customers' products have traditionally been lengthy, and we work with our OEM customers at the pre-design and design stages. As a result, our sales process typically requires us to maintain a long-term commitment and close working relationship with our existing and potential OEM customers. This process involves significant collaboration between our engineering team and the engineering and design teams of our OEM customers, and typically involves the concurrent development of our processors and the internally-designed packet processors of our OEM customers. We intend to continue to focus on building long-term relationships with industry-leading networking OEMs to facilitate the adoption of our products and to gain greater insight into the needs of our OEM customers.

*Leverage Technologies to Create New Products and Pursue New Market Opportunities.* We intend to leverage our core design expertise to develop our processors for a broader range of applications to further expand our market opportunities. We plan to address new market segments that are increasingly adopting network-aware processing, such as corporate storage networks, which increasingly use IP-based packet-switching networking protocols.

*Capitalize on Highly Focused Business Model.* We are a fabless semiconductor company, utilizing third parties to manufacture, assemble and test our products. This approach reduces our capital and operating requirements and enables us to focus greater resources on product development. We work closely with our wafer foundries to incorporate advanced process technologies in our solutions to achieve higher levels of performance and reduced cost. These technologies include advanced complementary metal oxide semiconductor, or CMOS, implemented in a 0.13, 0.11 and 0.09 and below micron logic process flow, with up to eight layers of copper interconnect and 300 millimeter wafer sizes. Our business model allows us to benefit from the large manufacturing investment of our wafer foundries who are able to leverage their investment across many markets.

*Expand International Presence.* We sell our products on a worldwide basis and utilize a network of direct sales and independent sales representatives in the U.S., Europe and Asia. We intend to continue to expand our sales and technical support organization to broaden our customer reach in new markets. We believe that Asia, in particular China, where we have already established customer relationships, provides the potential for significant additional long-term growth for our products. Given the continued globalization of OEM supply chains, particularly with respect to design and manufacturing, we believe that having a global presence will become increasingly important to securing new customers and design wins and to support OEMs in bringing their products to markets.

## **Our Markets and Products**

Our products are incorporated in a broad variety of networking systems that handle the processing of IP packets. These systems are used throughout multiple types of networks that comprise the global Internet infrastructure, including the enterprise, metro, access, edge and core networking markets. These networks vary in their requirements for bandwidth, number of users to support and complexity of IP packet processing. For

## Table of Contents

example, the core networking market has very high bandwidth requirements, as it typically handles traffic from many individual users, to enable Internet traffic over distances that typically span hundreds or thousands of miles. Our OEM customers' networking systems in the core network typically incorporate several of our knowledge-based processors to provide very large knowledge databases to accommodate large numbers of users. Due to the increased usage of the Internet, as well as the higher complexity of Internet-based applications, we expect network-aware processing to increasingly become a more essential component of networking systems throughout the global Internet infrastructure.

To enable network and content awareness for a variety of advanced networking systems, such as routers, switches, network access equipment and networked storage devices, we offer high performance knowledge-based processors. Our knowledge-based processors use an advanced processor architecture and a large knowledge or signature database to make complex decisions about individual packets of information traveling through the network. These features enable advanced processing across a variety of classes of packet processing, including access control for network security, prioritization of packets to maintain QoS and statistical measurement of Internet traffic for transaction billing. In addition, we design our products by connecting individual transistors and we use a full-custom layout flow to define precisely how circuits are constructed in silicon, enabling us to optimize circuit design, minimize chip size and reduce power dissipation of our integrated circuits.

Key features of our products include:

*Advanced Architecture for High-Speed Performance.* Our knowledge-based processors enable networking OEMs to offer products that process packets at wire-speed performance. Our knowledge-based processors are designed with a superscalar architecture that enables multiple decisions to be processed in parallel. In addition, our knowledge-based processors employ deep pipelining, which segments processing tasks into smaller sub-tasks for higher decision throughput. We use these advanced technologies to enable faster decision throughput in the network. In addition, our knowledge-based processors include features that give access to and support multiple NPUs, allowing more than one NPU to handle packet processing simultaneously. By incorporating our products, networking OEMs are able to process packets more rapidly.

*Expandable Processing Resources.* We offer knowledge-based processors that can process packets using knowledge databases containing up to approximately 256,000 IPv6 database entries or 1 million IPv4 database entries on a single integrated circuit. Additionally, our customers can interconnect multiple knowledge-based processors, which extends the usable knowledge database to up to approximately 1 million IPv6 database entries or 8 million IPv4 database entries. This allows our OEM customers' products to support a range of decision-making capacities that scales with end-user requirements. This feature becomes more critical as the number of devices connected to the Internet increases and networking OEMs deploy IPv6, creating the need for additional processing resources and larger knowledge databases to support longer IP addresses.

*Full-Custom Integrated Circuit Design for Reduced Cost and Low Power Dissipation.* We design our products using full-custom methodologies that allow us to optimize circuit area to implement specific functionality and accommodate larger databases. Our use of a full-custom layout flow allows for enhanced control of transistor characteristics as needed for optimized circuit design and enables us to minimize chip size and reduce power dissipation of our integrated circuits. By minimizing chip size, we are able to optimize the cost of our processors and facilitate the design of our OEM customers' products within smaller form factors.

*Systems-Level Solutions for Enhanced Design Flexibility and Rapid Time-to-Market.* To encourage our customers to design our processors into their products and to assist their design efforts, we offer various systems-level solutions. These include designs for programmable products that interface a customer's custom integrated circuits with our processors, software and firmware to program our processors and products that interface with our processors, and design tools and environments and reference designs that facilitate the incorporation of our processors into a customer's system. We do not charge our customers for providing these system-level solutions.

## **Table of Contents**

We work with NPU providers to validate our reference hardware and software, so that networking OEMs using our reference hardware and software can design their products with our processors more reliably and move to production more quickly. We also provide without charge dedicated applications support to enhance the product time-to-market for our OEM customers who choose to develop their own interfaces to our products.

*Transistor-Level Circuit Design for Enhanced Performance.* In order to meet the stringent demands on our processors for high speed, low power dissipation and small form factors, we use a highly customized design approach using transistor-level circuit techniques. By using a highly customized design flow, we are able to control precisely how the processing elements are constructed in silicon, leading to higher levels of integrated circuit performance. Designing integrated circuits at the transistor level requires a deep understanding of device physics to maximize transistor device performance. We employ simulation tools that are commonly used in the transistor-level design of analog integrated circuits. We complement these tools with our proprietary techniques to meet the complex design requirements of our processors.

We offer a broad range of our knowledge-based processors in two main product families: Layer 3-4 knowledge-based processors for use in routers, switches, network access equipment and networked storage devices; and Layer 7 knowledge-based processors for use in Layer 7 application switches and routers, UTM appliances, intrusion detection and prevention systems, and anti-virus gateways. To help reduce development time and cost, our knowledge-based processors are offered with the Cynapse Software Platform for customers to more easily integrate these processors into their systems. Cynapse is a single software environment that includes APIs, simulation models, device drivers, reference applications, and diagnostic code.

### *Layer 3-4 Knowledge-based Processors*

We offer Layer 3-4 knowledge-based processors with either a proprietary interface or with an NPU interface.

*Proprietary Interface Knowledge-based Processors NL5000, NL6000, NL7000 and NL8000 Families.* Our proprietary interface knowledge-based processors are used primarily by networking OEMs developing their own packet processors. Our products operate in conjunction with an OEM-developed custom integrated circuit or a programmable logic device, such as a field programmable gate array, and feature a proprietary interface that provides advanced interface technology to enable networking OEMs to meet their demanding system performance requirements.

Networking OEMs typically require solutions at different prices in order to target different market segments with the same design. To satisfy this demand, our proprietary interface knowledge-based processor family incorporates product offerings with a range of knowledge database sizes, and all of our knowledge-based processors are designed to be connected in groups to increase the knowledge database available for processing.

We introduced our first family of proprietary interface knowledge-based processors to the market in the second quarter of 2002. These knowledge-based processors operate from a 1.0 Volt power supply for reduced power consumption and support a knowledge database of up to approximately 256,000 IPv6 database entries to 1 million IPv4 database entries with throughput of up to 40 Gigabits per second. These knowledge-based processors also support advanced features for improved fault tolerance that help maintain the data integrity of the knowledge database by providing built-in circuitry to detect faults in the knowledge database.

We also provide versions of our proprietary interface knowledge-based processors that work with proprietary custom integrated circuits and application software developed by or in collaboration with Cisco.

*NPU Interface Knowledge-based Processors NL5000GLQ and NL6000GLQ Families.* Our NPU interface knowledge-based processors are designed to interface directly to NPUs, such as those provided by Intel Corporation, and merchant silicon Gigabit Ethernet switches. They incorporate architectural features that

## **Table of Contents**

simultaneously support multiple NPUs and NPU-based designs, resulting in more rapid packet processing. These features enable a single knowledge-based processor to make network-aware decisions for both incoming and outgoing communications line channels.

We introduced our NPU interface knowledge-based processors, which are designed in a 0.13 micron TSMC logic process, to the market in the first quarter of 2004. These processors operate from a 1.0 Volt power supply for reduced power consumption and support a knowledge database of up to approximately 512,000 records with performance of up to 125 million decisions per second.

*Layer 3-4 Knowledge-based Processors Under Development.* We are actively developing proprietary interface and NPU interface knowledge-based processors using CMOS logic manufacturing processes with geometries of less than 0.09 microns with up to eight layers of copper interconnect. These new designs, if successfully developed, will enable us to offer knowledge-based processors that feature higher levels of performance, including additional functionality developed in close cooperation with our customers to improve application-specific performance.

### *Layer 7 Knowledge-based Processors*

In January 2006, we announced the launch of our NETL7 family of Layer 7 knowledge-based processors. The first product in the NETL7 family is the NLS1000 content processor that accelerates content processing and signature recognition tasks for enterprise and carrier-class networks, and is used to perform 10 Gigabits per second wire-speed content inspection of packets traveling through the network. The NLS1000 content processor extends the processing capabilities of our knowledge-based processors into the packet payload, thereby enabling the design and deployment of next-generation networking systems that can make packet processing decisions based on an awareness of the packet content. Typical applications for the NLS1000 content processor include Layer 7 application switches and routers, mobile wireless infrastructure equipment, unified threat management appliances, intrusion detection and prevention systems and malware protection gateways. We recently started shipping revenue-generating development kits to customers, and were awarded two design wins for the NETL7 products with one of the world's largest providers of enterprise security solutions and services. We expect to ship revenue generating NETL7 processors in the second half of 2007.

### *Sahasra Knowledge-based Processors*

The Sahasra family of knowledge-based processors uses advanced algorithms to achieve low power dissipation, and is particularly well suited for applications using exact match or longest-prefix match functions. This family of devices scales up to 1.5 million IPv4 entries in a single device.

### *NETLite Processors*

Our NETLite NL3000 processor product family is specifically designed for cost-sensitive, high-volume applications such as entry-level switches, routers and access equipment. The NETLite processor family leverages circuit techniques developed and refined during the design of our knowledge-based processor families, and benefits from die size optimization, lower power dissipation and redundant computing techniques. In addition, the NETLite processor's simplified pipeline architecture allows for lower cost manufacturing and assembly in less expensive packages than our knowledge-based processors, and allows for lower cost system designs. As such, the NETLite processors are ideal for entry-level systems that do not require the advanced parallel processing and deep pipelining performance of our high-end knowledge-based processors.

For rapid time to market, our customers can use our software development kit, the NLSDK, to develop and verify hardware and software using the NETLite processors. The NLSDK allows customers to run cycle-accurate patterns at varying operating speeds to exercise the functionality of the NETLite processors and confirm compatibility with target applications. The NETLite processor family is also supported by a suite of production

## **Table of Contents**

qualified firmware and software drivers and system reference designs, which will enable the growing entry-level system segment to more quickly ramp production with new designs supporting next-generation Internet features such as QoS, security and Layer 3 routing.

Our Ayama10000 and Ayama 20000 are high-performance, pipelined, synchronous processors for use with ASIC/FPGA designs. These processors are offered in densities ranging from 128K to 512K IPv4 entries, and include differentiated features such as Mini-Key power management. The Ayama 20000 processors incorporate all the features of the Ayama 10000 processors and work seamlessly with industry-leading NPUs. To help reduce development time and cost, the Ayama processors are also offered with the Cynapse Software Platform for customers to more easily integrate these processors into their systems.

### *Legacy Products*

We continue to support our legacy network search engines, which include the NSE1000 through NSE4000 and the newly acquired NSE70000 network search engine families and the NSE3128GLM network search engines, a device that interfaces directly to certain NPUs from Applied Micro Circuits Corporation. We introduced our network search engine products between 1998 and 2001. These products are fabricated by UMC or TSMC using a range of process technologies from 0.35 micron to 0.15 micron.

We also continue to support a legacy classification and forwarding processor, or CFP product, that provides certain advantages over NSEs for particular classes of packet processing commonly used in networking systems.

We introduced the CFP, which is fabricated by UMC using a 0.25 micron process, to the market in the second quarter of 2000. We continue to research CFP technology and may incorporate it into a future knowledge-based processor product.

### **Customers**

The markets for networking systems utilizing our products and services are mainly served by large networking OEMs, such as Alaxala Networks Corporation, Alcatel-Lucent, ARRIS Group, Inc., Cisco Systems, Inc., Extreme Networks, Inc., Foundry Networks, Inc., Force10 Networks, Inc., Fujitsu Limited, Hitachi, Ltd., Huawei Technologies Co., Ltd., and Juniper Networks, Inc.

We work with these and other networking OEMs to understand their requirements, and provide them with solutions that they then qualify and, in some cases, specify for use within their systems. While we sell directly to some networking OEMs, we also provide our products and services indirectly to other networking OEMs through their contract manufacturers, who in turn assemble our products into systems for delivery to our OEM customers. Sales to contract manufacturers accounted for 78%, 79% and 78% of total revenue in 2006, 2005 and 2004, respectively. Sales of our products are made under short-term, cancelable purchase orders. As a result, our ability to predict future sales in any given period is limited and subject to change based on demand for our OEM customers' systems and their supply chain decisions.

We also provide our products and services indirectly to our OEM customers through distribution and our international stocking sales representatives. Our stocking sales representatives are independent entities that assist us in identifying and servicing foreign networking OEMs and generally purchase our products directly from us for resale to OEMs or contract manufacturers located outside the U.S. These international stocking sales representatives generally exclusively service a particular foreign region or customer base, and purchase our products pursuant to cancelable and reschedulable purchase orders containing our standard warranty provisions for defects in materials, workmanship and product performance. At our option, defective products may be returned for their purchase price or for replacement. To date, our international stocking sales representatives have returned a small number of defective products to us. Our international stocking sales representatives may also act as a sales representative and receive commissions on sales of our products. Our international stocking sales



**Table of Contents**

representatives include Bussan Microelectronics Corporation/Mitsui Comtek Corporation and Lestina International Limited. Sales through our international stocking sales representatives accounted for 13%, 13% and 12% of total revenue in 2006, 2005 and 2004, respectively. While we have purchase agreements with our international stocking sales representatives, our international stocking sales representatives do not have long-term contracts with any of our OEM customers that use our products and services.

On November 7, 2005, we entered into master purchase agreements with each of Cisco Systems, Inc. and Cisco Systems International B.V. Cisco, who together with their contract manufacturers, are our largest customers. Pursuant to these agreements, we agree to supply to Cisco (including its subsidiaries and contract manufacturers) certain of our products for incorporation into Cisco's products. These agreements set forth the general business terms and conditions applicable to our sales to Cisco.

our obligation to accept all purchase orders from Cisco, unless we are unable to meet Cisco's schedule;

our obligation to ensure that we have the capacity to increase or decrease production of our knowledge-based processors based upon Cisco's demand forecasts;

our obligation to use our best efforts to meet Cisco's stated cost reduction targets and to provide to Cisco all price decreases that we achieve;

most favored nation pricing and related audit rights in favor of Cisco, providing that, in any quarter, the prices paid by Cisco for our products (including progeny and replacements), will be the lowest prices paid for those products by any of our other customers who purchase as much or less than Cisco;

our obligation to provide Cisco, in the event of any short supply of products or components, an allocation that is no less favorable than that provided to our other customers purchasing similar quantities of similar products;

Cisco's cancellation rights for standard and custom products;

Cisco's approval and related rights with respect to any proposed changes to, or discontinuation of, our products purchased by Cisco;

Cisco's extended product warranties, generally for three years and, in the case of epidemic failures, for five years;

Cisco's right to purchase our knowledge-based processors directly from our manufacturers under the following circumstances:

product discontinuation;

bankruptcy, insolvency and similar situations; and

transfer of at least 50% of our voting control to a Cisco competitor that generates less than 50% of its annual sales from integrated circuit products;

in all cases, subject, among other things, to Cisco's continuing obligation to pay us for the product and our obligation to disclose the costs charged to us by our manufacturers;

perpetual, royalty-free, non-exclusive, worldwide license grant to Cisco to use binary code versions of our software in connection with Cisco's manufacture, sale, license, loan or distribution of its products; and

Cisco's extended product warranties, generally for three years and, in the case of epidemic failures, for five years and our indemnification obligation for epidemic failures which will not exceed the greater of (on a per claim basis) 25% of all amounts paid to us by Cisco during the preceding 12 months or \$9.0 million, plus replacement costs. The initial term of these agreements is three years, subject to renewal and termination rights.

In 2006, 2005 and 2004, Cisco, including its contract manufacturers, accounted for 61%, 74% and 73% of our total revenue, respectively. Cisco accounted for a smaller distribution of our total sales in 2006 as we

**Table of Contents**

increased our customer diversification. Notably, Alcatel-Lucent became a 10% customer, by revenue, in our fourth fiscal quarter of 2006. We expect to continue to further diversify our customer account base in 2007.

**Sales and Marketing**

Our sales and marketing strategy is to achieve design wins with leaders and emerging participants in the networking systems market and to maintain these design wins primarily through leading-edge products and superior customer service. We focus our marketing and sales efforts at a high organizational level of our potential customers to access key decision makers. In addition, as many networking OEMs design custom integrated circuits to interface to our products, we believe that applications support at the early stages of design is critical to reducing time-to-market and minimizing costly redesigns for our customers.

Our product sales cycles can take up to 24 months to complete, requiring a significant investment in time, resources and engineering before realization of income from product sales, if at all. Such long sales cycles mean that OEM customers' vendor selections, once made, are normally difficult to change. As a result, a design loss to the competition can negatively impact our financial results for several years. Similarly, design wins can result in an extended period of revenue opportunities with that customer.

We market and sell our products through our direct sales force and through approximately 14 independent sales representatives and one distributor throughout the world. Our direct sales force is dedicated to enhancing relationships with our customers. We supplement our direct sales force with independent sales representatives, who have been selected based on their understanding of the networking systems market and their level of penetration at our target OEM customers. We also use application engineers to provide technical support and design assistance to existing and potential customers.

Our marketing group is responsible for market and competitive analyses and defining our product roadmaps and specifications to take advantage of market opportunities. This group works closely with our research and development group to align development programs and product launches with our OEM customers' schedules. Additionally, this group develops and maintains marketing materials, training programs and our web site to convey our benefits to networking OEMs.

We operate in one business segment and sell our products directly to customers in the United States, Asia and Europe. Sales for the geographic regions reported below are based upon the customer headquarter locations. Following is a summary of the geographic information related to revenues for the years ended December 31, 2006, 2005 and 2004 (in thousands):

	Year Ended December 31,		
	2006	2005	2004
Revenue:			
United States	\$ 46,227	\$ 54,952	\$ 44,700
Malaysia	31,632	21,349	
Asia, excluding Malaysia	11,783	4,418	2,037
Other	7,164	1,040	1,096
Total	\$ 96,806	\$ 81,759	\$ 47,833

**Research and Development**

We devote substantial resources to the development of new products, improvement of existing products and support of the emerging requirements of networking OEMs. We have assembled a team of product designers possessing extensive experience in system architecture, analog and digital circuit design, hardware reference board design, software architecture and driver design and advanced fabrication process technologies. In 2005 we opened a design center in Bangalore, India to accelerate introduction of our product development. As of

## **Table of Contents**

December 31, 2006, we had approximately 100 full-time employees engaged in research and development worldwide. Our research and development expense was \$36.6 million, \$21.9 million and \$19.4 million for the years ended December 31, 2006, 2005 and 2004, respectively.

We use a number of standard design tools in the design, manufacture and verification of our products. Due to the highly complex design requirements of our products, we typically supplement these standard tools with our own tools to create a proprietary design method that allows us to optimize the performance of our products at the circuit-level.

### **Technology**

We have technological core competencies in the design of integrated circuits to enable network-aware and content-aware processing using very large databases. Our products integrate in a single integrated circuit high performance processing, storage circuitry, control functionality and advanced I/O interfaces. Due to the highly specialized nature of our design process, we implement almost all portions of our product design without third party technology, with the exception of readily available intellectual property to implement standard functions, such as memory and timing control circuits.

We have assembled a research and development team with extensive expertise in the following areas:

*Transistor-level Circuit Design.* A common approach to application specific processor design is to use pre-defined logic functions. This approach is used extensively to shorten the development cycle by allowing an automated process for mapping a product's logical definition to its construction in silicon. In order to provide processors that feature high speed, low power dissipation and small form factors, we use a more fundamental approach using transistor-level circuit design. With this highly-customized design flow, we are able to implement processing elements that are defined at the most fundamental transistor level and therefore provide higher levels of performance. We employ standard simulation tools that are commonly used in the transistor-level design of analog products. We complement these tools with unique and proprietary methods to meet the complex design requirements of our knowledge-based processors.

*Full-custom Layout.* In order to implement a transistor-level circuit design, we use a full-custom layout flow to define how circuits are constructed in silicon. This flow enables us to control transistor characteristics to optimize circuit design and minimize chip size. By minimizing chip size, we are able to reduce the cost of our knowledge-based processors. This flow also enables us to control the precise layout of transistors and the connections between them in order to reduce power dissipation. Minimizing the power dissipated by integrated circuits becomes increasingly important for networking systems, which are increasingly designed in small form factors.

*Advanced Design Architecture.* By working closely with the engineering and design teams of our OEM customers, we utilize our design architecture skills to help ensure that our knowledge-based processors are deployed within their systems in a manner that best addresses their target applications. This product architecture task involves effective partitioning of our processors' resources to multiple network decision processes, optimized timing to ensure efficient interfaces to other devices and determination of instruction sequences to allow for unique applications. We have acquired our advanced design architecture skills and application knowledge through close collaboration with networking OEMs during the development of successive generations of our products.

*Device Physics.* We possess a comprehensive understanding of device physics, which is important to the development of our knowledge-based processors. This understanding includes not only the desired transistor characteristics to be implemented but also the way in which process variations can affect the operation of an integrated circuit. To mitigate these effects, we utilize our extensive knowledge of device physics and skills in conjunction with standard tools to make circuit-level design modifications or manufacturing process changes to improve the performance of our products.

## **Table of Contents**

*Software Product Code and Development Tools.* Our knowledge-based processors are delivered to our OEM customers with a suite of supporting software that is intended to accelerate the integration of our solutions in their overall system environment. This product code includes database management software to assist in the initialization and management of records retained on our knowledge-based processors, as well as software used to communicate with our processor. In addition, we provide our OEM customers with emulation and modeling software for the design and verification of their software and hardware. We develop software packages using a team of engineers that possess advanced system knowledge and device modeling skills.

*High-speed I/O Interface.* Our products interface with high performance packet processors that utilize our knowledge-based processors to decide what action to take on an incoming packet of information. Due to the nature of this functional partitioning, a very high bandwidth connection is required between the packet processor and our knowledge-based processor. To meet the complex requirements of this interface, we develop custom high-speed I/O interfaces. We develop these circuits with advanced technology to support integrated circuit-to-integrated circuit communications.

## **Manufacturing**

We design and develop our products and electronically transfer our proprietary designs to third party wafer foundries to manufacture our products. Wafers processed by these foundries are shipped to our subcontractors, where they are assembled into finished products and electronically tested before delivery to our customers. We believe that this manufacturing model significantly reduces our capital requirements and allows us to focus our resources on the design, development and marketing of our products.

Our principal wafer foundry is TSMC in Taiwan, and we also use UMC in Taiwan. We are actively involved with product development on next-generation processes, and are designing products on TSMC's most advanced logic processes. The latest generation of our products employs up to eight layers of copper interconnect and 300 millimeter wafer sizes.

Our products are designed to use industry standard packages and be tested using widely available automatic test equipment. We develop and control product test programs used by our subcontractors based on our product specifications. We currently rely on ASAT Holdings Limited in Hong Kong, Amkor Technology, Inc., Advanced Semiconductor Engineering, Inc. in Taiwan, King Yuan Electronics Co., Ltd. in Taiwan, ISE Labs, Inc. and Viko Test Lab in the U.S. to assemble and test our products. We also have an office in Taiwan that employ local personnel to work directly with our Asian wafer manufacturers and assembly and test houses to facilitate manufacturing operations.

We have designed and implemented an ISO9001-certified quality management system that provides the framework for continual improvement of our products, processes and customer service. We apply well-established design rules and practices for CMOS devices through standard design, layout and test processes. We also rely on in-depth simulation studies, testing and practical application testing to validate and verify our products. We emphasize a strong supplier quality management practice in which our manufacturing suppliers are pre-qualified by our operations and quality teams. To ensure consistent product quality, reliability and yield, we closely monitor the production cycle by reviewing electrical, parametric and manufacturing process data from each of our wafer foundries and assembly subcontractors. We currently do not have long-term supply contracts with any of our significant third party manufacturing service providers. We generally place purchase orders with these providers according to terms and conditions of sale which specify price and 30-day payment terms and which limit the providers' liability.

## **Competition**

The markets for our products are highly competitive. We believe that the principal bases of competition are:

processing speed;

## **Table of Contents**

power dissipation;

capacity of the knowledge or signature database that can be processed;

advanced product features allowing OEM and system customer product differentiation;

price;

product availability and reliability;

customer support and responsiveness;

timeliness of new product introductions; and

credibility of supplier to design and manufacture product.

We believe that we compete favorably with respect to each of the bases identified above. However, some of our larger competitors have greater financial resources and a longer track record as a semiconductor supplier than we do. We anticipate that the market for our products will be subject to rapid technological change. As we enter new markets and pursue additional applications for our products, we expect to face competition from a larger number of competitors. Within our target market, we primarily compete with certain divisions of Integrated Device Technology, Inc. and Renesas Technology, Corp. In the new Layer 7 target market, we believe that companies focusing on developing content processors and software, whether for their internal use or for sale to other parties, that accelerate Layer 7 pattern and signature recognition tasks for enterprise and carrier-class networks targeting multi-Gigabit per second wire-speed content inspection of packets will be our principal competitors. We expect to face competition in the future from our current competitors, other manufacturers and designers of semiconductors, including large integrated device manufacturers, and innovative start-up semiconductor design companies.

## **Intellectual Property**

Our success and future growth will depend, in part, on our ability to protect our intellectual property. We rely primarily on patent, copyright, trademark and trade secret laws to protect our intellectual property. We also attempt to protect our trade secrets and other proprietary information through agreements with our customers, suppliers, employees and consultants and through security protection of our computer network and physical premises. However, these measures may not provide meaningful protection for our intellectual property. While our patents and other intellectual property rights are important, we believe that our technical expertise and ability to introduce new products in a timely manner will also be important factors in maintaining our competitive position.

As of February 21, 2007, we held 172 issued U.S. patents, 8 issued foreign patents, and numerous patent applications pending in the U.S and abroad. We may not receive any additional patents as a result of these applications or future applications. Nonetheless, we continue to pursue the filing of additional patent applications. Any rights granted under any of our existing or future patents may not provide meaningful protection or any commercial advantage to us.

Many participants in the semiconductor industry have a significant number of patents and have frequently demonstrated a willingness to commence litigation based on allegations of patent and other intellectual property infringement. From time to time, we have received, and expect to continue to receive, notices of claims of infringement or misappropriation of other parties' proprietary rights. In the event any such claims result in legal actions, we cannot assure you that we will prevail in these actions, or that other actions alleging infringement by us of third party intellectual property rights, misappropriation or misuse by us of third party trade secrets, or invalidity or unenforceability of our patents will not be asserted against us or that any assertions of infringement, misappropriation, misuse, invalidity or unenforceability will not materially and adversely affect our business, financial condition and results of operations.



## **Table of Contents**

We intend to protect our rights vigorously, but there can be no assurance that our efforts will be successful. Thus, despite our precautions, a third party may copy or otherwise obtain and use our products, services or technology without authorization, develop similar technology independently or design around our patents. In addition, effective patent, copyright, trademark and trade secret protection may be unavailable or limited in certain foreign countries. Moreover, we often incorporate the intellectual property of third parties into our designs, which is subject to certain obligations with respect to the non-use and non-disclosure of such intellectual property. We cannot assure you that the steps we have taken to prevent infringement, misappropriation or misuse of our intellectual property or the intellectual property of third parties will be successful. Furthermore, enforcement of our intellectual property rights may divert the efforts and attention of our management team and may be costly to us.

## **Employees**

As of December 31, 2006, we had 170 full-time employees, including 108 in research and development, 28 in operations, 23 in sales and marketing and 11 in general and administrative. None of our employees are covered by collective bargaining agreements. We believe our relations with our employees are good.

## **Available Information**

Our Web site address is [www.netlogicmicro.com](http://www.netlogicmicro.com). The information in our Web site is not incorporated by reference into this report. Through a link on the Investor Relations section of our Web site, we make available our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 as soon as reasonably practicable after they are filed with, or furnished to, the Securities and Exchange Commission.

## **ITEM 1A. RISK FACTORS.**

*If any of the following risks actually occur, our business, results of operations and financial condition could suffer significantly.*

**We expect to derive most of our revenue from sales of our knowledge-based processors, and, if the demand for these products does not grow, we may not achieve our growth and strategic objectives.**

Our knowledge-based processors are used primarily in networking systems, including routers, switches, network access equipment and networked storage devices. We derive a substantial portion of our total revenue from sales of our knowledge-based processors in the networking market and expect to continue to derive a substantial portion of our total revenue from this market for the foreseeable future. Sales of our knowledge-based processors accounted for 85%, 93% and 86% of our total revenue during the year ended December 31, 2006, 2005 and 2004, respectively. We believe our future business and financial success depends on continued market acceptance and increasing sales of our knowledge-based processors. Year-over-year sales of our knowledge-based processors increased 8% from 2005 to 2006. In order to meet our growth and strategic objectives, networking original equipment manufacturers, or OEMs, must continue to incorporate, and increase the incorporation of, our products into their systems as their preferred means of enabling network-aware processing of IP packets, and the demand for their systems must grow as well. We cannot provide assurance that sales of our knowledge-based processors will increase substantially in the future or that the demand for our customers' systems will increase as well. Thus, our future success depends in large part on factors outside our control, and sales of our knowledge-based processors may not meet our revenue growth and strategic objectives. Additionally, due to the high concentration of our sales with a small number of networking OEMs, we cannot guarantee that the demand for the systems offered by these customers will increase or that our sales will increase outside this core customer base, and, accordingly, prior quarterly or annual results may not be an indication of our future revenue growth or financial results.



## **Table of Contents**

**Because we rely on a small number of customers for a significant portion of our total revenue, the loss of, or a significant reduction in, orders for our products from these customers would negatively affect our total revenue and business.**

To date, we have been dependent upon orders for sales of knowledge-based processors to a limited number of customers, and, in particular, Cisco, for most of our total revenue. During the year ended December 31, 2006, 2005 and 2004, Cisco and its contract manufacturers accounted for 61%, 74% and 73% of our total revenue, respectively. We expect that our future financial performance will continue to depend in large part upon our relationship with Cisco and several other networking OEMs.

We cannot assure you that existing or potential customers will not develop their own solutions, purchase competitive products or acquire companies that use alternative methods to enable network-aware processing in their systems. We do not have long-term purchase commitments from any of our OEM customers or their contract manufacturers. Although we recently entered into master purchase agreements with Cisco and one of its foreign affiliates, these agreements do not include any long-term purchase commitments. Cisco and our other customers do business with us currently only on the basis of short-term purchase orders (subject, in the case of Cisco, to the terms of the master purchase agreements), which often are cancelable prior to shipment. The loss of orders for our knowledge-based processors for Cisco products or products of other major users of our knowledge-based processors would have a significant negative impact on our business.

**We face additional risks to our business success and financial condition because of our dependence on a small number of customers for sales of our products.**

Our dependence on a small number of customers, especially Cisco and its contract manufacturers, for most of our revenue in the foreseeable future creates additional risks for our business, including the following:

we may face increased pressure to reduce the average selling prices of our knowledge-based processors;

we may find it difficult to pass through increases in our manufacturing and other direct costs;

the reputation of our knowledge-based processors in the marketplace may be affected adversely if Cisco or other networking OEMs that represent a significant percentage of our sales of knowledge-based processors reduce or cease their use of our products; and

we may face problems in collecting a substantial portion of our accounts receivable if any of these companies faces financial difficulties or dispute payments.

**We have a history of net losses, may incur significant net losses in the future and may not be able to sustain profitability.**

Although we reported net income of \$0.6 million and \$16.4 million during the years ended December 31, 2006 and 2005, we reported net losses in years prior to fiscal 2005. At December 31, 2006, we had an accumulated deficit of approximately \$82.2 million. To sustain profitability, we will have to continue to generate greater total revenue and control costs and expenses. We cannot assure you that we will be able to generate greater total revenue, or limit our costs and expenses, sufficiently to sustain profitability on a quarterly or annual basis.

**Because we sell our products on a purchase order basis and rely on estimated forecasts of our customers' needs, inaccurate forecasts could adversely affect our business.**

We sell our products pursuant to individual purchase orders (subject, in the case of Cisco, to the terms of a master purchase agreement), and not pursuant to long-term purchase commitments. Therefore, we rely on estimated demand forecasts, based upon input from our customers, to determine how much product to manufacture. Because our sales are based on purchase orders, our customers may cancel, delay or otherwise modify their purchase commitments with little or no consequence to them and with little or no notice to us. For

---

**Table of Contents**

these reasons, we generally have limited visibility regarding our customers' product needs. We cannot provide assurance as to the quantities or timing required by our customers for our products. We cannot assure you that we will not experience subsequent substantial warranty claims or that warranty claims will not result in cancellation of existing orders or reluctance of customers to place future orders. In addition, the product design cycle for networking OEMs is lengthy, and it may be difficult for us to accurately anticipate when they will commence commercial shipments of products that include our knowledge-based processors. Whether in response to changes affecting the industry or a customer's specific business pressures, any cancellation, delay or other modification in our customers' orders could significantly reduce our revenue, cause our operating results to fluctuate from period to period and make it more difficult for us to predict our revenue. In the event of a cancellation or reduction of an order, we may not have enough time to reduce operating expenses to minimize the effect of the lost revenue on our business, and we may purchase too much inventory and spend more capital than expected.

As a result of acquiring Cypress Semiconductor's Network Search Engine Products on February 15, 2006, we began selling some of the acquired products through a distributor previously used by Cypress. The distributor has sole authority to accept returns from end customers in the ordinary course of business. Because we recognize revenue when the distributor sells product to end customers, returns from end customers to our distributor reduce our reported sales. We have no direct control over our distributor's policies or practices on accepting customer returns and may have no forewarning of significant customer returns. Consequently, large returns could have an unexpected material adverse impact on our sales.

**We may not significantly increase our revenue growth rate.**

We have recently experienced decreasing revenue growth. Specifically, our total revenue increased 253% from \$13.5 million in 2003 to \$47.8 million during the year ended December 31, 2004, 71% from 2004 to \$81.8 million for the year ended December 31, 2005, and 18% from 2005 to \$96.8 million for the year ended December 31, 2006. While our revenue has grown each year, we did experience a drop in revenue of 21% from our third fiscal quarter 2006 to our fourth fiscal quarter 2006. This was primarily due to inventory level adjustments by some of our larger customers who, it appears, had placed excess orders in prior quarters out of concern for a component shortage that did not occur. While we believe that this inventory correction is largely behind us, we can not guarantee that our customers have completed their inventory corrections, or that they will not place excess orders in anticipation of component shortages that in fact may not occur, or that they will increase their purchases of our products in any event. Accordingly, you should not rely on the results of any prior quarterly or annual periods as an indication of the future rate of our revenue growth or our future financial results.

**We are dependent on contract manufacturers for a significant portion of our revenue.**

Many of our OEM customers, including Cisco, use third party contract manufacturers to manufacture their networking systems. These contract manufacturers represented 78%, 79% and 78% of our total revenue for the year ended December 31, 2006, 2005 and 2004, respectively. Contract manufacturers purchase our products directly from us on behalf of networking OEMs. Although we work with our OEM customers in the design and development phases of their systems, these OEM customers are gradually giving contract manufacturers more authority in product purchasing decisions. As a result, we depend on a concentrated group of contract manufacturers for a substantial portion of our revenue. If we cannot compete effectively for the business of these contract manufacturers or if any of the contract manufacturers, which work with our OEM customers, experience financial or other difficulties in their businesses, our revenue and our business could be adversely affected. In particular, if one of our OEM customer's contract manufacturers becomes subject to bankruptcy proceedings, neither we nor our OEM customer may be able to obtain any of our products held by the contract manufacturer. In addition, we may not be able to recover any payments owed to us by the contract manufacturer for products already delivered or recover the products held in the contract manufacturer's inventory when the bankruptcy proceeding is initiated. If we are unable to deliver our products to our OEM customers in a timely manner, our business would be adversely affected.

## **Table of Contents**

### **The average selling prices of our products may decline, which could reduce our revenue and gross margin.**

The average selling prices of our products are expected to decline over the course of their commercial lives, principally due to the supply of competing products, reduction in demand from customers, pressure from customers to reduce prices and product cycle changes. In addition, under our master purchase agreements with Cisco, we agreed to provide to Cisco all price decreases that we achieve, and granted to Cisco the right (under limited circumstances) to purchase our knowledge-based processors directly from our manufacturers (subject to payments to us, net of specified costs). The average selling prices of our knowledge-based processors have declined by 19% from December 31, 2005 to December 31, 2006, and we expect average selling prices for each knowledge-based process family to decline approximately 10% to 20% each year. Declining average selling prices will adversely affect our future operating results. To maintain acceptable operating results, we will need to develop and introduce new products and product enhancements on a timely basis and continue to reduce our costs. If we are unable to offset any reductions in our average selling prices by increasing our sales volumes and achieving corresponding production cost reductions, or if we fail to develop and introduce new products and enhancements on a timely basis, our revenue and operating results will suffer.

### **We rely on third parties for the manufacture of our products, and a significant increase in wafer pricing or our failure to secure sufficient capacity could limit our growth and adversely affect our operating results.**

As a fabless semiconductor company, we rely on third-party wafer foundries to manufacture our products. We currently do not have long-term supply contracts with either of our wafer foundries, Taiwan Semiconductor Manufacturing Co., Ltd., or TSMC, and United Microelectronics Corporation, or UMC. Neither TSMC nor UMC is obligated to perform services or supply products to us for any specific period, in any specific quantities or at any specific price, except as may be provided in a particular purchase order. As a result, there are numerous risks associated with our reliance on these wafer foundries, including the possibilities that TSMC or UMC may give higher priority to their other customers or that our relationships with either wafer foundry may deteriorate. We cannot assure you that TSMC and UMC will continue to provide us with our products at acceptable yields or in sufficient quantities, for reasonable costs and on a timely basis to meet our customers' needs. A failure to ensure the timely fabrication of our products could cause us to lose customers and could have a material adverse effect on our operating results.

If either wafer foundry, and in particular TSMC, ceases to provide us with required production capacity with respect to our products, we cannot assure you that we will be able to obtain manufacturing capacity from other wafer foundries on commercially reasonable terms or that these arrangements, if established, will result in the successful manufacturing of our products. These arrangements might require us to share our technology and might be subject to unilateral termination by the wafer foundries. Even if such capacity is available from another manufacturer, we would need to convert the production of our integrated circuits to a new fabrication process and qualify the other manufacturer, which process could take nine months or longer. Furthermore, we may not be able to identify or qualify manufacturing sources that would be able to produce wafers with acceptable manufacturing yields.

### **We also rely on third parties for other products and services, including the assembly, testing and packing of our products, and engineering services, and any failure by third parties to provide the tools and services we require could limit our growth and adversely affect our future operating results.**

All of our products are assembled and tested by third-party vendors and require the use of high performance assembly and test equipment. In addition, in connection with the design of our products, we use software tools, which we obtain from third party software vendors, for simulation, layout and other design purposes. Our reliance on independent assembly, testing, software and other vendors involves a number of risks, including reduced control over delivery schedules, quality assurance and costs. We currently do not have long-term supply contracts with all of these third party vendors. As a result, most of these third party vendors are not obligated to provide products or perform services to us for any specific period, in any specific quantities or at any specific

## **Table of Contents**

price, except as may be provided in a particular purchase order. The inability of these third party vendors to deliver high performance products or services of acceptable quality and in a timely manner, could lengthen our design cycle, result in the loss of our customers and reduce our revenue.

We also rely on third party component suppliers to provide custom designed integrated circuit packages for our products. In some instances, these package designs are provided by a single supplier. Our reliance on these suppliers involves a number of risks, including reduced control over delivery schedules, quality assurance and costs. We currently do not have long-term supply contracts with all of these package vendors. As a result, most of these third party vendors are not obligated to provide products or perform services to us for any specific period, in any specific quantities or at any specific price, except as may be provided in a particular purchase order. The inability of these third party vendors to deliver packages of acceptable quality and in a timely manner, particularly the sole source vendors, could adversely affect our delivery commitments and adversely affect our operating results or cause them to fluctuate more than anticipated. Additionally, these packages may require specialized or high-performance component parts that may not be available in quantities or in time frames that meet our requirements or the anticipated requirement of our customers. For example, we did experience a drop in revenue of 21% from our third fiscal quarter 2006 to our fourth fiscal quarter 2006 primarily due to inventory level adjustments by some of our larger customers who, it appears, had placed excess orders in prior quarters out of concern of an anticipated component shortage at a package supplier to us. While we believe that this inventory correction is largely behind us, we can not guarantee that our customers have completed their inventory corrections, or that they will not place excess orders in anticipation of component shortages that in fact may not occur.

In connection with the design of our products, we have and may license third party intellectual property, and use third party engineering services. Our reliance on these third party intellectual property and engineering services providers involves a number of risks, including reduced control over and quality of the intellectual property and service deliverables, quality and costs. The inability of these third party providers to deliver high performance products or services of acceptable quality and in a timely manner, could lengthen our design cycle, result in the loss of our customers and reduce our revenue.

### **Our costs may increase substantially if the wafer foundries, assembly and test vendors that supply and test our products do not achieve satisfactory product yields, reliability or quality.**

The wafer fabrication process is an extremely complicated process where the slightest changes in the design, specifications or materials can result in material decreases in manufacturing yields or even the suspension of production. From time to time, we and our wafer foundries have experienced, and are likely to continue to experience manufacturing defects and reduced manufacturing yields related to errors or problems in our wafer foundries manufacturing processes or the interrelationship of their processes with our designs. In some cases, our wafer foundries may not be able to detect these defects early in the fabrication process or determine the cause of such defects in a timely manner, which may affect the quality or reliability of our products. We may incur substantial research and development expense for prototype or development stage products as we qualify the products for production.

Generally, in pricing our knowledge-based processors, we assume that manufacturing, assembly and test yields will continue to increase, even as the complexity of our products increases. Once our products are initially qualified with our wafer foundries, minimum acceptable yields are established. We are responsible for the costs of the wafers if the actual yield is above the minimum. If actual yields are below the minimum, we are not required to purchase the wafers. The minimum acceptable yields for our new products are generally lower at first and increase as we achieve full production. Whether as a result of a design defect or manufacturing, assembly or test error, unacceptably low product yields or other product manufacturing, assembly or test problems could substantially increase the overall production time and costs and adversely impact our operating results on sales of our products. Product yield losses will increase our costs and reduce our gross margin. In addition to significantly harming our operating results and cash flow, poor yields may delay shipment of our products and harm our relationships with existing and potential customers.

## **Table of Contents**

### **To be successful we must continue to develop and have manufactured for us, innovative products to meet the evolving requirements of networking OEMs.**

To remain competitive, we devote substantial resources to research and development, both to improve our existing knowledge-based processor technology and to develop new technology. We also seek to improve the manufacturing processes for our knowledge-based processors, including the use of smaller process geometries, which we believe is important for our products to serve our OEM customers' requirements for increased network-aware processing. Our failure to migrate our knowledge-based processors to logic processes at smaller process geometries could substantially reduce the future competitiveness of our products. In addition, from time to time, we may have to redesign some of our knowledge-based processors or modify the manufacturing process for them. We cannot give you any assurance that we will be able to improve our existing knowledge-based processor technology or develop and integrate new technology into our products. Even if we design better knowledge-based processors, we may encounter problems during the manufacturing or assembly process, including reduced manufacturing yields, production delays and increased expenses, all of which could adversely affect our business and results of operations.

In addition, given the highly complex nature of these products, even the slightest change or adjustment to our integrated circuit designs could require substantial resources to implement them. We may not be able to make these changes or adjustments to our knowledge-based processors or correct any errors or defects arising from their implementation. Failure to make these changes or adjustments or correct these errors or defects during the product development stages, or any resulting delays, could severely harm our existing and potential customer relationships and could likely increase our development costs, adversely affecting our operating results. If these changes, adjustments, errors or defects are not identified or requested until after commercial production has begun or after products have been delivered to customers, we may be required to re-test existing inventory, replace products already shipped or re-design the products, all of which would likely result in significant time delays and additional costs and expenses. For example, we accelerated production of our knowledge-based processors to meet the schedule demands of Cisco in the fall of 2003. As a result of certain design issues, these production runs had relatively low production yields, which resulted in related costs and expenses of approximately \$11.4 million in 2003 including \$9.8 million in adverse purchase commitments, \$1.0 million in warranty accruals and a \$0.6 million write down of inventory.

### **We have sustained substantial losses from low production yields in the past and may incur such losses in the future.**

Designing and manufacturing integrated circuits is a difficult, complex and costly process. Once research and development has been completed and the foundry begins to produce commercial volumes of the new integrated circuit, products still may contain errors or defects that could adversely affect product quality and reliability. We have experienced low yields and have incurred substantial research and development expenses in the design and initial production phases of all of our legacy network search engine products and knowledge-based processors. We cannot assure you that we will not experience low yields, substantial research and development expenses, product quality, reliability or design problems, or other material problems with our products that we have shipped or may ship in the future.

### **If we fail to retain key personnel and hire additional personnel, our business and growth could be negatively affected.**

Our business has been dependent to a significant degree upon the services of a small number of executive officers and technical employees. We generally do not have non-competition agreements or term employment agreements with any of our executive officers, whom we generally employ at will. We do not maintain key-man life insurance on the lives of any of our key personnel. The loss of any of these individuals could negatively impact our technology development efforts and our ability to service our existing customers and obtain new customers.

## **Table of Contents**

Our future growth will also depend, in part, upon our ability to recruit and retain other qualified managers, engineers and sales and marketing personnel. There is intense competition for these individuals in our industry, and we cannot assure you that we will be successful in recruiting and retaining these individuals. If we are unable to recruit and retain these individuals, our technology development and sales and marketing efforts could be negatively impacted.

**If we fail to maintain competitive stock option packages for our employees, or if our stock price declines materially for a protracted period of time, we might have difficulty retaining our employees and our business may be harmed.**

In today's competitive technology industry, employment decisions of highly skilled personnel are influenced by stock option packages, which offer incentives above traditional compensation only where there is a consistent, long-term upward trend over time of a company's stock price. If our stock price declines due to market conditions, investors' perceptions of the technology industry or managerial or performance problems we have, our stock option incentives may lose value to key employees, and we may lose these employees or be forced to grant additional options to retain them. This in turn could result in:

immediate and substantial dilution to investors resulting from the grant of additional options necessary to retain employees; and

potential compensation charges against the company, which could negatively impact our operating results.

**A failure to successfully address the potential difficulties associated with international business could reduce our growth, increase our operating costs and negatively impact our business.**

We conduct a significant amount of our business with companies that operate primarily outside of the United States, and intend to increase sales to companies operating outside of the United States. For example, our customers based outside the United States accounted for 52%, 33% and 7% of our total revenue during the years ended December 31, 2006, 2005 and 2004. The increase in foreign sales is primarily due to the use of off-shore contract manufacturers by our largest customers. Not only are many of our customers located abroad, but our two wafer foundries are based in Taiwan, and we outsource the assembly and some of the testing of our products to companies based in Taiwan and Hong Kong. We face a variety of challenges in doing business internationally, including:

foreign currency exchange fluctuations;

unanticipated changes in local regulations;

potentially adverse tax consequences, such as withholding taxes;

timing and availability of export and import licenses;

political and economic instability;

reduced or limited protection of our intellectual property;

protectionist laws and business practices that favor local competition; and

additional financial risks, such as potentially longer and more difficult collection periods.

Because we anticipate that we will continue to rely heavily on foreign companies for our future growth, the occurrence of any of the circumstances identified above could significantly increase our operating costs, delay the timing of our revenue and harm our business and financial condition.

**We must design our processors to meet the needs of our OEM customers and convince them to use our products, or our revenue will be adversely affected.**

In general, our OEM customers design our processors into their products during the early stages of their development after an in-depth technical evaluation of both our and our competitors' products. These design wins

## **Table of Contents**

are critical to the success of our business. In competing for design wins, if a competitor's product is already designed into the product offering of a potential customer, it becomes very difficult for us to sell our products to that customer. Changing suppliers involves additional cost, time, effort and risk for the customer. In addition, our products must comply with the continually evolving specifications of networking OEMs. Our ability to compete in the future will depend, in large part, on our ability to comply with these specifications. As a result, we expect to invest significant time and effort and to incur significant expense to design our products to ensure compliance with relevant specifications. Even if a networking OEM designs our knowledge-based processors into its systems, we cannot assure you that its systems will be commercially successful or that we will receive significant revenue from sales of knowledge-based processors for those systems.

### **Factors that negatively affect the businesses of the networking OEMs that use or could use our knowledge-based processors could negatively impact our total revenue.**

The timing and amount of our revenue depend on the ability of the networking OEMs who use our knowledge-based processors to market, produce and ship systems incorporating our technology. Factors that negatively affect a significant customer or group of customers could negatively affect our results of operations and financial condition. Many issues beyond our control influence the success of the networking OEMs that use our products, including, for example, the highly competitive environment in which they operate, the strength of the markets for their products, their engineering capabilities, their ability or inability to obtain other components from other suppliers, the compatibility of any of their other components with our products, and their financial and other resources. Likewise, we have no control over their product development or pricing strategies, which directly affect sales of their products and, in turn, our revenue. A decline in sales of our OEM customers' systems that use our knowledge-based processors would reduce our revenue. In addition, seasonal and other fluctuations in demand for their products could cause our operating results to fluctuate, which could cause our stock price to fall.

### **We have a lengthy sales cycle, which may result in significant expenses that do not generate significant revenue or delayed revenue generation from our selling efforts and limits our ability to forecast our revenue.**

We expect that our product sales cycle, which results in our knowledge-based processors being designed into our customers' products, could take up to 24 months. It can take an additional nine months to reach volume production of these products. A number of factors can contribute to the length of the sales cycle, including technical evaluations of our products by networking OEMs, the design process required to integrate our products into our OEM customers' products and the timing of networking OEMs' new product announcements. In anticipation of product orders, we may incur substantial costs before the sales cycle is complete and before we receive any customer payments. As a result, in the event that a sale is not completed or is cancelled or delayed, we may have incurred substantial expenses, making it more difficult for us to become profitable or otherwise negatively impacting our financial results. Furthermore, because of our lengthy sales cycle, our receipt of revenue from our selling efforts may be substantially delayed, our ability to forecast our future revenue may be more limited and our revenue may fluctuate significantly from quarter to quarter.

### **Our operating results could be adversely affected if we have to satisfy product warranty or liability claims.**

If our products are defective or malfunction, we could be subject to product warranty or product liability claims that could have significant related warranty charges or warranty reserves in our financial statements. Further, we may spend significant resources investigating potential product design, quality and reliability claims, which could result in additional charges in our financial statements until such claims are resolved. For example, during fiscal 2006 we recorded additional warranty reserves while we investigated reports by one of our international customers of malfunctioning systems that included our knowledge-based processors. We cannot guarantee that warranty reserves will either increase or decrease in future periods. Further, in connection with the master purchase agreements that we entered into with Cisco in 2005, we agreed to extended product warranties



## **Table of Contents**

for the benefit of Cisco. Specifically, we agreed to general three-year warranties and, in the case of epidemic failures, to five-year warranties. While we have insurance for product liability claims for matters other than product warranty, we may not have sufficient insurance coverage for all of the claims that may be asserted against us. In addition, under the Cisco agreements, we have agreed to indemnify Cisco for costs incurred in rectifying epidemic failures, up to the greater of (on a per claim basis) 25% of all amounts paid to us by Cisco during the preceding 12 months or \$9.0 million, plus replacement costs. If we are required to make payments under this indemnity, our operating results may be adversely affected. Moreover, these claims in the future, regardless of their outcome, could adversely affect our business.

### **Our revenue and operating results may fluctuate significantly from period to period, on a quarterly or annual basis, causing volatility in our stock price.**

Our total revenue and operating results have fluctuated from quarter to quarter in the past and are expected to continue to do so in the future. As a result, you should not rely on quarter to quarter comparisons of our operating results as an indication of our future performance. Fluctuations in our total revenue and operating results could negatively affect the trading price of our stock. In addition, our total revenue and results of operations may, in the future, be below the expectations of analysts and investors, which could cause our stock price to decline. Factors that are likely to cause our revenue and operating results to fluctuate include, for example, the periodic costs associated with the generation of mask sets for new products and product improvements and the risk factors discussed throughout this section. Additional factors that could cause our revenue and operating results to fluctuate from period to period include:

the timing and volume of orders received from our customers;

market demand for, and changes in the average selling prices of, our products;

the rate of qualification and adoption of our knowledge-based processors by networking OEMs;

fluctuating demand for, and lengthy life cycles of, the products and systems that incorporate our knowledge-based processors;

the market success of the OEMs' networking systems that incorporate our products;

the ability of our wafer foundries to supply us with production capacity and finished products to sell to our OEM customers;

changes in the level of our costs and operating expenses;

our ability to receive our manufactured products from our wafer foundries and ship them within a particular reporting period;

deferrals or cancellations of customer orders in anticipation of the development and commercialization of new technologies or for other reasons;

changes in our product lines and revenue mix;

the timing of the introduction by others of competing, replacement or substitute network-aware processing technologies;

## Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-K

our ability or the ability of networking OEM customers that use our knowledge-based processors to procure required components or fluctuations in the cost of such components;

our ability to enforce our intellectual property rights or to defend claims that we infringe the intellectual property rights of others, and the significant costs to us of related litigation;

cyclical fluctuations in semiconductor or networking markets; and

general economic conditions that may affect end-user demand for products that use our knowledge-based processors.

## **Table of Contents**

### **We have grown rapidly, and a failure to manage any continued growth could reduce our potential revenue and could negatively impact our future operating results.**

In order to successfully implement our overall growth strategies, we will need to carefully and efficiently manage our planned expansion. Among other things, this will require us to continue to:

improve our existing knowledge-based processor technology and develop new processor technologies;

implement and manage new marketing and distribution channels to penetrate different and broader markets for our products;

manage an increasing number of complex relationships with our customers, wafer foundries and other third parties;

monitor and improve our operating systems, procedures and financial controls on a timely basis;

retain existing, and hire additional, key management and technical personnel; and

expand, train and manage our workforce and, in particular, our development, sales, marketing and support organizations.

We may not be able to adequately manage our growth or meet the foregoing objectives. A failure to do so could jeopardize our future revenue and cause our stock price to decline. Also, our ability to execute our business plan and grow our business will be heavily dependent on our management team's ability to work effectively together.

### **The cyclical nature of the semiconductor industry and the networking markets could adversely affect our operating results and our business.**

We expect our business to be subject to the cyclical nature of the semiconductor industry, especially the market for communications integrated circuits. Historically, there have been significant downturns in this industry segment, characterized by reduced demand for integrated circuits and accelerated erosion of average selling prices. At times, these downturns have lasted for prolonged periods of time. Furthermore, from time to time, the semiconductor industry also has experienced periods of increased demand and production constraints, in which event we may not be able to have our products produced in sufficient quantities, if at all, to satisfy our customers' needs. It is likely that the communications integrated circuit business will experience similar downturns in the future and that, during such times, our business could be affected adversely. It is also likely that the semiconductor industry will experience periods of strong demand. We may have difficulty in obtaining enough product to sell to our customers or may face substantial increases in the wafer prices charged by our foundries.

In addition, the networking industry from time to time has experienced and may experience a pronounced downturn. To respond to a downturn, many networking service providers may be required to slow their research and development activities, cancel or delay new product developments, reduce their workforces and inventories and take a cautious approach to acquiring new equipment and technologies from networking OEMs, which would have a significant negative impact on our business. In the future, a downturn in the networking industry may cause our operating results to fluctuate significantly from year to year, which also may tend to increase the volatility of the price of our common stock.

### **We may not be able to protect and enforce our intellectual property rights, which could impair our ability to compete and reduce the value of our technology.**

Our success and future revenue growth depend, in part, on our ability to protect our intellectual property. We rely primarily on patent, copyright, trademark and trade secret laws, as well as confidentiality procedures, to protect our proprietary technologies and processes. However, these measures may not provide meaningful protection for our intellectual property.



## **Table of Contents**

We cannot assure you that any patents will issue from any of our pending applications. Any rights granted under any of our existing or future patents may not provide meaningful protection or any commercial advantage to us. For example, such patents could be challenged or circumvented by our competitors or declared invalid or unenforceable in judicial or administrative proceedings. The failure of any patents to adequately protect our technology would make it easier for our competitors to offer similar products. We do not have foreign patents or pending applications corresponding to many of our U.S. patents and patent applications, including in some foreign countries where our products are sold or may be sold in the future. Even if foreign patents are granted, effective enforcement in foreign countries may not be available.

With respect to our other proprietary rights, it may be possible for third parties to copy or otherwise obtain and use our proprietary technology or marks without authorization or to develop similar technology independently. Monitoring unauthorized use of our proprietary technology or marks is difficult and costly, and we cannot be certain that the steps we have taken will prevent misappropriation or unauthorized use of our technology or marks. In addition, effective patent, copyright, trademark and trade secret protection may not be available or may be limited in certain foreign countries. Many companies based in the U.S. have encountered substantial infringement problems in foreign countries, including countries in which we sell products. Our failure to effectively protect our intellectual property could reduce the value of our technology and could harm our business, financial condition and operating results.

Furthermore, we have in the past and may in the future initiate claims or litigation against third parties to determine the validity and scope of proprietary rights of others. In addition, we may in the future initiate litigation to enforce our intellectual property rights or the rights of our customers or to protect our trade secrets. Litigation by us could result in significant expense and divert the efforts of our technical and management personnel and could materially and adversely affect our business, whether or not such litigation results in a determination favorable to us.

### **Any claim that our products or our proprietary technology infringe third party intellectual property rights could increase our costs of operation and distract management and could result in expensive settlement costs.**

The semiconductor industry is characterized by vigorous protection and pursuit of intellectual property rights or positions, which have resulted in often protracted and expensive litigation. From time to time, we are involved in litigation relating to intellectual property rights. In addition, we have received notices from time to time that claim we have infringed upon or misappropriated intellectual property rights owned by others. We typically respond when appropriate and as advised by legal counsel. We cannot assure you that parties will not pursue litigation with respect to those allegations. We may, in the future, receive similar notices, any of which could lead to litigation against us. For example, parties may initiate litigation based on allegations that we have infringed their intellectual property rights or misappropriated or misused their trade secrets or may seek to invalidate or otherwise render unenforceable one or more of our patents. Litigation against us can result in significant expense and divert the efforts of our management, technical, marketing and other personnel, whether or not the litigation results in a determination adverse to us. We cannot assure you that we will be able to prevail or settle any such claims or that we will be able to do so at a reasonable cost. In the event of an adverse result in any such litigation, we could be required to pay substantial damages for past infringement and royalties for any future use of the technology. In addition, we may be required to cease the sale of certain products, recall certain products from the market, redesign certain products offered for sale or under development or cease the use of certain marks or names. We cannot assure you that we will be able to successfully redesign our products or do so at a reasonable cost. Additionally, we have in the past sought and may in the future seek to obtain a license to a third party's intellectual rights and have granted and may in the future grant a license to certain of our intellectual property rights to a third party in connection with a cross-license agreement or a settlement of claims or actions asserted against us. However, we cannot assure you that we would be able to obtain a license on commercially reasonable terms, or at all.

## **Table of Contents**

Our customers could also become the target of litigation relating to the patent and other intellectual property rights of others. This could trigger technical support and indemnification obligations in some of our license or customer agreements. These obligations could result in substantial expenses, including the payment by us of costs and damages related to claims of patent infringement. In addition to the time and expense required for us to provide support or indemnification to our customers, any such litigation could disrupt the businesses of our customers, which in turn could hurt our relations with our customers and cause the sale of our products to decrease. We cannot assure you that claims for indemnification will not be made or that if made, such claims would not have a material adverse effect on our business, operating results or financial condition. We do not have any insurance coverage for intellectual property infringement claims for which we may be obligated to provide indemnification. If we are obligated to pay damages in excess of, or otherwise outside of, our insurance coverage, or if we have to settle these claims, our operating results could be adversely affected.

### **If we are unable to compete effectively, our revenue and market share may be reduced.**

Our business is extremely competitive, especially during the design-in phase of networking OEMs' design cycles. We compete with the enterprise and networking divisions of large semiconductor manufacturers, such as IDT and Renesas Technology, Corp., which have more established reputations, more diverse customer bases and greater financial and other resources than we do. In addition, our OEM customers may design their own integrated circuits to address their needs for network-aware processing. As we develop new applications for our knowledge-based processors and expand into new markets, we expect to face even greater competition. Our present and future competitors may be able to better anticipate customer and industry demands and to respond more quickly and efficiently to those demands, such as with product offerings, financial discounts or other incentives. Furthermore, our OEM customers may be able to develop or acquire integrated circuits that satisfy their needs faster or most cost effectively than we can. We cannot assure you that we will be able to compete effectively against these and our other competitors. If we do not compete effectively, our revenue and market share may decline.

### **Any acquisitions we make, such as our recent acquisition of NSE products and business from Cypress Semiconductor, could disrupt our business, and harm our financial condition and dilute our stockholders.**

In the future, we may consider opportunities to acquire other businesses or technologies that would complement our current offerings, expand the breadth of our markets or enhance our technical capabilities. Acquisitions, like our 2006 purchase of assets and intellectual property associated with Cypress Semiconductor's standard NSE products, present a significant number of potential challenges that could, if not met, disrupt our business operations, increase our operating costs, reduce the value to us of the acquired company or business, including:

integration of the acquired employees, operations, technologies and products with our existing business and products;

focusing management's time and attention on our existing core business;

retention of business relationships with suppliers and customers of the acquired company;

entering markets in which we may lack prior experience;

retention of key employees of the acquired company or business;

amortization of intangible assets, write-offs, stock-based compensation and other charges relating to the acquired business and our acquisition costs; and

dilution to our existing stockholders from the issuance of additional shares of common stock in connection with an acquisition that fails to increase the value of our company.

## Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-K

As a result of our purchase of assets and intellectual property associated with Cypress Semiconductor's standard NSE products, we incurred \$13.0 million in charges for amortization of intangible assets, an in-process research and development charge and the effect of a fair value adjustment to acquired inventory. Additionally, we issued 1,653,407 shares of common stock to Cypress in connection with the acquisition, which represented approximately 8.3% of our common shares outstanding as of the closing date of the acquisition on February 15, 2006.

## **Table of Contents**

We cannot provide assurances, however, that this acquisition or future acquisitions that we might make will achieve our business objectives or increase our value or the price of our common stock.

### **Our success may depend on our ability to comply with new or evolving industry standards applicable to our products or our business.**

Our ability to compete in the future may depend on our ability to ensure that our products comply with evolving industry standards affecting the networking equipment and other markets in which we compete. In addition, from time to time, new industry standards may emerge which could render our products incompatible with the products of our customers or suppliers. In order to ensure compliance with the relevant standards, we may be required to devote significant time, capital and other resources to modify or redesign our existing products or to develop new products. We cannot assure you that we will be able to develop products which comply with prevailing standards. If we are unable to develop these products in a timely manner, we may miss significant business opportunities, and our revenue and operating results could suffer.

### **If an earthquake or other natural disaster disrupts the operations of our third party wafer foundries or other vendors located in high risk regions, we could experience significant delays in the production or shipment of our products.**

TSMC and UMC, which manufacture our products, along with most of our vendors who handle the assembly and testing of our products, are located in Asia. The risk of an earthquake in the Pacific Rim region is significant due to the proximity of major earthquake fault lines. In September 1999, a major earthquake in Taiwan affected the facilities of several of these third party vendors, as well as other providers of these services. As a result of this earthquake, these vendors suffered power outages and disruptions that impaired their production capacity. In March 2002 and September 2003, additional earthquakes occurred in Taiwan. The occurrence of additional earthquakes or other natural disasters could result in the disruption of the wafer foundry or assembly and test capacity of the third parties that supply these services to us. We may not be able to obtain alternate capacity on favorable terms, if at all.

### **Our stock price could drop, and there could be significantly less trading activity in our stock, if securities or industry analysts downgrade our stock or do not publish research or reports about our business.**

Our stock price and the trading market for our stock are likely to be affected significantly by the research and reports concerning our company and our business which are published by industry and securities analysts. We do not have any influence or control over these analysts, their reports or their recommendations. Our stock price and the trading market for our stock could be negatively affected if any analyst downgrades our stock, publishes a report which is critical of our business, or discontinues coverage of us.

### **Our common stock has experienced substantial price volatility.**

Our common stock has experienced substantial price volatility. Such volatility may occur in the future, particularly because of quarter-to-quarter variations in our actual or anticipated financial results, or the reported financial results of other semiconductor companies or our customers. Stock price volatility may also result from product announcements by us or our competitors, or from changes in perceptions about the various types of products we manufacture and sell. In addition, our stock price may fluctuate due to price and volume fluctuations in the stock market, especially in the technology sector.

### **A limited number of stockholders will have the ability to influence the outcome of director elections and other matters requiring stockholder approval.**

Our executive officers, directors and entities affiliated with them will, in the aggregate, beneficially own a significant portion of our outstanding common stock. These stockholders acting together will have the ability to



## **Table of Contents**

exert substantial influence over all matters requiring the approval of our stockholders, including the election and removal of directors and any proposed acquisition, consolidation or sale of all or substantially all of our assets. In addition, they could dictate the management of our business and affairs. This concentration of ownership could have the effect of delaying, deferring or preventing a change in control, or impeding an acquisition, consolidation, takeover or other business combination, which might otherwise involve the payment of a premium for your shares of our common stock.

### **Provisions of our certificate of incorporation and bylaws, Delaware law and customer agreements might delay or prevent a change of control transaction and depress the market price of our stock.**

Various provisions of our certificate of incorporation and bylaws might have the effect of making it more difficult for a third party to acquire, or discouraging a third party from attempting to acquire, control of us. These provisions could limit the price that certain investors might be willing to pay in the future for shares of our common stock. Certain of these provisions eliminate cumulative voting in the election of directors, limit the right of stockholders to call special meetings and establish specific procedures for director nominations by stockholders and the submission of other proposals for consideration at stockholder meetings.

We are also subject to provisions of Delaware law which could delay or make more difficult a merger, tender offer or proxy contest involving us. In particular, Section 203 of the Delaware General Corporation Law prohibits a Delaware corporation from engaging in any business combination with any interested stockholder for a period of three years unless specific conditions are met. Any of these provisions could have the effect of delaying, deferring or preventing a change in control, including, without limitation, discouraging a proxy contest or making more difficult the acquisition of a substantial block of our common stock.

Our board of directors might issue up to 50,000,000 shares of preferred stock without stockholder approval on such terms as the board might determine. The rights of the holders of common stock will be subject to, and might be adversely affected by, the rights of the holders of any preferred stock that might be issued in the future.

Under our master purchase agreements with Cisco, in the event of, among other things, the transfer of at least 50% of our voting control to a Cisco competitor that generates less than 50% of its annual sales from integrated circuit products, Cisco may exercise its rights to purchase our knowledge-based processors directly from our manufacturers, subject to payments to us. This provision may discourage or complicate attempts by some third parties to acquire us.

### **The price of our stock could decrease as a result of shares being sold in the market, including sales by directors, officers and other significant stockholders.**

Sales of a substantial number of shares of common stock in the public market could adversely affect the prevailing market price of our common stock from time to time. Substantially all the shares of our common stock currently outstanding are eligible for sale in the public market subject to the volume restrictions set forth in SEC Rule 144(e). We believe that as of March 2, 2007, approximately 4,332,055 shares (including currently exercisable options) are held by our directors and officers.

As of March 2, 2007, half of our executive officers have entered into plans for selling a portion of their shares of common stock in the manner described under Rule 10b5-1 of the Securities Exchange Act of 1934. Each plan is non-discretionary and is administered by an independent brokerage firm. The plans provide for aggregate sales of between 8,600 and 150,000 shares pursuant to limit orders at specified prices. The duration of a majority of the plans is through December 31, 2007. Pursuant to these plans, these executive officers may sell up to 401,600 shares of common stock combined during 2007. Sales of the shares are further subject to the volume restrictions set forth in SEC Rule 144(e). Each plan provides for termination upon the completion of the specified trading program, the instruction of the stockholder, or the occurrence of other specified events, whichever is earliest. All of the shares are sold through broker-dealers in ordinary market transactions. In

**Table of Contents**

addition, subject to compliance with applicable securities laws, each of these executive officers may sell shares of common stock outside of these plans. Pre-designated trading under these plans may cause unexpected declines in the market price of our common stock.

**Our stockholder rights plan could prevent stockholders from receiving a premium over the market price for their shares from a potential acquirer.**

We adopted a stockholder rights plan that generally entitles our stockholders to rights to acquire additional shares of our common stock when a third party acquires 15.0% of our common stock or commences or announces its intent to commence a tender offer for at least 15.0% of our common stock, other than for certain stockholders that were stockholders prior to our initial public offering as to whom this threshold is 20.0%. This plan could delay, deter or prevent an investor from acquiring us in a transaction that could otherwise result in stockholders receiving a premium over the market price for their shares of common stock.

**We may need to obtain financing in order to fund our growth strategy.**

We believe that we have or will have access to capital sufficient to satisfy our working capital requirements for at least the next 12 months. After that time, it may be necessary for us to raise additional funds to support our growth. We cannot assure you that we will be able to obtain financing when needed or that, if available to us, the terms will be acceptable to us. If we issue equity securities in any financing, the new securities may have rights and preferences senior to our shares of common stock, and the ownership interest in us of our current stockholders will be proportionately reduced. If we issued debt securities, they will rank senior to all equity securities. If we are unable to raise additional capital, we may not be able to implement our growth strategy, and our business could be harmed significantly. Our future capital requirements will depend on many factors, including the amount of revenue we generate, the timing and extent of spending to support product development efforts, the expansion of sales and marketing activities, the timing of introductions of new products, the costs to ensure access to adequate manufacturing capacity, and the continuing market acceptance of our products, and any future business acquisitions that we might undertake. However, if we do not meet our plan, we could be required, or might elect, to seek additional funding through public or private equity or debt financing and additional funds may not be available on terms acceptable to us or at all. We also might decide to raise additional capital at such times and upon such terms as management considers favorable and in the interests of the Company. For this purpose, we have a current effective universal shelf registration statement on Form S-3 under which we may sell up to \$150 million of our debt and/or equity securities (before reductions for expenses, underwriting discounts and commissions). We may sell these securities from time-to-time without prior announcement.

**EXECUTIVE OFFICERS OF THE REGISTRANT**

The following table provides the names, ages and offices of each of our executive officers as of February 27, 2007:

<b>Name</b>	<b>Age</b>	<b>Position</b>
Ronald Jankov	48	Director, Chief Executive Officer and President
Donald Witmer	53	Vice President and Chief Financial Officer
Dimitrios Dimitrelis	49	Vice President of Engineering
Ibrahim Korgav	58	Senior Vice President of Worldwide Business Operations
Mozafar Maghsoudnia	40	Vice President of Worldwide Manufacturing
Varadarajan Srinivasan	56	Vice President of Product Development and Chief Technical Officer
Marcia Zander	44	Senior Vice President of Worldwide Sales
Roland Cortes	42	Senior Director of Legal Affairs and IP Management and Secretary

## **Table of Contents**

*Ronald Jankov* has served as our President, Chief Executive Officer and as a member of our board of directors since April 2000. From September 1995 to September 1999, Mr. Jankov was Vice President of Sales and then Vice President and General Manager for the Multimedia Division of NeoMagic Corporation, a provider of semiconductors for handheld systems. Prior to that time, Mr. Jankov was Vice President of Cyrix Corporation, a microprocessor company, and held various engineering, sales and management positions at other semiconductor companies, including LSI Logic Corp. and Texas Instruments.

*Donald Witmer* has served as our Vice President of Finance and Chief Financial Officer since January 2004. From September 2001 to December 2003, Mr. Witmer was the chairman of the board and Chief Executive Officer of Home Director, Inc., a home networking company. From December 1999 to September 2001, Mr. Witmer was the chairman of the board and Chief Executive Officer of Digital Interiors, Inc., a home networking company that was acquired by Home Director in October 2000. From June 1997 to December 1999, Mr. Witmer was the President and Chief Executive Officer of Amazing Smart Card Technologies, Inc., a smart card solutions company. In addition, Mr. Witmer has served previously as Chief Financial Officer of each of Catalyst Semiconductor, Inc. and DeltaPoint, Inc. and as an accountant with PricewaterhouseCoopers LLP.

*Dimitrios Dimitrelis* has served as our Vice President of Engineering since July 2002. From July 1999 to March 2002, Mr. Dimitrelis was Director of Engineering for Vitesse Semiconductor Corp., a communications integrated circuit company, where he was primarily responsible for the development of a 10G network processor. From May 1998 to June 1999, Mr. Dimitrelis was Director of ASIC Development for XaQti Corporation, a manufacturer of digital network processors, which was acquired by Vitesse Semiconductor Corp.

*Ibrahim Korgav* has served as our Senior Vice President of Worldwide Business Operations since January 2007 and as our Senior Vice President of Manufacturing and Business Operations from March 2002 to January 2007. From April 2001 to March 2002, Mr. Korgav was a member of the venture capital firm Global Catalyst Partners, during which time he consulted with several semiconductor companies. From April 2000 to March 2001, Mr. Korgav was Senior Vice President of Manufacturing Operations for Zaffire Inc., an optical transport systems company. From June 1994 to March 2000, Mr. Korgav was Vice President of Manufacturing Operations for NeoMagic Corporation.

*Mozafar Maghsoudnia* has served as our Vice President of Worldwide Manufacturing since January 2007, as Vice President of Manufacturing since August 2006, and Director of Technology since June 2003. From June 1988 to June 2003, Mr. Maghsoudnia was employed by Analog Devices, Inc., where he was responsible for wafer fabrication and technology in his last assignment.

*Varadarajan Srinivasan* has served as our Vice President of Product Development since March 1996, as our Chief Technical Officer since August 2000. From January 1989 to March 1996, Mr. Srinivasan was a director of Design Engineering for Quality Semiconductor, Inc., working with SRAMs and logic products.

*Marcia Zander* has served as our Senior Vice President of Worldwide Sales since January 2006 and Vice President of Sales since July 1999. From July 1987 to July 1999, Ms. Zander held various sales and sales management positions, including General Sales Manager, with QuadRep, Inc., a manufacturer's representative firm, who represented large semiconductor and other electronic component companies. From June 1984 to June 1987, Ms. Zander worked in sales and sales management for AVX Corporation and Corning Electronics.

*Roland Cortes* has served as our Secretary since May 2004, as our Senior Director of Legal Affairs and IP Management since July 2002, and as our Director of Legal Affairs and IP Management since April 1999. From December 1995 to April 1999, Mr. Cortes was an intellectual property attorney with Blakely, Sokoloff, Taylor & Zafman LLP.

### **ITEM 1B. UNRESOLVED STAFF COMMENTS.**

Not applicable.

**Table of Contents**

**ITEM 2. PROPERTIES.**

Our main executive, administrative and technical offices occupy approximately 42,000 square feet in Mountain View, California, under a lease that expires in July 2011. We also lease approximately 7,800 square feet in Bangalore, India under a lease that expires in February 2009. We believe that these facilities are adequate for our current needs and that suitable additional or substitute space will be available as needed to accommodate foreseeable expansion of our operations.

**ITEM 3. LEGAL PROCEEDINGS.**

We are not involved in any legal proceedings that management believes will have a material adverse effect our business, results of operations, financial position or cash flows.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.**

Not applicable.

**Table of Contents****PART II****ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

Our common stock is traded on the Global Select Market of the NASDAQ Stock Market under the symbol NETL. The following table sets forth, for the periods indicated, the intra-day high and low per share sale prices of our common stock, as reported by the Nasdaq National Market or the Global Select Market.

	<b>High</b>	<b>Low</b>
<i>Fiscal 2006:</i>		
Fourth quarter	\$ 28.21	\$ 17.55
Third quarter*	\$ 32.49	\$ 22.61
Second quarter	\$ 45.03	\$ 27.67
First quarter	\$ 42.59	\$ 26.30
<i>Fiscal 2005:</i>		
Fourth quarter	\$ 28.11	\$ 17.93
Third quarter	\$ 22.64	\$ 16.02
Second quarter	\$ 18.32	\$ 11.08
First quarter	\$ 15.00	\$ 8.55

\* Our stock became listed on the Global Select Market automatically on August 1, 2006.

As of February 15, 2007, there were approximately 192 holders of record (not including beneficial holders of stock held in street names) of our common stock.

**Dividend Policy**

We have not declared or paid cash dividends on our common stock and do not anticipate paying any cash dividends in the foreseeable future. We expect to retain future earnings, if any, to fund the development and growth of our business. Our board of directors will determine future dividends, if any.

**Recent Sales of Unregistered Securities and Securities Authorized for Issuance Under Equity Compensation Plans**

On January 30, 2007, in accordance with Nasdaq Marketplace rule 4350(i)(1)(A)(iv), our board of directors granted NSOs to purchase a total of 75,600 shares of common stock to 15 new non-executive employees of the Company as an inducement material to each individual entering into employment with the Company. The grants were made pursuant to Nasdaq Marketplace rule 4350(i)(1)(A)(iv). All the stock options have an exercise price equal to the fair market value on the grant date. The options have a 10 year term and vest over four years as follows: 25 percent on the anniversary of the vesting commencement date, and with respect to one thirty-sixth of the remaining shares subject to such option at the end of each calendar month thereafter, subject in all instances to the optionee's continuous employment with the Company.

See Item 12 of Part III of this Report regarding information about securities authorized for issuance under our equity compensation plans.

**Table of Contents****Performance Graph**

The following graph shows the thirty-month cumulative total stockholder return (change in stock price plus reinvested dividends) assuming the investment of \$100 on July 9, 2004 (the day of the Company's initial public offering) in each of the Company's common stock, the S&P 500 Index and the Philadelphia Semiconductor Index. The comparisons in the table are required by the SEC and are not intended to forecast or be indicative of possible future performance of the Company's common stock.

	<b>Cumulative Total Return</b>			
	<b>7/9/04</b>	<b>12/31/04</b>	<b>12/30/05</b>	<b>12/31/06</b>
NetLogic Microsystems, Inc.	\$ 100.00	\$ 83.33	\$ 227.00	\$ 180.75
S&P 500 Index	\$ 100.00	\$ 108.91	\$ 112.17	\$ 127.45
Philadelphia Semiconductor Index	\$ 100.00	\$ 96.05	\$ 106.28	\$ 103.52

**Use of Proceeds from Registered Securities**

The Securities and Exchange Commission declared our first registration statement, filed on Form S-1 under the Securities Act of 1933 (File No. 333-114549) relating to our initial public offering of common stock, effective on July 8, 2004. We realized approximately \$39.2 million after offering expenses.

As of the date of this report, we used the net proceeds of the offering as follows:

We used \$10.5 million to repay existing debt under our credit lines with Silicon Valley Bank;

We used \$7.6 million to repay the convertible promissory notes we issued and sold in March 2004; and

We invested the remaining net proceeds in short-term, interest-bearing instruments, pending their use to fund working capital and other general corporate purposes, including capital expenditures and research and development.

**Table of Contents****Purchases of Equity Securities by the Issuer and Affiliated Purchasers**

We are furnishing the following information with respect to purchases made by us or on our behalf or on behalf of any affiliated purchaser (as defined in Rule 10b-18(a)(3) under the Securities Exchange Act of 1934) of shares of our common stock during each of the three months ended December 31, 2006:

<b>Period</b>	<b>(a) Total Number of Shares (or Units) Purchased <sup>(1)</sup></b>	<b>(b) Average Price Paid per Share (or Unit) <sup>(1)</sup></b>	<b>(c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs <sup>(2)</sup></b>	<b>(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs <sup>(2)</sup></b>
Month #1 (October 1-31)	167	\$ 2.00		
Month #2 (November 1-30)				
Month #3 (December 1-31)	430	\$ 2.00		
Total	597	\$ 2.00		

<sup>(1)</sup> We repurchased these shares from the individuals upon their termination of employment or service with us pursuant to our right to repurchase unvested shares at the original exercise price in accordance with our 2000 Stock Plan and the stock option agreements with the individuals.

<sup>(2)</sup> We did not have any publicly announced plans or programs to purchase our common stock during 2006.

**Table of Contents****ITEM 6. SELECTED FINANCIAL DATA**

The following selected consolidated financial data are qualified by reference to, and should be read in conjunction with, Management's Discussion and Analysis of Financial Condition and Results of Operations and the Financial Statements and related Notes included in Item 8 of this report, which discusses factors affecting the comparability of such financial data. The selected balance sheet data as of December 31, 2006 and 2005 and selected statements of operations data for the years ended December 31, 2006, 2005 and 2004 are derived from our audited financial statements included elsewhere in this report. The selected balance sheet data as of December 31, 2004, 2003 and 2002 and the selected statements of operations data for the years ended December 31, 2003 and 2002 were derived from audited financial statements not included in this report. Our historical results are not necessarily indicative of our future results.

**Statement of Operations Data:**

	2002	Year Ended December 31,			2006
		2003	2004	2005	
	(in thousands, except per share data)				
Revenue	\$ 2,895	\$ 13,535	\$ 47,833	\$ 81,759	\$ 96,806
Cost of revenue	1,723	20,315	26,664	33,415	36,762
Gross profit	1,172	(6,780)	21,169	48,344	60,044
Operating expenses:					
Research and development	17,137	19,799	19,425	21,939	36,578
In-process research and development					10,700
Selling, general and administrative	4,184	5,593	9,932	10,936	15,455
Total operating expenses	21,321	25,392	29,357	32,875	62,733
Income (loss) from operations	(20,149)	(32,172)	(8,188)	15,469	(2,689)
Interest income	759	466	382	1,568	3,737
Interest expense	(481)	(166)	(4,076)	(203)	
Other income (expense), net	(48)	(88)	(149)	(16)	3
Income (loss) before income taxes	(19,919)	(31,960)	(12,031)	16,818	1,051
Provision for income taxes				379	459
Net income (loss)	(19,919)	(31,960)	(12,031)	16,439	592
Net income per share - basic	\$ (7.49)	\$ (11.01)	\$ (1.17)	\$ 0.93	\$ 0.03
Net income per share - diluted	\$ (7.49)	\$ (11.01)	\$ (1.17)	\$ 0.87	\$ 0.03
Shares used in calculation - basic	2,658	2,903	10,318	17,725	19,758
Shares used in calculation - diluted	2,658	2,903	10,318	18,992	21,107

	2002	2003	December 31,		2006
			2004	2005	
	(in thousands)				
<b>Balance Sheet Data:</b>					
Cash, cash equivalents and short-term investments	\$ 39,660	\$ 16,150	\$ 41,411	\$ 65,788	\$ 89,879
Working capital	35,233	6,896	45,283	65,164	95,986
Total assets	44,815	31,844	59,454	85,529	157,769
Software license and other obligations	1,471	10,396	1,317	687	2,625
Redeemable convertible preferred stock	91,600	91,600			



## Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-K

Stockholders' equity (deficit)	(53,733)	(82,351)	48,102	68,658	142,524
--------------------------------	----------	----------	--------	--------	---------

### Supplemental Information:

The tables present financial information including the acquisition of NSE Business from Cypress Semiconductor Corp. completed in fiscal 2006. See Note 2 of Notes to Consolidated Financial Statements under Item 8 of this Annual Report on Form 10-K for further discussion of the acquisition, which may affect the comparability of the data. Effective in fiscal year 2006, we implemented Statement of Financial Accounting Standards (SFAS) No. 123(R) Share-Based Payment. It requires us to measure all employee stock-based compensation awards using a fair value method and record such expense in our consolidated financial statements.

---

**Table of Contents**

**ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.**

On February 15, 2006, we completed the acquisition of Cypress Semiconductor Corporation's (Cypress) Network Search Engine (NSE) products pursuant to an Agreement for the Purchase and Sale of Assets entered into on January 25, 2006, as amended. Upon closing the transaction, we acquired assets relating to Cypress' NSE business, including all intellectual property related primarily to the acquired NSE business (including all intellectual property related to the Sahasra algorithmic technology), the NSE70000 and Ayama product families and all inventory and fixed assets for those product families (the Business). We did not acquire any of Cypress' TCAM1, TCAM2, TCAM2-CR, TurboCAM or Toy Cam products and inventory.

To date we have paid Cypress approximately \$56.2 million in shares of common stock for the acquired assets. We may be required to pay an additional \$10.0 million in cash and up to approximately \$10.0 million in shares of common stock if we achieve specific revenue objectives as outlined in the agreement.

The Sahasra algorithmic technology complements our Layer 7 processing initiative and is a beneficial building block in driving towards low-cost Layer 7 applications acceleration and security processing solutions. In addition, the NSE70000, Ayama 10000 and Ayama 20000 expanded our product offerings in the high-volume, entry-level Layer 3 switch market. The discussions in this section of the Annual Report on Form 10-K, as well as the financial statements contained herein, include the effects of this acquisition from February 15, 2006, the date on which the transaction was completed.

**Overview**

We are a semiconductor company that designs, develops and markets high performance knowledge-based processors for a variety of advanced wireline and wireless networking systems, such as routers, switches, wireless infrastructure equipment, network security appliances, network access equipment and networked storage devices. Our knowledge-based processors accelerate a wide variety of complex functions to enable emerging quad-play networks and services, or the convergence of voice, video, data and mobility over a single unified Internet Protocol infrastructure.

Knowledge-based processors are integrated circuits that employ an advanced processor architecture and a large knowledge or signature database containing information on the network, as well as applications and content that run on the network to make complex decisions about individual packets of information traveling through the network. Our knowledge-based processors significantly enhance the ability of networking original equipment manufacturers, or OEMs, to supply network service providers with systems offering more advanced functionality for the Internet, such as high-definition video delivery over the Internet, or IPTV, voice transmission over the Internet, or VoIP, unified threat management, or UTM, virtual private networks, or VPNs, rich content delivery over mobile wireless networks, and streaming video and audio.

Our knowledge-based processors incorporate advanced technologies that enable rapid processing, such as a superscalar architecture, which uses parallel-processing techniques, and deep pipelining, which segments processing tasks into smaller sub-tasks, for higher decision throughput. These technologies enable networking systems to perform a broad range of network-aware and content-aware processing functions, such as application-based routing, UTM network security, intrusion detection and prevention, virus inspection, access control for network security, prioritization of traffic flow to maintain quality of service, or QoS, and statistical measurement of Internet traffic for transaction billing.

Since the second half of 2003, we have experienced significant revenue growth caused by a rapid rise in new customer orders for our knowledge-based processors. Our total revenue increased by 253% from \$13.5 million for fiscal 2003 to \$47.8 million for fiscal 2004, and by 71% from fiscal 2004 to \$81.8 million for fiscal 2005. Our total revenue for fiscal year ended December 31, 2006 was \$96.8 million, which increased 18% over fiscal 2005.

## **Table of Contents**

As a fabless semiconductor company, our business is less capital intensive than others because we rely on third parties to manufacture, assemble, and test our products. In general, we do not anticipate making significant capital expenditures. In the future, as we launch new products or expand our operations, however, we may require additional funds to procure product mask sets, order elevated quantities of wafers from our foundry partners, perform qualification testing and assemble and test those products.

We employ a direct sales force as well as a sales representative network to sell our products. The majority of our revenue comes from customers headquartered in the United States; however, we also earn a significant amount from customers headquartered in countries outside the United States. All revenue to date has been denominated in U.S. dollars.

Our product sales cycles can take up to 24 months to complete and volume production can take an additional six months to be achieved, if at all. Cancellations of customer orders or changes in product specifications might result in the loss of anticipated sales without allowing us sufficient time to reduce our inventory or operating expenses. Our recent rapid revenue growth makes it difficult for us to assess the impact of seasonal factors on our business.

In general, we recognize revenue at the time of shipment to our customers or our international stocking sales representatives. Our revenue consists primarily of sales of our knowledge-based processors to networking OEMs and contract manufacturers. Initial sales of our products for a new design are usually made directly to networking OEMs. Once a design enters production, a networking OEM often outsources its manufacturing to contract manufacturers that purchase products directly from us.

As a consequence of the acquisition of NSE Business from Cypress, we began selling our products to a distributor in February 2006. We offer price protection and limited stock rotation rights to this distributor. Given the uncertainties associated with the levels of returns and price protection and other credits potentially issuable to this distributor, revenues and costs relating to sales to this distributor are deferred, on a gross basis, until such rights lapse, which is generally upon receiving notification from this distributor that it has resold the products to our end customer.

Because we purchase all wafers from suppliers with fabrication facilities and outsource the assembly and testing to third party vendors, a significant portion of our costs of revenue consists of payments to our third party vendors. We do not have long-term agreements with any of our suppliers and rely upon them to fulfill our orders.

Research and development expenses consist primarily of compensation and related costs for personnel as well as costs related to new and existing product development, depreciation, software maintenance and facilities costs. All research and development costs are expensed in the period incurred. In order for us to remain competitive, we believe a significant portion of our operating expenses will continue to be related to research and development efforts. We also believe research and development headcount will increase in the future, and that research and development costs will increase in absolute dollars but decline as a percentage of revenue.

Selling expenses consist primarily of compensation and related costs for sales and marketing personnel, marketing programs, travel, facilities overhead and bonuses and commissions for independent sales representatives. General and administrative expenses consist primarily of compensation and related costs for finance and accounting, patent and corporate legal expenses, and facilities overhead.

Our operating expenses are denominated primarily in U.S. Dollars, except for expenses incurred by our wholly owned subsidiary in India, which are denominated in the local currency. The expenses incurred by our subsidiary in India, excluding any foreign currency remeasurement gains or losses which are recorded in other income (expense), net, were included in research and development expenses.

Beginning in fiscal 2006, our cost of revenue and operating expenses include stock-based compensation recorded in accordance with FAS 123(R). For the year ended December 31, 2006, our cost of revenue, research and development and selling, general and administrative expenses included stock-based compensation of \$0.5 million, \$7.5 million and \$3.9 million, respectively.

## **Table of Contents**

### **Critical Accounting Policies and Estimates**

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the U.S. requires management to make fair and reasonable estimates and assumptions that affect reported amounts of assets, liabilities and operating expenses during the period reported. The following accounting policies require management to make estimates and assumptions. These estimates and assumptions are reviewed periodically and the effects of revisions are reflected in the period that they are determined to be necessary. If actual results differ significantly from management's estimates, our financial statements could be materially impacted. Our estimates are guided by observing the following critical accounting policies.

*Revenue Recognition.* We derive revenue mainly from product sales and, to a lesser extent, from engineering services. Except for shipments to one distributor, we recognize revenue from product sales upon shipment when persuasive evidence of an arrangement exists, legal title and risk of ownership has transferred, the price is fixed or determinable, and collection of the resulting receivables is reasonably assured. Our sales agreements do not provide for any customer acceptance provisions or return rights. We have no obligation to provide any modification or customization, upgrades, enhancements, post-contract customer support, additional products or enhancements. Customers, other than the distributor discussed below, have no rights of return unless the product does not perform according to specifications. Provisions for warranty expenses are recorded when revenue is recognized.

As a consequence of the acquisition of NSE Business from Cypress, we began selling our products to a distributor in February 2006. We offer price protection and limited stock rotation rights to this distributor. Given the uncertainties associated with the levels of returns and price protection and other credits potentially issuable to this distributor, revenues and costs relating to the sales to this distributor are deferred, on a gross basis, until such rights lapse, which is generally upon receiving notification from this distributor that it has resold the products to our end customer.

From time-to-time we perform engineering services for third parties. Engineering service revenue is recognized as services are performed, agreed-upon milestones are achieved and customer acceptance, if required, is received from the customer.

*Inventory Valuation and Adverse Purchase Commitments.* We value our inventories at the lower of cost or market. We record inventory reserves for estimated obsolescence or unmarketable inventories based upon assumptions about future demand and market conditions. These estimates are generally based on a 12-month forecast prepared by management. If our inventory on hand is in excess of our forecast, the excess amounts are reserved. Once a reserve is established, it is maintained until the product to which it relates is sold or otherwise disposed of. If actual market conditions are less favorable than those expected by management, additional adjustment to inventory valuation may be required. The carrying value of inventory and the determination of possible adverse purchase commitments are dependent on our estimate of the yield that will be achieved, or the percent of good products identified when the product is tested. A small change in yield could result in a significant adjustment and have a significant impact on our financial position and results of operations.

*Warranty Accrual.* Our products are subject to warranty for a period ranging from one to five years from the date of sale and we provide for the estimated future costs of replacement upon shipment of the product in the accompanying statements of operations. Our warranty accrual is estimated based on historical claims compared to historical revenue and assumes that we have to replace products subject to a claim. For new products, we use our historical percentage for the appropriate class of product. Should actual product failure rates differ from our estimates, revisions to the estimated warranty liability would be required. In the future, as we continue to introduce new products, warranty expenses may increase.

*Allowance for Doubtful Accounts.* In order to determine the collectability of our accounts receivable, we continually assess factors such as previous customer transactions and the credit-worthiness of the customer. To date, our accounts receivable write-offs have been immaterial. We maintain allowances for doubtful accounts for

**Table of Contents**

estimated losses resulting from the inability of certain customers to make required payments. In general, such allowances are established for accounts aged over 90 days from the invoice date, unless specific circumstances indicate that the balance is collectible. If the financial conditions of our customers were to deteriorate, additional allowances may be required.

*Accounting for Income Taxes.* We account for income taxes under the provisions of Statement of Financial Accounting Standards (SFAS) No. 109 Accounting for Income Taxes. In applying SFAS 109, we are required to estimate our current tax exposure together with assessing temporary differences resulting from differing treatments of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities. Significant management judgment is required to assess the likelihood that our deferred tax assets will be recovered from future taxable income. We have established a full valuation allowance against our deferred tax assets due to uncertainties regarding our ability to realize these assets. These uncertainties relate primarily to the level of our historical losses and the absence of objective evidence supporting the future realization of these assets. In the event we were to determine that it is more likely than not that we are able to realize our deferred tax assets in the future, an adjustment to the valuation allowance would increase income in the period such determination is made.

*Stock-based Compensation.* We estimate the fair value of stock options using the Black-Scholes-Merton valuation model (the Black-Scholes Model), consistent with the provisions of SFAS 123(R), SAB 107 and our prior period pro forma disclosures of net income, including stock-based compensation determined under a fair value method as prescribed by SFAS 123. The Black-Scholes Model requires the input of highly subjective assumptions, including the option's expected life, the price volatility of the underlying stock and future forfeitures and related tax effects. The expected stock price volatility assumption was determined using both the historical and implied volatility of the Company's common stock. Changes in the subjective assumptions required in the valuation models may significantly affect the estimated value of the awards, the related stock-based compensation expense and, consequently, our results of operations.

**Results of Operations***Comparison of Year Ended December 31, 2006 to Year Ended December 31, 2005***Revenue, cost of revenue and gross profit**

The table below sets forth the fluctuations in revenue, cost of revenue and gross profit data for the years ended December 31, 2006 and 2005 (in thousands, except percentage data):

	Year ended		Year ended		Year-to-Year Increase	Increase Percentage
	December 31, 2006	Percentage of Revenue	December 31, 2005	Percentage of Revenue		
Revenue	\$ 96,806	100.0%	\$ 81,759	100.0%	\$ 15,047	18.4%
Cost of revenue	36,762	38.0%	33,415	40.9%	3,347	10.0%
Gross profit	\$ 60,044	62.0%	\$ 48,344	59.1%	\$ 11,700	24.2%

*Revenue.* The increase in total revenue during the year ended December 31, 2006 resulted from the continued growth in sales of our knowledge-based processors and from sales of products associated with the purchase of the Cypress NSE Business. During the year ended December 31, 2006, the volume of our knowledge-based processor shipments increased approximately 8% over fiscal 2005. The increase in our knowledge-based processor sales for the year ended December 31, 2006 was driven by a \$4.1 million increase in the sales of our NL6000 products, which was introduced in early 2005, as well as a \$1.9 million increase in the sales of our NL5000 products over fiscal 2005. Revenue for the year ended December 31, 2006 also included approximately \$7.5 million from sales of the acquired NSE products. The average selling price of our products in fiscal 2006 decreased as compared to fiscal 2005 primarily due to lower average selling prices for the acquired NSE products, which was 70% lower than that of our knowledge-based processor products in the recent period.

**Table of Contents**

Revenue from sales to Cisco and its contract manufacturers represented 61% of total revenue for the year ended December 31, 2006 compared to 74% during the year ended December 31, 2005. The decrease in sales to Cisco and its contract manufacturers as a percentage of sales in 2006 was due to the growth of sales to other customers.

Revenue for the year ended December 31, 2006 also included \$0.6 million of NRE revenue. No such revenue was recorded in fiscal 2005. We do not expect to generate this type of revenue regularly; however, we may enter into agreements that will generate NRE revenue from time-to-time.

During the latter part of the year ended December 31, 2006, inventory level adjustments at some of our larger customers and slowing demand from our Japanese customers resulted in reduced levels of new orders and slower revenue growth. It appears that the inventory level adjustments were due to excess order placements by our customers in prior quarters to offset an anticipated shortage of organic substrates from suppliers used for some of our knowledge-based processors. It appears, however, that these suppliers did not experience such a shortage, but, as a consequence of their excess order placements earlier in the year, some of our larger customers were left with excess inventory of our knowledge-based processors. We believe this inventory level adjustment will not affect us materially in the future as our largest customers appear to have completed their adjustment process during the fourth quarter of fiscal 2006.

*Cost of Revenue/Gross Profit/Gross Margin.* The increase in cost of revenue and gross profit during the year ended December 31, 2006 was primarily due to the continued growth in sales of our knowledge-based processors. Improvements in our production yields also contributed to the increase in gross profit. During the year ended December 31, 2006 and 2005, we recorded a provision for excess and obsolete inventory reserve of \$2.5 million and \$3.5 million, respectively, for inventory that is not saleable. The cost of revenue during the year ended December 31, 2006 included an additional provision of warranty reserve of \$0.9 million to address a warranty issue related to specific devices sold to one of our international customers, and approximately \$0.5 million of stock-based compensation expense under SFAS 123R that was inapplicable in 2005. The devices were tested by both us and the customer and passed quality assurance inspection at the time they were sold. The customer subsequently identified malfunctioning systems that included our devices. No specific warranty reserve was provided for additional units shipped subsequent to June 30, 2006 as the customer modified the software associated with its products to remedy the observed malfunction. As of December 31, 2006, we maintained \$0.7 million of warranty reserves for anticipated replacement costs of the parts sold to this customer.

Cost of revenue for the year ended December 31, 2006 also included \$2.0 million of amortization of intangible assets acquired in connection with the acquisition of Cypress NSE Business.

The NRE revenue of \$0.6 million during the year ended December 31, 2006 had no associated cost, and accordingly generated 100% gross margin.

Gross margin for the year ended December 31, 2005 was benefited by \$1.0 million from the sale of products that had been fully reserved in prior periods and accordingly had no associated cost of revenue. This amount represented approximately 2.1% of the gross margin during the year ended December 31, 2005.

**Table of Contents****Operating expenses**

The table below sets forth operating expense data for the years ended December 31, 2006 and 2005 (in thousands, except percentage data):

	Year ended December 31, 2006	Percentage of Revenue	Year ended December 31, 2005	Percentage of Revenue	Year-to-Year Increase	Increase Percentage
Operating expenses:						
Research and development	\$ 36,578	37.8%	\$ 21,939	26.8%	\$ 14,639	66.7%
In-process research and development	10,700	11.1%		0.0%	10,700	100.0%
Selling, general and administrative	15,455	16.0%	10,936	13.4%	4,519	41.3%
<b>Total operating expenses</b>	<b>\$ 62,733</b>	<b>64.9%</b>	<b>\$ 32,875</b>	<b>40.2%</b>	<b>\$ 29,858</b>	<b>90.8%</b>

*Research and Development Expenses.* Research and development expenses increased during the year ended December 31, 2006, as compared to fiscal 2005, primarily due to increases in stock-based compensation expense of \$6.7 million, payroll related expenses of \$3.5 million, of which \$1.7 million was due to the acquisition of Cypress NSE Business, consulting expenses of \$2.1 million, masks, tooling and product testing expenses of \$0.6 million, and product development and qualification expenses of \$0.3 million as we continue to invest in the development of the next generation knowledge-based processor products as well as non-knowledge-based processor products. Depreciation expense increased by \$0.7 million during the year ended December 31, 2006 as we purchased software and other tools to support our research and development efforts. The increase in stock-based compensation expense was due to the adoption of SFAS No.123(R) effective January 1, 2006. The remainder of the increase in research and development expenses was caused by individually minor items.

*In-Process Research and Development.* As part of the purchase price allocation in connection with the acquisition of the Cypress NSE Business, we recorded an in-process research and development (IPRD) charge of \$10.7 million during the year ended December 31, 2006 based upon our estimate of the fair values of assets acquired. We acquired only one IPRD project, which is related to the acquired Sahasra algorithmic technology, that has not reached technological feasibility, and has no alternative use. The Sahasra algorithmic technology complements our Layer 7 processing initiative and is a beneficial building block in driving towards low-cost Layer 7 applications acceleration and security processing solutions.

To date, there have been no significant differences between the actual and estimated results of the IPRD project. As of December 31, 2006, we incurred total post-acquisition costs of approximately \$0.9 million related to the IPRD project and estimate that an additional investment of approximately \$2.2 million will be required to complete the project. We expect to complete the project by June 2007 and to benefit from it beginning in fiscal 2008, which is consistent with our original estimate.

The development of the acquired technology remains a significant risk due to factors including the remaining efforts to achieve technical viability, rapidly changing customer markets, uncertain standards for new products, and competitive threats. The nature of the efforts to develop the acquired technology into commercially viable products consists primarily of planning, designing, experimenting, and testing activities necessary to determine that the technology can meet market expectations, including functionality and technical requirements. Failure to bring these products to market in a timely manner could result in a loss of market share or a lost opportunity to capitalize on emerging markets and could have a material adverse impact on our business and operating results.

*Selling, General and Administrative Expenses.* Selling, general and administrative expenses increased during the year ended December 31, 2006, as compared to fiscal 2005, primarily due to increases in stock-based

**Table of Contents**

compensation expense of \$2.9 million, payroll related expenses of \$1.1 million, and legal expenses of \$0.4 million. The increase in stock-based compensation expense was due to the adoption of SFAS No.123(R) effective January 1, 2006. The increase in payroll related costs was due to the increased headcount to support our growing operations primarily in the sales and marketing areas.

**Other items**

The table below sets forth other data for the years ended December 31, 2006 and 2005 (in thousands, except percentage data):

	Year ended		Year ended			
	December 31, 2006	Percentage of Revenue	December 31, 2005	Percentage of Revenue	Year-to-Year Change	Change Percentage
Other income, net:						
Interest income	\$ 3,737	4.6%	\$ 1,568	1.9%	\$ 2,169	138.33%
Interest expense		0.0%	(203)	-0.2%	203	-100.00%
Other income (expense), net	3	0.0%	(16)	0.0%	19	-118.75%
Total interest and other income, net	\$ 3,740	4.6%	\$ 1,349	1.7%	\$ 2,391	177.24%

*Interest and Other Income (Expenses), net.* The net interest and other income of \$3.7 million generated during the year ended December 31, 2006 was due to a higher average cash and investment balance during the period and higher market yields for our chosen investments.

*Provision for income taxes.* Income tax expense was \$0.5 million and \$0.4 million for the years ended December 31, 2006 and 2005. Our effective tax rate in 2006 and 2005 was significantly less than statutory rates because we utilized net operating loss carry-forwards, from which no previous benefit had been recognized to offset taxable income in the U.S.

**Stock-Based Compensation under SFAS No. 123(R)**

On January 1, 2006, the Company adopted SFAS 123(R), on the modified prospective application method, which requires the measurement and recognition of compensation expense for all share-based awards made to the Company's employees and directors including employee stock options and employee stock purchases outstanding as of and awarded after January 1, 2006. The total stock-based compensation expense recognized for the year ended December 31, 2006 was allocated as follows (in thousands):

	Year ended December 31, 2006
Cost of revenues	\$ 548
Research and development	7,481
Selling, general and administrative	3,878
Total stock-based compensation expense	\$ 11,907

In addition, we capitalized approximately \$0.2 million of stock-based compensation in inventory as of December 31, 2006, which represented indirect manufacturing costs related to our inventory.

As of December 31, 2006, there was approximately \$20.4 million of total unrecognized stock-based compensation cost, after estimated forfeitures, related to unvested employee stock options, restricted common stock and shares under the 2004 ESPP, which is expected to be recognized over an estimated weighted average amortization period of 2.90 years. The tax benefit, and the resulting effect on cash flows from operations and financing activities, related to stock-based compensation expense was not recognized as the Company currently provides a full valuation allowance for its deferred tax assets.





**Table of Contents****Comparison of Year Ended December 31, 2005 to Year Ended December 31, 2004****Revenue, cost of revenue and gross profit**

The table below sets forth the fluctuations in revenue, cost of revenue and gross profit data for the years ended December 31, 2005 and 2004 (in thousands, except percentage data):

	Year ended		Year ended		Year-to-Year Increase	Increase Percentage
	December 31, 2005	Percentage of Revenue	December 31, 2004	Percentage of Revenue		
Revenue	\$ 81,759	100.0%	\$ 47,833	100.0%	\$ 33,926	70.9%
Cost of revenue	33,415	40.9%	26,664	55.7%	6,751	25.3%
Gross profit	\$ 48,344	59.1%	\$ 21,169	44.3%	\$ 27,175	128.4%

*Revenue.* The increase in total revenue during the year ended December 31, 2005 resulted from the growth in sales of our knowledge-based processors. During the year ended December 31, 2005, the units of knowledge-based processor shipments increased more than 138% compared to that of the year ended December 31, 2004. Revenue from sales to one of Cisco Systems, Inc.'s contract manufacturers, Solectron, represented 69% of total revenue for the years ended December 31, 2005 and December 31, 2004.

Revenue for the year ended December 31, 2004 also included \$1.1 million of NRE revenue. No such revenue was recorded in fiscal 2005.

*Cost of Revenue.* The cost of revenue increased to \$33.4 million for the year ended December 31, 2005 primarily due to the increased unit shipments of knowledge-based processors.

*Gross Profit/Gross Margin.* Gross margin increased to 59.1% during the year ended December 31, 2005 from 44.3% during the year ended December 31, 2004. The improvement in gross margin in 2005 was primarily due to the continued improvements in our production yields for the knowledge-based processor products. Version 4 of our knowledge-based processors, which was introduced earlier in 2005, produces a higher number of die per wafer as compared to that of the previous version and contributed to the lower overall production costs. Further, gross margin was favorably impacted during the first quarter of 2005 by \$1.0 million from the sale of products that had been fully reserved in prior periods and accordingly had no associated cost of revenue. This amount represented approximately 2.1% of the gross margin during the year ended December 31, 2005.

The NRE revenue of \$1.1 million during the year ended December 31, 2004 had no associated cost, and accordingly generated 100% gross margin.

**Operating expenses**

The table below sets forth operating expense data for the years ended December 31, 2005 and 2004 (in thousands, except percentage data):

	Year ended		Year ended		Year-to-Year Increase	Increase Percentage
	December 31, 2005	Percentage of Revenue	December 31, 2004	Percentage of Revenue		
Operating expenses:						
Research and development	\$ 21,939	26.8%	\$ 19,425	40.6%	\$ 2,514	12.9%
Selling, general and administrative	10,936	13.4%	9,932	20.8%	1,004	10.1%
Total operating expenses	\$ 32,875	40.2%	\$ 29,357	61.4%	\$ 3,518	12.0%



**Table of Contents**

*Research and Development Expenses.* Research and development expenses increased during the year ended December 31, 2005, as compared to the year ended December 31, 2004, primarily due to increases in product development and qualification expenses of \$0.7 million, payroll related expenses of \$0.9 million and consulting expenses of \$1.0 million as we continued to invest in the development of the next generation knowledge-based processor products as well as new non-knowledge-based processor products. In addition, depreciation expense and software maintenance expense increased by \$0.4 million and \$0.2 million, respectively, during the year ended December 31, 2005 as we purchased software licenses to support our research and development efforts. During the year ended December 31, 2005, we also incurred \$0.3 million of expenses associated with our new design center in Bangalore, India, which consisted primarily of payroll related costs for 19 engineers. The remainder of the increase in research and development expenses was caused by individually minor items.

*Selling, General and Administrative Expenses.* Selling, general and administrative expenses increased during the year ended December 31, 2005, as compared to the year ended December 31, 2004, primarily due to increases in directors and officers' insurance premium of \$0.2 million, payroll related costs of \$1.3 million, accounting and consulting expenses of \$0.8 million, investor relations expense of \$0.2 million, sales commission of \$0.3 million and state and local taxes of \$0.4 million. The increases in directors and officers' insurance premium and investor relations expenses occurred subsequent to our initial public offering in July 2004. The increase in payroll related costs was due to increased headcount to support our growing operations and the accrual of management bonuses pursuant to an incentive bonus plan, which was adopted for fiscal 2005. The increase in accounting and consulting expenses primarily related to our on-going effort to document, evaluate and test our system of internal control over financial reporting as we prepare to comply with Section 404 of the Sarbanes-Oxley Act of 2002. The increase in commission expense was the result of a significant sales increase during the year ended December 31, 2005. The increase in state and local taxes was primarily due to the increased business activities in the states where we conduct business. The increases in expenses were offset by the release of the allowance for bad debt of \$0.4 million as we continue to improve cash collections. The remainder of the fluctuation in selling, general and administrative expenses was caused by individually minor items.

**Other items**

The table below sets forth other data for the years ended December 31, 2005 and 2004 (in thousands, except percentage data):

	Year ended December 31, 2005	Percentage of Revenue	Year ended December 31, 2004	Percentage of Revenue	Year-to-Year Change	Change Percentage
Other income (expense), net:						
Interest income	\$ 1,568	1.9%	\$ 382	0.8%	\$ 1,186	310.47%
Interest expense	(203)	-0.2%	(4,076)	-8.5%	3,873	-95.02%
Other income (expense), net	(16)	0.0%	(149)	-0.3%	133	-89.26%
Total interest and other income (expense), net	\$ 1,349	1.7%	\$ (3,843)	-8.0%	\$ 5,192	-135.10%

*Interest and Other Income (Expenses), net.* The net interest and other income of \$1.3 million generated during the year ended December 31, 2005 was due to a higher average cash and investment balance during the period and higher market yields for our chosen investments. The higher average cash and investment balance during the year ended December 31, 2005 as compared to the year ended December 31, 2004 was primarily due to the cash generated from operating activities, which totaled \$25.9 million during fiscal 2005. The higher interest expense during the year ended December 31, 2004 resulted primarily from the accelerated amortization of beneficial conversion feature and warrants that were originally recorded in connection with the issuance of

**Table of Contents**

promissory notes in March 2004. The promissory notes were repaid in full in July 2004, and accordingly, the remaining value of beneficial conversion feature at the time of repayment was entirely charged to interest expense. During the year ended December 31, 2004, amortization of beneficial conversion feature and warrant fair values totaled \$2.5 million. Interest expense for the year ended December 31, 2004 also included the amounts associated with the outstanding balance under the lines of credit. All outstanding amounts under the lines of credit and convertible promissory notes were paid off in July 2004 and our credit lines expired in October 2005.

**Liquidity and Capital Resources**

At December 31, 2006, our principal sources of liquidity were our cash, cash equivalents and short-term investments which totaled \$89.9 million.

The table below (in thousands) sets forth the key components of cash flow for the years ended December 31, 2006, 2005 and 2004:

	Year ended December 31,	Year ended December 31,	Year ended December 31,
	2006	2005	2004
Net cash provided by (used in) operating activities	\$ 22,308	\$ 25,925	\$ (9,658)
Net cash provided by (used in) investing activities	\$ (41,391)	\$ (1,635)	\$ 6,814
Net cash provided by financing activities	\$ 4,053	\$ 77	\$ 31,100

***Cash Flows during the Year ended December 31, 2006***

During the year ended December 31, 2006, our operating activities generated net cash of \$22.3 million. During the period, we recorded non-cash items of \$29.5 million primarily consisting of an in-process research and development charge of \$10.7 million related to the acquisition of the Cypress NSE assets, stock-based compensation of \$11.9 million, provision for inventory reserve of \$2.5 million, accretion of discount on debt securities of \$0.5 million and depreciation and amortization of intangibles of \$4.9 million. The cash generated was offset by the increase in accounts receivable of \$1.7 million on higher sales of our knowledge-based processors during the period, an increase in inventory of \$2.6 million primarily due to the addition of NSE products acquired from Cypress and a decrease in accounts payable of \$3.5 million due to the timing of payments to our vendors.

Our investing activities used cash of \$41.4 million during the year ended December 31, 2006, of which \$39.1 million was for the purchase of short-term investments. We used \$1.5 million to purchase computer equipment and research and development design tools to support our growing operations. We expect to make capital expenditures of approximately \$5.1 million during fiscal 2007. These capital expenditures will be used primarily to support product development activities. We will use our cash and cash equivalents to fund these purchases. We paid approximately \$0.8 million for expenses directly associated with the acquisition of the NSE Business from Cypress Semiconductor Corp.

Our financing activities provided net cash of \$4.1 million for the year ended December 31, 2006, primarily from stock option exercises. Cash provided by financing activities was offset by repayment of software license and other obligations.

***Cash Flows during the Year ended December 31, 2005***

During the year ended December 31, 2005, our operating activities generated net cash of \$25.9 million. For cash provided by operating activities, our primary source was net income of \$16.4 million, adjusted for non-cash items of \$4.0 million primarily related to depreciation, amortization of deferred stock-based compensation and provision for inventory reserves. The provision for inventory reserves of \$3.5 million was primarily related to the

## **Table of Contents**

write-off of approximately \$2.0 million of inventory during the second quarter of 2005. The inventory write-off was related to specific inventory that we mutually agreed with our foundry partner did not meet specifications. This write-off did not impact our cash flows during the year ended December 31, 2005 as we received wafer credits from the foundry partner for the same amount. Cash was also generated from increases in accounts payable and accrued liabilities of \$2.8 million and \$3.2 million, respectively. The decrease in accounts receivable resulted from our continued effort to improve cash collections. The increases in accounts payable and accruals were primarily due to the growth of our overall operations and the timing of vendor invoice payments. The primary use of cash for operating activities during the year ended December 31, 2005 was for inventory, which increased as we ramped up our production volume in order to meet our customers' increasing demand for knowledge-based processors.

Our investing activities used cash of \$1.6 million during the year ended December 31, 2005. Cash was primarily used to purchase research and development design tools and computer equipment to support our growing operations.

Our financing activities provided net cash of \$0.1 million for the year ended December 31, 2005. The primary sources of cash were the proceeds from exercises of stock options and repayment of stockholder notes received, which were offset by repayment of software license and other obligations.

### ***Cash Flows during the Year ended December 31, 2004***

During the year ended December 31, 2004, our operating activities used net cash of \$9.7 million. Cash used in operating activities consisted of a net loss of \$12.0 million adjusted for non-cash items primarily related to depreciation, amortization of stock-based compensation and interest expense, which included the amortization and write-off of discount related to the issuance of promissory notes. The primary use of cash for operating activities during the year ended December 31, 2004 was for our inventory, which increased as we ramped up our production volume in order to meet our customers' increasing demand for our knowledge-based processors. In addition, the significant growth in our product sales in 2004 increased accounts receivable and lowered our operating cash flows. Cash was also used to reduce our accrued liabilities as we settled our product warranty obligations during the period and used a portion of our initial public offering proceeds to reduce our overall liability balance. Other uses of cash for operating activities included an increase in prepaid and other assets due to the payment of a directors and officers insurance premium in connection with our initial public offering, and a decrease in deferred revenue as we completed our obligation under the agreement with Micron. Cash used for activities related to inventory, accounts receivable, accrued liabilities, prepaid and other assets and deferred revenue was offset by an increase in accounts payable due to the growth in our operations.

Our investing activities provided net cash of \$6.8 million during the year ended December 31, 2004. Cash was provided by the sale of short-term investments and the reduction in restricted cash as our amended line of credit agreement with a bank no longer required a restricted cash deposit. Cash provided by the sale of short-term investments and the reduction in restricted cash was offset by the acquisition of property and equipment totaling \$1.2 million. The property and equipment expenditures were primarily for purchases of computer equipment and research and development design tools to support our growing operations.

Our financing activities provided net cash of \$31.1 million for the year ended December 31, 2004. The primary source of cash was the net proceeds received in connection with our initial public offering of \$39.3 million. The other sources of cash included the issuance of convertible promissory notes, repayment of stockholder notes received, proceeds from exercises of stock options and warrants and borrowings under the line of credit. Cash provided by these activities was offset by repayment of convertible promissory notes, repayment of the outstanding balance under the working capital line and the payments for software license obligations.

**Table of Contents****Capital Resources**

We believe that our existing cash, cash equivalents and short-term investments balance of \$89.9 million will be sufficient to meet our anticipated cash needs for at least the next 12 months. Our future capital requirements will depend on many factors, including the amount of revenue we generate, the timing and extent of spending to support product development efforts, the expansion of sales and marketing activities, the timing of introductions of new products, the costs to ensure access to adequate manufacturing capacity, and the continuing market acceptance of our products. However, if we do not meet our plan, we could be required, or might elect, to seek additional funding through public or private equity or debt financing and additional funds may not be available on terms acceptable to us or at all. We also might decide to raise additional capital at such times and upon such terms as management considers favorable and in the interests of the Company, including, but not limited to, from the sale of up to \$150 million of our debt and/or equity securities (before reductions for expenses, underwriting discounts and commissions) under our shelf registration statement.

**Contractual Obligations**

Our principal commitments as of December 31, 2006 are summarized below (in thousands):

	<b>Total</b>	<b>Less than 1 year</b>	<b>1-3 years</b>	<b>4-5 years</b>	<b>After 5 years</b>
Operating lease obligations	\$ 4,474	\$ 958	\$ 1,979	\$ 1,537	\$
Software license obligations	2,625	1,382	1,243		
Wafer purchases	6,582	6,582			
Other	420	420			
<b>Total</b>	<b>\$ 14,101</b>	<b>\$ 9,342</b>	<b>\$ 3,222</b>	<b>\$ 1,537</b>	<b>\$</b>

In addition to the enforceable and legally binding obligations quantified in the table above, we have other obligations for goods and services entered into in the normal course of business. These obligations, however, either are not enforceable or legally binding or are subject to change based on our business decisions.

Other obligations shown above represent \$0.4 million of adverse purchase commitments for which the inventory is considered unsalable.

**Off-Balance Sheet Arrangements**

As part of our ongoing business, we do not participate in transactions that generate relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, or SPEs, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. As of December 31, 2006, we were not involved in any unconsolidated SPE transactions.

**Indemnities, Commitments and Guarantees**

In the normal course of business, we have made certain indemnities, commitments and guarantees under which we may be required to make payments in relation to certain transactions. These include agreements to indemnify our customers with respect to liabilities associated with the infringement of other parties' technology based upon our products, obligation to indemnify our lessors under facility lease agreements, and obligation to indemnify our directors and officers to the maximum extent permitted under the laws of the state of Delaware. The duration of such indemnification obligations, commitments and guarantees varies and, in certain cases, is indefinite. We have not recorded any liability for any such indemnification obligations, commitments and guarantees in the accompanying balance sheets. We do, however, accrue for losses for any known contingent liability, including those that may arise from indemnification provisions, when future payment is probable.

## **Table of Contents**

Under master purchase agreements signed with Cisco in November 2005, we have agreed to indemnify Cisco for costs incurred in rectifying epidemic failures, up to the greater of (on a per claim basis) 25% of all amounts paid to us by Cisco during the preceding 12 months or \$9.0 million, plus replacement costs. If we are required to make payments under the indemnity, our operating results may be adversely affected.

### **Recent Accounting Pronouncements**

In March 2006, the Emerging Issues Task Force reached a consensus on Issue 06-03 How Taxes Collected from Customers and Remitted to Government Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation) ( EITF 06-03 ). We are required to adopt the provisions of EITF 06-03 beginning in 2007. We do not expect the provisions of EITF 06-03 to have a material impact on our consolidated financial statements.

In June 2006, the FASB issued FASB Interpretation (FIN) 48, Accounting for Uncertainty in Income Taxes . FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB SFAS 109, Accounting for Income Taxes . This Interpretation defines the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 is effective for the Company in the first fiscal quarter of 2007. The adoption of FIN 48 is not expected to have a material impact on our consolidated financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards (SFAS) 157, Fair Value Measurements which clarifies the principle that fair value should be based on the assumptions market participants would use when pricing an asset or liability and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. Under the standard, fair value measurements would be separately disclosed by level within the fair value hierarchy. SFAS 157 is effective the first quarter of 2008 with early adoption permitted. We have not yet determined the impact, if any, that the implementation of SFAS 157 will have on our financial position or results of operations.

### **ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.**

The primary objective of our investment activities is to preserve principal while maximizing the income we receive from our investments without significantly increasing the risk of loss. Some of the investment securities permitted under our cash management policy may be subject to market risk for changes in interest rates. To mitigate this risk, we plan to maintain a portfolio of cash equivalent and short-term investments in a variety of securities which may include money market funds, government debt issued by the United States of America, state debt, certificates of deposit and investment grade corporate debt. Presently, we are exposed to minimal market risks associated with interest rate changes. We manage the sensitivity of our results of operations to these risks by maintaining investment grade short-term investments. Our cash management policy does not allow us to purchase or hold derivative or commodity instruments or other financial instruments for trading purposes. Additionally, our policy stipulates that we periodically monitor our investments for adverse material holdings related to the underlying financial solvency of the issuer. As of December 31, 2006, our investments consisted of money market funds and U.S. government securities. Our results of operations and financial condition would not be significantly impacted by either a 10% increase or decrease in interest rates due mainly to the short-term nature of our investment portfolio.

Our sales outside the United States are transacted in U.S. dollars; accordingly our sales are not generally impacted by foreign currency rate changes. Our operating expenses are denominated primarily in U.S. Dollars, except for expenses incurred by our wholly owned subsidiary in India, which are denominated in the local currency. To date, fluctuations in foreign currency exchange rates have not had a material impact on our results of operations.



**Table of Contents**

**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.  
NETLOGIC MICROSYSTEMS, INC.**

**Index to Financial Statements and Financial Statement Schedule**

	<b>Page</b>
<u>Report of Independent Registered Public Accounting Firm</u>	55
<u>Consolidated Balance Sheets as of December 31, 2006 and 2005</u>	57
<u>Consolidated Statements of Operations for the years ended December 31, 2006, 2005 and 2004</u>	58
<u>Consolidated Statement of Stockholders' Equity (Deficit) and Comprehensive Income (Loss)</u>	59
<u>Consolidated Statements of Cash Flows for the years ended December 31, 2006, 2005 and 2004</u>	60
<u>Notes to Consolidated Financial Statements</u>	61

**Table of Contents**

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Stockholders of

NetLogic Microsystems, Inc.:

We have completed integrated audits of NetLogic Microsystems, Inc.'s 2006 and 2005 consolidated financial statements and of its internal control over financial reporting as of December 31, 2006, and an audit of its 2004 consolidated financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

*Consolidated financial statements and financial statement schedule*

In our opinion, the consolidated financial statements listed in the accompanying index appearing under Item 8 present fairly, in all material respects, the financial position of NetLogic Microsystems, Inc. and its subsidiaries at December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2006 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the index appearing under Item 15(a)(2) presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 1 to the consolidated financial statements, the Company changed the manner in which it accounts for share-based compensation in fiscal 2006.

*Internal control over financial reporting*

Also, in our opinion, management's assessment, included in Management's Annual Report on Internal Control Over Financial Reporting appearing under Item 9A, that the Company maintained effective internal control over financial reporting as of December 31, 2006 based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control - Integrated Framework* issued by the COSO. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management's assessment and on the effectiveness of the Company's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

**Table of Contents**

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ PricewaterhouseCoopers LLP

San Jose, California

March 2, 2007

**Table of Contents**

**NETLOGIC MICROSYSTEMS, INC.**  
**CONSOLIDATED BALANCE SHEETS**  
**(IN THOUSANDS)**

	December 31, 2006	December 31, 2005
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 50,752	\$ 65,788
Short-term investments	39,127	
Accounts receivable, net	7,736	5,972
Inventory	10,703	8,822
Prepaid expenses and other current assets	1,387	832
Total current assets	109,705	81,414
Property and equipment, net	5,530	4,012
Goodwill	37,069	
Intangible asset	5,362	
Other assets	103	103
Total assets	\$ 157,769	\$ 85,529
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 4,930	\$ 8,458
Accrued liabilities	7,353	7,434
Deferred income on sales to a distributor	54	
Software license and other obligations, current	1,382	360
Total current liabilities	13,719	16,252
Software license and other obligations, long-term	1,243	327
Other liabilities	283	294
Total liabilities	15,245	16,873
Commitments and contingencies (Note 12)		
Stockholders' equity:		
Preferred stock; 50,000 shares authorized at December 31, 2006 and 2005; none issued and outstanding at December 31, 2006 and 2005		
Common stock; 200,000 shares authorized at December 31, 2006 and 2005; 20,439 and 18,705 shares issued and outstanding at December 31, 2006 and 2005		
	201	180
Additional paid-in capital	224,650	152,379
Notes receivable from stockholders		(44)
Deferred stock-based compensation	(182)	(1,114)
Accumulated other comprehensive income	8	
Accumulated deficit	(82,153)	(82,745)
Total stockholders' equity	142,524	68,656
Total liabilities and stockholders' equity	\$ 157,769	\$ 85,529

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

**Table of Contents****NETLOGIC MICROSYSTEMS, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS****(IN THOUSANDS, EXCEPT FOR PER SHARE AMOUNTS)**

	Year Ended December 31,		
	2006	2005	2004
Revenue	\$ 96,806	\$ 81,759	\$ 47,833
Cost of revenue	36,762	33,415	26,664
Gross profit	60,044	48,344	21,169
Operating expenses:			
Research and development	36,578	21,939	19,425
In-process research and development	10,700		
Selling, general and administrative	15,455	10,936	9,932
Total operating expenses	62,733	32,875	29,357
Income (loss) from operations	(2,689)	15,469	(8,188)
Interest income	3,737	1,568	382
Interest expense		(203)	(4,076)
Other income (expense), net	3	(16)	(149)
Income (loss) before income taxes	\$ 1,051	\$ 16,818	\$ (12,031)
Provision for income taxes	459	379	
Net income (loss)	\$ 592	\$ 16,439	\$ (12,031)
Net income (loss) per share Basic	\$ 0.03	\$ 0.93	\$ (1.17)
Net income (loss) per share Diluted	\$ 0.03	\$ 0.87	\$ (1.17)
Shares used in calculation Basic	19,758	17,725	10,318
Shares used in calculation Diluted	21,107	18,992	10,318

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

**Table of Contents****NETLOGIC MICROSYSTEMS, INC.****CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY (DEFICIT) AND COMPREHENSIVE INCOME (LOSS)****(IN THOUSANDS)**

	Common Stock		Additional Paid-In Capital	Notes Receivable from Stockholders	Deferred Stock-based Compensation	Accumulated Other Comprehensive Income	Accumulated Deficit	Total Stockholders Equity (Deficit)
	Shares	Amount						
Balance at December 31, 2003	3,638	\$ 36	\$ 10,686	\$ (1,620)	\$ (4,300)	\$	\$ (87,153)	\$ (82,351)
Issuance of common stock in connection with initial public offering, net of expenses of \$2,442	3,737	38	39,224					39,262
Issuance of common stock in connection with conversion of redeemable preferred stock	9,640	96	91,504					91,600
Repurchase of Restricted Common Stock	(14)		(23)	23				
Repayment of stockholders notes				1,163				1,163
Beneficial conversion feature on notes payable			2,466					2,466
Issuance of warrants in connection with line of credit			220					220
Issuance of warrants in connection with notes payable			981					981
Issuance of Common Stock upon exercise of warrants	127	1	238					239
Issuance of Common Stock for cash and services	453	5	869					874
Deferred stock-based compensation, net of reversal due to terminations			4,606		(4,606)			
Amortization of deferred stock-based compensation					5,679			5,679
Net loss and comprehensive loss							(12,031)	(12,031)
Balance at December 31, 2004	17,581	176	150,771	(434)	(3,227)		(99,184)	48,102
Issuance of stock under stock compensation plans	495	4	1,834					1,838
Issuance of stock for warrant exercise	2							
Additional deferred compensation for below-market option grants			192		(192)			
Amortization of deferred stock-based compensation					1,897			1,897
Reversal of deferred stock-based compensation due to terminations			(408)		408			
Repurchase of Common Stock	(3)		(10)					(10)
Repayment of notes receivable				390				390
Net income and comprehensive income							16,439	16,439
Balance at December 31, 2005	18,075	180	152,379	(44)	(1,114)		(82,745)	68,656
Issuance of stock in connection with the acquisition of Cypress Semiconductor's Network Search Engine Business	1,653	17	56,184					56,201
Issuance of stock under stock compensation plans	697	4	4,806					4,810
Issuance of stock for warrant exercise	14							
Amortization of deferred stock-based compensation					778			778
Reversal of deferred stock-based compensation due to terminations			(16)		16			
Reversal of deferred stock-based compensation upon adoption of FAS 123R			(138)		138			
Recording of stock-based compensation expense under SFAS 123R			11,316					11,316
Repayment of notes receivable				44				44
Tax benefits of stock options			119					119
Currency translation adjustments						8		8
Net income							592	592

Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-K

Total comprehensive income 600

Balance at December 31, 2006 20,439 \$ 201 \$ 224,650 \$ (182) \$ 8 \$ (82,153) \$ 142,524

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



**Table of Contents**

**NETLOGIC MICROSYSTEMS, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(IN THOUSANDS)**

	<b>Year Ended December 31,</b>		
	<b>2006</b>	<b>2005</b>	<b>2004</b>
<b>Cash flows from operating activities:</b>			
Net (income) loss	\$ 592	\$ 16,439	\$ (12,031)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Depreciation and amortization	4,937	2,062	1,607
Accretion of discount in debt securities	(544)		
Stock-based compensation	11,907	1,916	5,690
Non-cash interest expense		204	3,634
Provision for (recovery of) doubtful accounts	(16)	(225)	192
Provision for inventory reserves	2,471	3,473	
In-process research and development	10,700		
Changes in current assets and liabilities, net of effects of NSE assets acquired:			
Accounts receivable	(1,748)	126	(2,003)
Inventories	(2,598)	(4,536)	(4,175)
Prepaid expenses and other assets	284	323	(409)
Accounts payable	(3,528)	2,768	2,109
Accrued liabilities	(73)	3,272	(3,953)
Tax benefit from stock-based awards	(119)		
Deferred revenue	54		(500)
Other long-term liabilities	(11)	113	181
Net cash provided by (used in) operating activities	22,308	25,935	(9,658)
<b>Cash flows from investing activities:</b>			
Purchase of property and equipment	(1,510)	(1,635)	(1,181)
Purchase of short-term investments	(39,127)		
Sales and maturities of short-term investments			2,995
Restricted cash			5,000
Cash paid for acquisition	(754)		
Net cash (used in) provided by investing activities	(41,391)	(1,635)	6,814
<b>Cash flows from financing activities:</b>			
Proceeds from initial public offering, net			39,262
Proceeds from issuance of convertible promissory notes and warrants			7,650
Repayment of convertible promissory notes			(7,650)
Payment of software license and other obligations	(920)	(2,122)	(517)
Repurchase of restricted Common Stock for cash		(10)	
Proceeds from issuance of Common Stock	4,810	1,819	1,102
Tax benefit from stock-based awards	119		
Proceeds from payment of notes receivable from stockholders	44	390	1,163
Proceeds from notes payable and lines of credit			27,039
Repayment of notes payable and lines of credit			(36,949)
Net cash provided by financing activities	4,053	77	31,100
Net increase (decrease) in cash and cash equivalents	(15,030)	24,377	28,256
Effects of exchange rate on cash and cash equivalents	(6)		
Cash and cash equivalents at beginning of year	65,788	41,411	13,155
Cash and cash equivalents at end of year	\$ 50,752	\$ 65,788	\$ 41,411

## Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-K

### Supplemental disclosure of cash flow information:

Cash paid for interest	\$	\$ 1	\$ 277
------------------------	----	------	--------

### Supplemental disclosure of non-cash investing and financing activities:

Conversion of Redeemable Convertible Preferred stock into Common Stock in connection with the initial public offering	\$	\$	\$ 91,600
Acquisition of property and equipment under capital leases and software license obligations	\$ 3,233	\$ 1,490	\$ 1,348
Repurchase of restricted Common Stock through cancellation of stockholders' notes	\$	\$	\$ 23
Issuance of warrants in connection with notes payable and line of credit	\$	\$	\$ 1,201
Beneficial conversion feature of convertible promissory notes	\$	\$	\$ 2,466
Issuance of warrants in connection with convertible promissory notes	\$	\$	\$ 979
Issuance of common stock in connection with the acquisition of Cypress NSE assets	\$ 56,201	\$	\$

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

**Table of Contents**

**NETLOGIC MICROSYSTEMS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2006**

**NOTE 1 THE COMPANY AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:**

*The Company*

We are a fabless semiconductor company that designs, develops and markets high performance knowledge-based processors for a variety of advanced internet, corporate and other networking systems, such as routers, switches, network access equipment and networked storage devices.

*Basis of Presentation*

The consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

*Use of estimates*

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

*Revenue recognition*

We derive revenue mainly from product sales and, to a lesser extent, from engineering services. Except for shipments to one distributor, we recognize revenue from product sales upon shipment when persuasive evidence of an arrangement exists, legal title and risk of ownership has transferred, the price is fixed or determinable, and collection of the resulting receivables is reasonably assured. Our sales agreements do not provide for any customer acceptance provisions or return rights. We have no obligation to provide any modification or customization, upgrades, enhancements, post-contract customer support, additional products or enhancements. Customers, other than the distributor discussed below, have no rights of return unless the product does not perform according to specifications. Provisions for warranty expenses are recorded when revenue is recognized.

As a consequence of the acquisition of NSE Business from Cypress, we began selling our products to a distributor in February 2006. We offer price protection and limited stock rotation rights to this distributor. Given the uncertainties associated with the levels of returns and price protection and other credits potentially issuable to this distributor, revenues and costs relating to the sales to this distributor are deferred, on a gross basis, until such rights lapse, which is generally upon receiving notification from this distributor that it has resold the products to our end customer.

From time-to-time we perform engineering services for third parties. Engineering service revenue is recognized as services are performed, agreed-upon milestones are achieved and customer acceptance, if required, is received from the customer.

*Warranty*

We provide a limited warranty on our products for a period ranging from one to five years from the date of sale. We provide for the estimated future costs of repair or replacement upon shipment of the product. Our warranty accrual is estimated based on actual and historical claims compared to historical revenue and assumes that we have to replace products subject to a claim.

**Table of Contents**

**NETLOGIC MICROSYSTEMS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2006**

*Cash, cash equivalents and short-term investments*

We consider all highly liquid investments purchased with a remaining maturity of three months or less at the date of purchase to be cash equivalents. These investments consist of money-market funds, which are readily convertible to cash and are stated at cost, which approximates market value. We deposit cash and cash equivalents with high credit quality financial institutions.

Short-term investments are comprised of government agency debt securities with remaining contractual maturities on the date of purchase greater than 90 days but less than one year. Investments in debt securities are classified as available-for-sale and carried at fair value. As of December 31, 2006, we did not have any material unrealized gains or losses.

*Risks and uncertainties and concentration of credit risk*

While we achieved profitability during the year ended December 31, 2006 and 2005, we have a history of net losses prior to 2005. Our net loss for the year ended December 31, 2004 was \$12.0 million. Our ability to remain profitable is dependent, among other factors, upon the rate of growth of our target markets, continued customer acceptance of our products, continued end-user acceptance of our customer's products, the strategic position of our products related to current or future competitors, our ability to develop new products that fulfill customer's specifications, our ability to lower cost of goods sold through yield improvements and our ability to manage expenses. If we are unable to achieve profitability, we could be required, or could elect, to seek additional funding through public or private equity or debt financing. Such funds may not be available on terms acceptable to us or at all.

We depend on a few key customers for a substantial majority of our sales and the loss of, or a significant reduction in orders from any of them would likely significantly reduce revenues. For the years ended December 31, 2006, 2005 and 2004, our top five customers accounted for approximately 79.0%, 83.6% and 84.5% of total product revenue, respectively. Because of the substantial market share owned by our top five customers, our revenue in the foreseeable future will likely continue to depend on sales to a relatively small number of customers, as well as the ability of these customers to sell products that use our products. Our revenue would likely decline if one or more of these customers were to significantly reduce, delay or cancel their orders for any reason. In addition, any difficulty associated with collecting outstanding accounts receivable amounts due from our customers, particularly for our top five customers, would harm our financial performance. Because our sales are based upon standard purchase orders and not on long-term contracts, we cannot assure you that our customers will continue to purchase our products at current levels, or at all.

We purchase all of our semiconductor products from third party foundries. Because future foundry capacity may be limited and because we do not have long-term supply agreements with our foundries, we may not be able to secure adequate manufacturing capacity to satisfy the demand for our products. Although we presently utilize two foundries for wafers, we rely on one for current generation product. We provide the two foundries with monthly rolling forecasts of our production requirements. The ability of each foundry to provide wafers to us is limited however, by the foundry's available capacity. Moreover, the price of our wafers may fluctuate based on changes in available industry capacity. Because we do not have long-term supply contracts with any of our foundries, they could choose to prioritize capacity for other customers, particularly larger customers, reduce or eliminate deliveries to us on short notice or increase the prices they charge us. Accordingly, we cannot be certain that our foundries will allocate sufficient capacity to satisfy our requirements. If we are not able to obtain foundry capacity as required, our relationships with present and future customers would be harmed and our revenue, gross margin and operating results would be materially impacted.

**Table of Contents****NETLOGIC MICROSYSTEMS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****December 31, 2006**

Financial instruments that potentially subject us to a concentration of credit risk consist of cash, cash equivalents, short-term investments and accounts receivable. Deposits held with financial institutions may exceed the amount of insurance provided on such deposits. To date we have not experienced any losses on our deposits of cash or cash equivalents. Our accounts receivable are derived from revenue earned from customers located in North America and Asia. We perform ongoing credit evaluations of our customers' financial condition and, generally, require no collateral.

The following table summarizes customers who accounted for more than 10% of the total revenue:

	Year Ended December 31,		
	2006	2005	2004
Solectron Corporation	56%	69%	69%

The following table summarizes customers who accounted for more than 10% of the total accounts receivable:

	December 31,		
	2006	2005	2004
Solectron Corporation	57%	51%	64%
Mitsui Comtek Corporation		12%	5%
Celestica Thailand	2%	3%	11%
Sanmina Corporation	11%		

*Inventories*

Inventories are stated at the lower of cost or market, cost being determined using the first-in, first-out method. We provide reserves to adjust inventories when we believe that the net realizable value is less than the carrying value of our inventory. We also provide reserves when the number of units on hand exceeds the number of units that we forecast to sell over a certain period, generally twelve months. In order to determine whether the carrying value of our inventory exceeds its estimated market value, we must estimate the expected manufacturing yield, or the percentage of good product resulting from the manufacturing process, as identified when the product is tested. If actual yields are below estimates, the cost of inventory may exceed its estimated market value and an adjustment could result, having a significant impact on the carrying value of our inventory.

*Property and equipment*

Property and equipment are stated at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the assets. Leased assets and leasehold improvements are amortized using the straight-line method over the shorter of the estimated useful life of the asset or the term of the lease.

The depreciation and amortization periods for property and equipment categories are as follows:

Machinery and equipment	3 years
Software	3 years
Furniture and fixtures	5 years



**Table of Contents**

**NETLOGIC MICROSYSTEMS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2006**

*Long-lived assets*

We review the recoverability of our long-lived assets, such as property and equipment, goodwill and intangible assets, whenever events or changes in circumstances occur that indicate that the carrying value of the asset or asset group may not be recoverable. The assessment of possible impairment is based on our ability to recover the carrying value of the asset or asset group from the expected future pre-tax cash flows, undiscounted and without interest charges, of the related operations. If these cash flows are less than the carrying value of such asset, an impairment loss is recognized for the difference between estimated fair value and carrying value. The measurement of impairment requires management to estimate future cash flows and the fair value of long-lived assets.

*Fair value of financial instruments*

Carrying amounts of certain of our financial instruments including cash and cash equivalents, short-term investments, accounts receivable, accounts payable and software license and other obligations approximate fair value due to their short maturities and interest rates currently available to us.

*Foreign currency*

The functional currencies of our significant foreign subsidiaries are the local currencies. Accordingly, all assets and liabilities of these foreign subsidiaries are translated to U.S. dollars at current period end exchange rates, and revenues and expenses are translated to U.S. dollars using average exchange rates in effect during the period. The gains and losses from foreign currency translation of these subsidiaries' financial statements are recorded directly into a separate component of stockholders' equity under the caption Accumulated other comprehensive income. Assets and liabilities that are not denominated in the functional currency are remeasured into U.S. dollars and the resulting gains or losses are included in other income (expense), net. Such gains or losses have not been material for any period presented.

*Income taxes*

We account for income taxes under an asset and liability approach that requires the recognition of deferred tax liabilities and assets for the expected future tax consequences of timing differences between the carrying amounts and the tax bases of assets and liabilities. Valuation allowances are established when necessary to reduce deferred tax assets to amounts expected to be realized.

*Computation of net income (loss) per share*

We have computed net income (loss) per share under two methods, basic and diluted. Basic net income (loss) per share is computed by dividing net income (loss) by the weighted average number of common shares outstanding for the period. Diluted net income (loss) per share is computed by dividing net income (loss) by the sum of the weighted average number of common shares outstanding and potential common shares (when dilutive).

**Table of Contents****NETLOGIC MICROSYSTEMS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****December 31, 2006**

The following table sets forth the computation of basic and diluted net income (loss) attributable to common stockholders per share (in thousands):

	Year Ended December 31,		
	2006	2005	2004
<b>Numerator:</b>			
Net income (loss): basic and diluted	\$ 592	\$ 16,439	\$ (12,031)
<b>Denominator:</b>			
Add: weighted-average common shares outstanding	19,805	17,834	10,570
Less: unvested common shares subject to repurchase	(47)	(109)	(252)
Total shares: basic	19,758	17,725	10,318
Add: weighted-average stock options and warrants outstanding	1,302	1,158	
Add: shares subject to repurchase	47	109	
<b>Total shares: diluted</b>	<b>21,107</b>	<b>18,992</b>	<b>10,318</b>
Basic earnings per share	\$ 0.03	\$ 0.93	\$ (1.17)
Diluted earnings per share	\$ 0.03	\$ 0.87	\$ (1.17)

The following outstanding common stock warrants and common stock options were excluded from the computation of diluted net income (loss) per share as they had an anti-dilutive effect (in thousands):

	Year Ended December 31,		
	2006	2005	2004
Common stock warrants			62
Stock options	795	216	2,213
Advertising costs			

Advertising costs are expensed as incurred. Advertising costs were not significant in 2006, 2005 or 2004.

*Research and development*

Research and development costs are expensed as incurred.

*Stock-based compensation*

We estimate the fair value of stock options using the Black-Scholes Model, consistent with the provisions of SFAS 123(R), SAB 107 and our prior period pro forma disclosures of net income, including stock-based compensation determined under a fair value method as prescribed by SFAS 123. The Black-Scholes Model requires the input of highly subjective assumptions, including the option's expected life and the price



## Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-K

volatility of the underlying stock. The expected stock price volatility assumption was determined using both the historical and implied volatility of the Company's common stock. Changes in the subjective assumptions required in the valuation models may significantly affect the estimated value of the awards, the related stock-based compensation expense and, consequently, our results of operations.

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment, ( SFAS 123(R) ) which requires the measurement and recognition of

**Table of Contents**

**NETLOGIC MICROSYSTEMS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2006**

compensation expense for all share-based payment awards, including employee stock options and employee stock purchases, based on estimated fair values. SFAS 123(R) supersedes the Company's previous accounting under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25) for periods beginning in fiscal 2006. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 (SAB 107) relating to SFAS 123(R). The Company has applied the provisions of SAB 107 in its adoption of SFAS 123(R). The Company adopted SFAS 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006, the first day of the Company's 2006 fiscal year. The Company's Consolidated Financial Statements as of and for the year ended December 31, 2006 reflect the adoption of SFAS 123(R).

Stock-based compensation expense recognized under SFAS 123(R) for the year ended December 31, 2006 was \$11.9 million and related to employee stock options and employee stock purchase rights. Under the modified prospective transition method, the Company's Consolidated Financial Statements for prior periods need not be restated to reflect or include the effect of SFAS 123(R). Accordingly, there was no stock-based compensation expense related to employee stock options and employee stock purchase rights recognized in prior periods presented, other than stock-based compensation expense recognized and disclosed previously.

SFAS 123(R) requires companies to estimate the fair value of option and ESPP awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in the Company's Consolidated Statement of Operations. Prior to the adoption of SFAS 123(R), the Company accounted for stock-based awards using the intrinsic value method in accordance with APB 25 as allowed under Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation (SFAS 123). Under the intrinsic value method, no stock-based compensation expense for options had been recognized in the Company's Consolidated Statement of Operations if the exercise price of the Company's stock options granted to employees and directors equaled the fair market value of the underlying stock at the date of grant.

Stock-based compensation expense recognized during the period is based on the value of the portion of share-based payment awards that is ultimately expected to vest. Stock-based compensation expense recognized in the Company's Consolidated Statement of Operations for the year ended December 31, 2006 included (i) compensation expense for share-based payment awards granted prior to, but not yet vested as of, December 31, 2005 based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123, and (ii) compensation expense for the share-based payment awards granted subsequent to December 31, 2005 based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). The Company attributes the value of stock-based compensation to expense on a straight-line single option method for the awards granted subsequent to December 31, 2005, while the accelerated method is used for awards granted on or prior to December 31, 2005. As stock-based compensation expense recognized in the Consolidated Statement of Operations for the year ended December 31, 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. For the periods prior to fiscal 2006, the Company accounted for forfeitures as they occurred in its pro forma information required under SFAS 123.

The Company uses the Black-Scholes-Merton option-pricing model (Black-Scholes Model) as its method of valuation for share-based awards granted beginning in fiscal 2006, which is the same model used for the Company's pro forma information required under SFAS 123. The Company's determination of fair value of share-based payment awards on the date of grant using an option-pricing model is affected by the Company's

**Table of Contents**

**NETLOGIC MICROSYSTEMS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2006**

stock price, as well as assumptions regarding a number of subjective variables. These variables include, but are not limited to, the Company's expected stock price volatility over the term of the awards, as well as actual and projected employee stock option exercise behavior.

*Recent accounting pronouncements*

In March 2006, the Emerging Issues Task Force reached a consensus on Issue 06-03 How Taxes Collected from Customers and Remitted to Government Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation) ( EITF 06-03 ). We are required to adopt the provisions of EITF 06-03 beginning in 2007. We do not expect the provisions of EITF 06-03 to have a material impact on our consolidated financial statements.

In June 2006, the FASB issued FASB Interpretation (FIN) 48, Accounting for Uncertainty in Income Taxes . FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB SFAS 109, Accounting for Income Taxes . This Interpretation defines the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 is effective for the Company in the first fiscal quarter of 2007. The adoption of FIN 48 is not expected to have a material impact on our consolidated financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards (SFAS) 157, Fair Value Measurements which clarifies the principle that fair value should be based on the assumptions market participants would use when pricing an asset or liability and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. Under the standard, fair value measurements would be separately disclosed by level within the fair value hierarchy. SFAS 157 is effective the first quarter of 2008 with early adoption permitted. We have not yet determined the impact, if any, that the implementation of SFAS 157 will have on our consolidated financial statements.

**NOTE 2 Business Combination**

On February 15, 2006, the Company completed the acquisition of net assets of the NSE business of Cypress including the Ayama10000, Ayama 20000, and NSE70000 Network Search Engine families, as well as the Sahasra50000 Algorithmic Search Engine family (the Business ). The Sahasra algorithmic technology complements the Company's Layer 7 processing initiative and is a beneficial building block in driving towards low-cost Layer 7 applications acceleration and security processing solutions. In addition, the NSE70000, Ayama 10000 and Ayama 20000 expanded the Company's product offerings in the high-volume, entry-level Layer 3 switch market. These factors contributed to a purchase price in excess of the fair value of net tangible assets acquired from Cypress and as a result, the Company recorded goodwill in connection with this transaction. The results of operations relating to the Business have been included in the results of operations from the acquisition date.

Under terms of the agreement, the Company paid \$1,000 in cash and issued 1,488,063 shares of common stock valued at \$49.7 million on February 15, 2006. In addition, the Company agreed to pay Cypress up to an additional \$10.0 million in cash and up to an additional \$10.0 million in shares of our common stock if certain revenue milestones associated with the Business are achieved in the twelve-month period after the close of the transaction.

On April 11, 2006, the Company issued an additional 165,344 shares of our common stock to Cypress upon Cypress furnishing the audited financial statements related to the Business. The value of the additional shares of \$6.5 million was considered additional purchase price and recorded as an increase to goodwill during the year ended December 31, 2006.

**Table of Contents****NETLOGIC MICROSYSTEMS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****December 31, 2006**

The acquisition was accounted for as a purchase business combination. The purchase price of the Business, including the additional 165,344 shares issued on April 11, 2006, was approximately \$57.0 million, which has been determined as follows (in thousands of dollars):

Cash	\$ 1
Value of NetLogic common stock issued	56,201
Direct transaction costs	753
 Total purchase price	 \$ 56,955

The value of the 1,488,063 shares of common stock issued on February 15, 2006 was determined based on the average price of the common stock over a five-day period including the two days before and after January 25, 2006 (the date the definitive agreement was signed and announced), or \$33.43 per share. The value of the additional 165,344 shares of the common stock issued on April 11, 2006 upon Cypress furnishing the audited financial statements related to the Business was determined based on the closing price of the common stock on that date, or \$39.03 per share.

Under the purchase method of accounting, the total purchase price is allocated to the Business net tangible and intangible assets based on their fair values as of the date of the completion of the acquisition. Based on management estimates of the fair values, the estimated purchase price was allocated as follows (in thousands):

Tangible assets	\$ 1,850
Amortizable intangible assets:	
Developed technology	6,500
Backlog	836
In-process research and development	10,700
Goodwill	37,069
 Total purchase price allocation	 \$ 56,955

Developed technology comprises products that have reached technological feasibility and include the Ayama10000, Ayama 20000, and NSE70000 product families. The value assigned to developed technology was based upon future discounted cash flows related to the existing products projected income streams using a discount rate of 20%. The Company believes that the discount rate was appropriate given the business risks inherent in marketing and selling these products. Factors considered in estimating the discounted cash flows to be derived from the existing technology include risks related to the characteristics and applications of the technology, existing and future markets and an assessment of the age of the technology within its life span. The Company expects to amortize the existing technology intangible asset on a straight-line basis over an estimated life of five years.

The backlog intangible asset represents the value of the sales and marketing costs required to establish the order backlog and was valued using the cost savings approach. The Company estimated these orders to be delivered and billed within six months from the acquisition date, which is the period over which the asset is amortized.

Of the total estimated purchase price, an estimate of \$10.7 million was allocated to in-process research and development (IPRD) based upon management's estimate of the fair values of assets acquired, and was charged to expense during the year ended December 31, 2006. The Company acquired only one IPRD project, which is



**Table of Contents****NETLOGIC MICROSYSTEMS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****December 31, 2006**

related to the Sahasra algorithmic technology that has not reached technological feasibility and has no alternative use. The Sahasra algorithmic technology complements the Company's Layer 7 processing initiative and is a beneficial building block in driving towards low-cost Layer 7 applications acceleration and security processing solutions.

The fair value assigned to IPRD was determined using the income approach, under which the Company considered the importance of products under development to its overall development plans, estimated the costs to develop the purchased IPRD into commercially viable products, estimated the resulting net cash flows from the products when completed and discounted the net cash flows to their present values. The Company used a discount rate of 23% in the present value calculations, which was derived from a weighted-average cost of capital analysis, adjusted to reflect additional risks related to the products' development and success, as well as the products' stage of completion. The estimates used in valuing IPRD were based upon assumptions believed to be reasonable, but which are inherently uncertain and unpredictable. Those assumptions may be incomplete or inaccurate, and unanticipated events and circumstances may occur. Accordingly, actual results may vary from the projected results.

To date, there have been no significant differences between the actual and estimated results of the IPRD project. As of December 31, 2006, the Company incurred total post-acquisition costs of approximately \$0.9 million related to the IPRD project, and the Company estimates that an additional investment of approximately \$2.2 million will be required to complete the project. The Company expects to complete the project by June 2007 and to benefit from the IPRD project beginning in fiscal 2008, which is consistent with original estimates.

Of the total estimated purchase price, approximately \$37.1 million has been allocated to goodwill. Goodwill represents the excess of the purchase price of an acquired business over the fair value of the underlying net tangible and intangible assets, and is deductible for tax purposes. In accordance with the Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets, goodwill is not amortized but instead is tested for impairment at least annually, and more frequently if certain indicators are present. In the event the Company determines that the value of goodwill has become impaired, it will incur an accounting charge for the amount of impairment during the fiscal quarter in which such determination is made.

***Unaudited pro forma results of operations***

Summarized below are the unaudited pro forma results of the Company as though the acquisition described above had occurred at the beginning of the periods indicated. Adjustments have been made for the amortization of intangibles and other appropriate pro forma adjustments. The charges for purchased in-process research and development are not included in the pro forma results, because they are non-recurring. The information presented does not purport to be indicative of the results that would have been achieved had the acquisition been made as of those dates, nor of the results that may occur in the future.

(in thousands, except per share amounts)	Year Ended December 31,	
	2006	2005
Revenue	\$ 97,616	\$ 91,161
Net income (loss)	\$ 9,594	\$ (2,260)
Net income (loss) per share - basic	\$ 0.48	\$ (0.12)
Net income (loss) per share - diluted	\$ 0.45	\$ (0.12)

**Table of Contents****NETLOGIC MICROSYSTEMS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****December 31, 2006****NOTE 3 Goodwill and Other Intangible Assets**

The following table summarizes the components of goodwill, other intangible assets and related accumulated amortization balances, which were recorded as a result of the business combination described in Note 2 (in thousands):

	<b>Gross Carrying Amount</b>	<b>December 31, 2006 Accumulated Amortization</b>	<b>Net Carrying Amount</b>
Goodwill	\$ 37,069	\$	\$ 37,069
Other intangible assets:			
Developed technology	6,500	(1,138)	5,362
Backlog	836	(836)	
<b>Total</b>	<b>\$ 7,336</b>	<b>\$ (1,974)</b>	<b>\$ 5,362</b>

Backlog, with an estimated useful life of six months, was classified within prepaid expenses and other current assets and is fully amortized as of December 31, 2006. For the year ended December 31, 2006, amortization expense related to other intangible assets was \$2.0 million, all of which was included in cost of sales because the amortization expense related to products sold during such periods. As of December 31, 2006, the estimated future amortization expense of other intangible assets in the table above is as follows (in thousands):

<b>Fiscal Year</b>	<b>Estimated Amortization</b>
2007	1,300
2008	1,300
2009	1,300
2010	1,300
2011	162
<b>Total</b>	<b>\$ 5,362</b>

In accordance with SFAS 142, the Company evaluates goodwill for impairment at least on an annual basis or whenever events and changes in circumstances suggest that the carrying amount may not be recoverable from its estimated future cash flow. The Company performed its annual goodwill impairment assessment in the fourth quarter of fiscal 2006 and no impairment charges were recorded. No assurances can be given that future evaluations of goodwill will not result in charges as a result of future impairment.

**Table of Contents****NETLOGIC MICROSYSTEMS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****December 31, 2006****NOTE 4 BALANCE SHEET COMPONENTS:**

	<b>December 31,</b>	
	<b>2006</b>	<b>2005</b>
	<b>(in thousands)</b>	
<b>Accounts receivable:</b>		
Trade accounts receivable	\$ 7,802	\$ 6,032
Less: Allowance for doubtful accounts and customer returns	(66)	(60)
	\$ 7,736	\$ 5,972
<b>Inventories:</b>		
Finished goods	\$ 1,903	\$ 2,108
Work-in-progress	8,800	6,714
	\$ 10,703	\$ 8,822
<b>Property and equipment, net:</b>		
Machinery and equipment	\$ 4,684	\$ 3,764
Software	12,755	9,536
Furniture and fixtures	311	154
Leasehold improvements	81	
	17,831	13,454
Less: Accumulated depreciation and amortization	(12,301)	(9,442)
	\$ 5,530	\$ 4,012

Property and equipment includes \$1.7 million of machinery and equipment under capital lease arrangements, which were fully depreciated at December 31, 2006 and 2005.

Depreciation and amortization expense related to property and equipment for the years ended December 31, 2006, 2005 and 2004 was \$3.0 million, \$2.1 million and \$1.6 million, respectively.

	<b>December 31,</b>	
	<b>2006</b>	<b>2005</b>
	<b>(in thousands)</b>	
<b>Accrued liabilities:</b>		
Payroll and related expenses	\$ 3,365	\$ 2,489
Accrued inventory purchases	897	692
Accrued warranty	1,270	531
Accrued adverse purchase commitments	420	931
Accrued professional services	398	991



Other accrued expenses	1,004	1,800
	\$ 7,353	\$ 7,434

**Table of Contents****NETLOGIC MICROSYSTEMS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****December 31, 2006**

The following table summarizes the activity related to the product warranty liability during the years ended December 31, 2006 and 2005 (in thousands):

	<b>Year Ended December 31,</b>	
	<b>2006</b>	<b>2005</b>
<b>Warranty accrual:</b>		
Beginning balance	\$ 531	\$ 381
Provision for warranty	1,105	1,102
Settlements made during the period	(366)	(840)
Other adjustments		(112)
Ending balance	\$ 1,270	\$ 531

**NOTE 5 Revolving Line of Credit:**

In March 2004, we amended the terms of a line of credit with Silicon Valley Bank (the Working Capital Line), which we originally obtained in October 2003. The terms of the amended agreement eliminated the requirement for a \$5.0 million deposit with the bank and allowed us to borrow up to \$4.5 million for working capital purposes to the extent we have cash, cash equivalents and short term investments in the custody of the bank. In addition, the portion of the facility that was also available based on certain accounts receivable balances was replaced by an accounts receivable financing facility. The accounts receivable financing facility allowed us to borrow up to \$10.0 million based on a percentage of certain customer purchase orders and accounts receivable balances.

In March 2004, in connection with the amendment to the Working Capital Line, we issued the bank a warrant to purchase approximately 15,000 shares of our Series E Redeemable Convertible Preferred Stock at \$19.95 per share. The warrant was exercised for common stock in full by the bank during the year ended December 31, 2006. The fair value of the warrants of \$223,000 was being amortized as interest expense over the remaining 18-month life of the agreement. The fair value of the warrant was estimated using the Black-Scholes model using a risk-free interest rate of 3.49%, the seven-year contractual life of the warrant, expected dividend yield of zero, volatility of approximately 80% and a fair value of \$4.88 per share. During the year ended December 31, 2005 and 2004, we recorded \$112,000 and \$111,000 of amortization expense, respectively, associated with the warrants.

In July 2004, we repaid in full \$10.5 million outstanding under the Working Capital Line. Subsequent to our initial public offering on July 14, 2004, the Working Capital Line was amended twice and our line of credit was increased to \$14.5 million available for general working capital purposes.

The Working Capital Line expired on October 2, 2005 and was not renewed as management determined that the Company's currently available liquid resources were adequate for its operational needs for the foreseeable future.

**NOTE 6 CONVERTIBLE PROMISSORY NOTES:**

In March 2004, we issued \$7.6 million in convertible promissory notes (the Notes) bearing interest at 10.0% per annum and warrants to purchase 76,500 shares of common stock at \$2.00 per share to existing stockholders, directors and management. The Notes were convertible at a conversion price of \$3.25 at the option of the holder in March 2005 into approximately 2.6 million shares of Series D Redeemable Convertible Preferred Stock, if not earlier repaid. The difference between the conversion price and the fair value of the common stock



**Table of Contents**

**NETLOGIC MICROSYSTEMS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2006**

on the transaction date resulted in a beneficial conversion feature of \$2.5 million. The warrants had a fair value of \$1.0 million, estimated using the Black-Scholes valuation model, with a risk-free interest rate of 2.44%, a four-year life of the warrants, expected dividend yield of zero, volatility of 90% and a fair value of \$3.55. The beneficial conversion feature and the fair value of the warrants were recorded as a discount to the promissory notes. Both the beneficial conversion feature and the warrants were charged to interest expense over the term of the notes.

In July 2004, the promissory notes and accrued interest were repaid in full following the closing of the initial public offering of our common stock. As the Notes were issued and fully repaid in 2004, the entire value of the beneficial conversion feature and the warrants aggregating \$3.5 million was charged to interest expense during the year ended December 31, 2004.

**NOTE 7 REDEEMABLE CONVERTIBLE PREFERRED STOCK:**

Prior to our initial public offering in July 2004, we had 38,560,664 shares of Series A, B, C, D and E redeemable convertible preferred stock (the Preferred Stock ) outstanding. The holders of the Preferred Stock were entitled to certain dividend and liquidation preference rights. No dividends were declared or paid related to the Preferred Stock. Each share of the Preferred Stock was convertible at the option of the holder, or upon our completion of a qualifying public offering of common stock. Upon completion of our initial public offering in July 2004, all outstanding shares of the Preferred Stock were converted into 9,640,145 shares of our common stock.

**NOTE 8 COMMON STOCK:**

Our Certificate authorizes us to issue 200,000,000 shares of \$0.01 par value Common Stock. A portion of the shares sold are subject to a right of repurchase by us subject to vesting, which is generally over a four year period from the earlier of grant date or employee hire date, as applicable, until vesting is complete. At December 31, 2006 and 2005, there were 47,000 and 109,000 shares, respectively, subject to repurchase.

*Warrants for common stock*

At December 31, 2006, warrants to purchase approximately 30,000 shares of Common Stock at an exercise prices ranging from \$0.80 to \$13.00 per share remain outstanding and expire at various dates through March 2011.

*Stockholder rights plan*

We adopted a stockholder rights plan that generally entitles our stockholders to rights to acquire additional shares of our common stock when a third party acquires 15.0% of our common stock or commences or announces its intent to commence a tender offer for at least 15.0% of our common stock, other than for certain stockholders that were stockholders prior to our initial public offering as to whom this threshold is 20.0%. This plan could delay, deter or prevent an investor from acquiring us in a transaction that could otherwise result in stockholders receiving a premium over the market price for their shares of common stock.

**NOTE 9 NOTES RECEIVABLE FROM STOCKHOLDERS:**

Notes receivable from stockholders include full recourse promissory notes issued in conjunction with the exercise of options by employees. The notes bear interest rates of 6% and 7% compounded semi-annually or

**Table of Contents**

**NETLOGIC MICROSYSTEMS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2006**

annually. Accrued interest and principal are due and payable upon the earlier of the termination of the employees or the maturity of the notes. The terms of the notes range from 4 to 8 years. Notes receivables from stockholders and related accrued interest totaled \$44,000 and \$14,000, respectively, at December 31, 2005. During the year ended December 31, 2006, all remaining outstanding principal and accrued interest balances were paid off.

**NOTE 10 STOCK OPTION PLANS:**

We have two stock option plans, the 2004 Equity Incentive Plan and the 2000 Stock Plan (collectively, the Plans ) that provide for the granting of stock options to employees and consultants. Options granted under the Plans may be either incentive stock options or nonqualified stock options. Incentive stock options ( ISO ) may be granted only to our employees (including officers and directors who are also employees). Nonqualified stock options ( NSO ) may be granted to our employees, non-employee directors and consultants. We no longer grant options under the 2000 Stock Plan. A total of 5,823,191 shares of common stock have been reserved for awards issuable under the 2004 Equity Incentive Plan, which further provides for an annual increase of 150,000 shares on each January 1.

Options under the Plans may be granted for periods of up to ten years. Under the Plans the exercise price of (i) an ISO shall not be less than 100% of the estimated fair value of the shares on the date of grant, and (ii) an ISO granted to a 10% stockholder shall not be less than 110% of the estimated fair value of the shares on the date of grant. The exercise price of an NSO under the 2004 Plan may be any price as determined by the board of directors. Options granted under the 2000 Stock Plan were exercisable immediately subject to repurchase options held by us which lapse over a maximum period of five years at such times and under such conditions as determined by the board of directors. We have an option to repurchase, in the event of a termination of the optionee's employment relationship, any unvested shares at a price per share equal to the original exercise price per share for the option. When the unvested shares were issued with a promissory note, we have a right to repurchase these unvested shares at the lower of the fair market value of our common stock as of the time the repurchase option is exercised and the original purchase price per share. To date, options granted generally vest over four years. As of December 31, 2006, approximately 47,000 shares of common stock granted under the 2000 Stock Plan were subject to repurchase.

The 2004 Plan also allows for the grant of restricted common stock. During the year ended December 31, 2006, the Board of Directors granted 0.2 million shares of restricted common stock to certain employees. No shares of restricted common stock were granted in 2005 or 2004. We measured compensation expense for restricted stock granted during the year ended December 31, 2006 based on the fair value of the common stock on the date of grant. We recognize such compensation expense over the vesting period of 2 years.

During the fiscal year ended December 31, 2006, we issued and sold the following unregistered securities. None of these sales involved an underwriter, finder or other agent or the payment of any selling commission to any person.

We issued to one investor an aggregate of 1,153 shares of our common stock upon exercise of a warrant previously issued. The exercise price for the warrant was \$4.875 per share, and the exercise resulted in aggregate proceeds to us of \$5,621. These shares were issued in reliance on Section 3(a)(9) of the Securities Act or Regulation D promulgated under the Securities Act. The sale of the securities were deemed to be exempt from registration under the Securities Act in reliance on the basis noted above. The purchaser of the securities represented their intention to acquire the securities for investment only and not with a view to or for sale in connection with any distribution of the securities, and appropriate legends were affixed to the share certificates and instruments issued in such transactions.

**Table of Contents****NETLOGIC MICROSYSTEMS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****December 31, 2006**

On January 30, 2007, in accordance with Nasdaq Marketplace rule 4350(i)(1)(A)(iv), our board of directors granted NSOs to purchase a total of 75,600 shares of common stock to 15 new non-executive employees of the Company as an inducement material to each individual s entering into employment with the Company. The grants were made pursuant to Nasdaq Marketplace rule 4350(i)(1)(A)(iv). All the stock options have an exercise price equal to the fair market value on the grant date. The options have a 10 year term and vest over four years as follows: 25 percent on the anniversary of the vesting commencement date, and with respect to one thirty-sixth of the remaining shares subject to such option at the end of each calendar month thereafter, subject in all instances to the optionee s continuous employment with the Company.

A summary of all options activity under the Plans is presented below (number of shares in thousands):

	Shares Available for Grant	Options Outstanding Number of Shares Outstanding	Options Outstanding Weighted Average Exercise Price
Balances at December 31, 2003	326	1,270	\$ 1.96
Additional shares authorized	3,823		
Options granted	(1,450)	1,450	8.00
Options exercised		(454)	1.93
Options forfeited or expired	16	(16)	3.72
Balances at December 31, 2004	2,715	2,250	5.81
Additional shares authorized	150		
Options granted	(1,562)	1,562	18.72
Options exercised		(449)	2.96
Options forfeited or expired	223	(223)	5.82
Balances at December 31, 2005	1,526	3,140	12.63
Additional shares authorized	1,737		
Transfer of authorized shares from 2004 Employee Stock Purchase Plan	700		
Options granted	(1,285)	1,285	28.03
Options exercised		(450)	8.69
Options forfeited or expired	171	(171)	25.74
Restricted stock granted	(217)		
Restricted stock cancelled	25		
Balances at December 31, 2006	2,657	3,804	17.70

Exercise Price	Number of Shares	Options Outstanding at December 31, 2006			Aggregate Intrinsic Value (in thousands)	Options Exercisable at December 31, 2006		
		Weighted-Average Remaining Contractual Life (in Years)	Weighted-Average Exercise Price			Number of Shares	Weighted-Average Exercise Price	Aggregate Intrinsic Value (in thousands)
\$ 0.80 \$ 9.12	762	6.88	\$ 3.77	\$ 13,655	490	\$ 3.16	\$ 9,080	
\$ 9.13 \$13.00	890	7.78	12.42	8,250	431	12.44	3,987	
\$13.01 \$19.83	779	9.30	19.10	2,018	145	18.12	518	

Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-K

\$19.84	\$27.24	808	9.01	23.53	267	340	25.01	86
\$27.25	\$40.43	565	9.13	34.58		14	28.49	
		3,804	8.37	17.70	\$ 24,190	1,420	12.98	\$ 13,671

**Table of Contents****NETLOGIC MICROSYSTEMS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****December 31, 2006**

The aggregate intrinsic value in the table above represents the total pretax intrinsic value, based on the Company's closing stock price of \$21.69 as of December 31, 2006, which would have been received by the option holders had all option holders exercised their options as of that date. The total number of in-the-money options exercisable as of December 31, 2006 was 1.2 million.

The total intrinsic value of options exercised and total cash received from employees for those exercises during the years ended December 31, 2006 and 2005 were as follows (in thousands):

	<b>Year Ended December 31,</b>	
	<b>2006</b>	<b>2005</b>
Total intrinsic value of options exercised	\$ 10,770	\$ 6,043
Total cash received for option exercises	\$ 3,907	\$ 1,332

***Deferred Stock-Based Compensation***

Prior to January 1, 2006, our adoption date of SFAS 123(R), we recorded deferred stock-based compensation of \$12.2 million (of which \$11.1 million had been amortized as of December 31, 2005) due to the difference between the exercise price and the estimated fair value of common stock. Deferred stock-based compensation is being amortized over the vesting period of four years. Beginning in fiscal 2006, stock-based compensation expense is calculated based on an estimated fair value under SFAS 123(R) and recognized over the remaining vesting periods. However, as the deferred stock-based compensation balance recorded as of December 31, 2005 related to the awards granted prior to our becoming a publicly traded company, the remaining balance of deferred stock-based compensation will continue to be accounted for under APB 25 and be amortized for the remaining vesting period. During the year ended December 31, 2006, we amortized \$0.8 million of deferred stock-based compensation, which is included in the total stock-based compensation expense of \$11.9 million for the same period.

***2004 Employee Stock Purchase Plan***

In July 2004, we adopted the 2004 ESPP, which complies with the requirements of Section 423 of the Internal Revenue Code. The shares reserved under the 2004 ESPP are subject to an automatic increase on January 1 of each year in the number of shares equal to the lesser of 75,000 shares or 0.5% of the outstanding shares of our common stock at the end of the preceding fiscal year. The 2004 ESPP permits eligible employees (as defined in the plan) to purchase up to \$25,000 worth of our common stock annually over the course of two six-month offering periods, other than the initial two-year offering period which commenced on July 8, 2004. The purchase price to be paid by participants is 85% of the price per share of our common stock either at the beginning or the end of each six-month offering period, whichever is less. At our 2006 Annual Meeting of Stockholders held on May 18, 2006, our stockholders approved the reduction in the number of shares reserved under the 2004 ESPP by 700,000 shares, and the transfer of those reserved shares to our 2004 Equity Incentive Plan. During the year ended December 31, 2006 and 2005, approximately 55,000 shares and 46,000 shares were issued under the Purchase Plan, and approximately 173,000 shares remain available for future issuance at December 31, 2006. No shares were issued under the Purchase Plan in 2004. The 2004 ESPP terminates in May 2014.

***Stock-Based Compensation under SFAS No. 123(R)***

On January 1, 2006, the Company adopted SFAS 123(R), on the modified prospective application method, which requires the measurement and recognition of compensation expense for all share-based awards made to the



**Table of Contents****NETLOGIC MICROSYSTEMS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****December 31, 2006**

Company's employees and directors including employee stock options and employee stock purchases outstanding as of and awarded after January 1, 2006. The total stock-based compensation expense recognized for the year ended December 31, 2006 was allocated as follows (in thousands):

	<b>Year Ended</b>	
	<b>December 31, 2006</b>	
Cost of revenues	\$	548
Research and development		7,481
Selling, general and administrative		3,878
 Total stock-based compensation expense	 \$	 11,907

In addition, we capitalized approximately \$0.2 million of stock-based compensation in inventory as of December 31, 2006, which represented indirect manufacturing costs related to our inventory.

As of December 31, 2006, there was approximately \$20.4 million of total unrecognized stock-based compensation cost, after estimated forfeitures, related to unvested employee stock options, restricted common stock and shares under the 2004 ESPP, which is expected to be recognized over an estimated weighted average amortization period of 2.90 years. The tax benefit, and the resulting effect on cash flows from operations and financing activities, related to stock-based compensation expense was not recognized as the Company currently provides a full valuation allowance for its deferred tax assets.

The method of valuation for share-based awards granted beginning in fiscal 2006 is the Black-Scholes Model, which was also the method used for the Company's pro forma information required under FAS 123. The expected term of the awards represents the weighted-average period the stock options are expected to remain outstanding, and assumes that the employees' exercise behavior is a function of the option's remaining contractual life and the extent to which the option is in-the-money (i.e., the average stock price during the period is above the strike price of the stock option). The Company's expected volatility assumption uses both the historical and implied volatility of the Company's stock, as applicable for the expected term. The Company also used its historical stock price to determine the fair value of awards for purposes of its pro forma information under FAS 123. Since the Company does not pay dividends, the expected dividend yield is zero. The risk-free interest rate assumption is based upon observed interest rates appropriate for the term of the Company's employee stock options. The post-vesting forfeiture rate is based on the Company's historical option cancellation and employee exercise information, as well as the historical information of similar sized companies in the same industry.

**Valuation Assumptions**

For the year ended December 31, 2006, the fair value of employee stock options granted under the 2004 Equity Incentive Plan and 2004 ESPP was estimated using the following weighted average assumptions:

	<b>Year Ended</b>	
	<b>December 31, 2006</b>	
	<b>Stock</b>	<b>Purchase</b>
	<b>Options</b>	<b>Plan</b>
<b>Stock Option Plans:</b>		
Risk-free interest rate	4.51%	4.65%

Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-K

Expected life of options	4.47 years	0.5 years
Expected dividend yield	0%	0%
Volatility	57%	58%

Table of Contents

## NETLOGIC MICROSYSTEMS, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

December 31, 2006

The weighted average fair value of employee stock options and shares purchased under the 2004 ESPP for the year ended December 31, 2006 were as follows:

	Year Ended December 31, 2006	
	Stock Options	Purchase Plan
Weighted average estimated fair value	\$ 14.11	\$ 9.64

*Pro Forma Information under SFAS No. 123 for Periods Prior to Fiscal 2006*

Prior to adopting SFAS No. 123(R), we made pro forma disclosures of the effects of stock-based compensation under SFAS No. 123 and SFAS No. 148, Accounting for Stock-Based Compensation, Transition and Disclosure. The pro forma effects of recognizing compensation expense under the fair value method on our net income per share for the year ended December 31, 2005 and 2004 were as follows (in thousands, except per share data):

	Year Ended December 31,	
	2005	2004
Net income as reported	\$ 16,439	\$ (12,031)
Add: stock-based compensation expense included in reported net income	1,897	5,679
Deduct: stock-based compensation expense determined under fair value based method for all awards	(9,938)	(7,806)
Net income pro forma	\$ 8,398	\$ (14,158)
Net income per common share		
As reported:		
Basic	\$ 0.93	\$ (1.17)
Diluted	\$ 0.87	\$ (1.17)
Pro forma:		
Basic	\$ 0.47	\$ (1.37)
Diluted	\$ 0.44	\$ (1.37)

For the year ended December 31, 2005 and 2004, the fair value of employee stock options granted under the 2004 Equity Incentive Plan and 2004 ESPP was estimated using the following weighted average assumptions:

	Year Ended December 31,			
	2005		2004	
	Stock Options	Purchase Plan	Stock Options	Purchase Plan

## Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-K

Stock Option Plans:				
Risk-free interest rate	4.02%	2.65%	2.07% - 3.62%	2.51%
Expected life of options	3.7 years	0.5 to 2 years	4 years	2 years
Expected dividend yield	0%	0%	0%	0%
Volatility	71%	80%	0% - 80%	80%

The weighted average fair value of employee stock option grants was \$9.62 and \$8.02 for year ended December 31, 2005 and 2004, respectively.

**Table of Contents****NETLOGIC MICROSYSTEMS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****December 31, 2006****NOTE 11 INCOME TAXES:**

The components of the provision for income taxes are as follows (in thousands):

	<b>Year ended December 31,</b>		
	<b>2006</b>	<b>2005</b>	<b>2004</b>
<b>Current:</b>			
Federal	\$ 349	\$ 313	\$
State	59	46	
Foreign	51	20	
<b>Total current</b>	<b>459</b>	<b>379</b>	
<b>Deferred</b>			
Federal			
State			
Foreign			
<b>Total deferred</b>			
<b>Provision for income taxes</b>	<b>\$ 459</b>	<b>\$ 379</b>	<b>\$</b>

The provision for income taxes differs from the amount computed by applying the U.S. statutory federal rate to income (loss) before income tax provision as a result of the following (in thousands):

	<b>Year ended December 31,</b>		
	<b>2006</b>	<b>2005</b>	<b>2004</b>
Tax at statutory rate	\$ 358	\$ 5,759	\$ (4,090)
State taxes, net of federal benefit	59	46	
Change in valuation allowance	99	(5,446)	4,090
Foreign	(57)	20	
	<b>\$ 459</b>	<b>\$ 379</b>	<b>\$</b>

Deferred tax assets and liabilities consist of the following (in thousands):

	<b>December 31,</b>	
	<b>2006</b>	<b>2005</b>
<b>Deferred Tax Assets:</b>		
Net operating loss carryforwards	\$ 14,832	\$ 19,355

Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-K

Accrued liabilities and other	2,560	2,251
Deferred stock-based compensation	2,374	780
Depreciation and amortization	5,319	657
Research and development tax credits	9,441	7,718
Gross deferred tax assets	34,526	30,761
Valuation allowance	(34,526)	(30,761)
Net deferred tax assets	\$	\$

Due to the uncertainty surrounding the realization of the deferred tax asset in future tax returns, we have placed a valuation allowance against our net deferred tax assets. Approximately \$2.0 million of the deferred tax assets at December 31, 2006 related to benefits of stock option deductions which, when recognized, will be accounted for as an addition to equity rather than a reduction of the provision for taxes.

**Table of Contents****NETLOGIC MICROSYSTEMS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****December 31, 2006**

At December 31, 2006, we had federal and state net operating loss carryforwards of approximately \$42.6 million and \$6.3 million, respectively. These net operating loss carryforwards will expire commencing in 2022 and 2014 for federal and state purposes, respectively. We also have federal and state research and development tax credit carryforwards of approximately \$5.1 million and \$5.4 million, respectively. The federal tax credits carryforwards will expire commencing in 2019 and California tax credits have no expiration date.

For federal and state purposes, a portion of our net operating loss carryforwards may be subject to limitation on annual utilization in case of a change in ownership, as defined by federal and state tax law.

Undistributed earnings of our foreign subsidiary of approximately \$0.3 million at December 31, 2006 are considered to be indefinitely reinvested and, accordingly, no provisions for federal and state income taxes have been provided thereon. Upon distribution of those earnings in the form of dividends or otherwise, we would be subject to both U.S. income taxes (subject to an adjustment for foreign tax credits) and withholding taxes payable to various foreign countries.

In June 2006, the FASB issued FASB Interpretation (FIN) 48, Accounting for Uncertainty in Income Taxes. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB SFAS 109, Accounting for Income Taxes. This Interpretation defines the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 is effective for the Company in the first fiscal quarter of 2007. The adoption of FIN 48 is not expected to have a material impact on our consolidated financial statements.

**NOTE 12 COMMITMENTS AND CONTINGENCIES:***Leases*

We lease office space under noncancelable operating leases with various expiration dates through 2011. Rent expense for the years ended December 31, 2006, 2005 and 2004 was \$0.9 million, \$0.7 million and \$0.5 million, respectively. The terms of the facility lease provide for rental payments on a graduated scale. We recognize rent expense on a straight-line basis over the lease period and accrue for rent expense incurred but not paid.

Future minimum lease payments under noncancelable operating lease, which include common area maintenance charges, are as follows (in thousands):

Year Ending December 31,	Operating Leases
2007	958
2008	979
2009	1,000
2010	1,021
2011 and thereafter	516
Total minimum lease payments	\$ 4,474

**Table of Contents****NETLOGIC MICROSYSTEMS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****December 31, 2006**

We have software license obligations that are paid over the license periods, which range from one to three years. These software licenses are used for our internal research and development projects. At December 31, 2006 and 2005, we had \$2.6 million and \$0.7 million of software license obligations, respectively. Future payments for software license obligations are as follows:

<b>Year Ending December 31,</b>	<b>Software License Obligations</b>
2007	1,382
2008	1,243
<b>Total</b>	<b>\$ 2,625</b>

*Purchase Commitments*

At December 31, 2006, we had approximately \$6.5 million in non-cancelable purchase commitments with suppliers. We have recorded a liability of \$0.4 million for adverse purchase commitments related to a portion of these commitments for which the inventory is considered unsalable.

*Contingencies*

We are party to claims and litigation proceedings arising in the normal course of business. Although the legal responsibility and financial impact with respect to such claims and litigation cannot currently be ascertained, we do not believe that these matters will result in the payment of monetary damages, net of any applicable insurance proceeds, that, in the aggregate, would be material in relation to our business, financial position, results of operations or cash flows. There can be no assurance that these matters will be resolved without costly litigation, in a manner that is not adverse to our business, financial position, results of operations or cash flows, or without requiring royalty payments in the future which may adversely impact gross margins.

*Indemnities, Commitments and Guarantees*

In the normal course of business, we have made certain indemnities, commitments and guarantees under which we may be required to make payments in relation to certain transactions. These include agreements to indemnify our customers with respect to liabilities associated with the infringement of other parties' technology based upon our products, obligation to indemnify our lessors under facility lease agreements, and obligation to indemnify our directors and officers to the maximum extent permitted under the laws of the state of Delaware. The duration of such indemnification obligations, commitments and guarantees varies and, in certain cases, is indefinite. We have not recorded any liability for any such indemnification obligations, commitments and guarantees in the accompanying balance sheets. We do, however, accrue for losses for any known contingent liability, including those that may arise from indemnification provisions, when future payment is probable.

Under master purchase agreements signed with Cisco in November 2005, we have agreed to indemnify Cisco for costs incurred in rectifying epidemic failures, up to the greater of (on a per claim basis) 25% of all amounts paid to us by Cisco during the preceding 12 months or \$9.0 million, plus replacement costs. If we are required to make payments under the indemnity, our operating results may be adversely affected.



**Table of Contents****NETLOGIC MICROSYSTEMS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****December 31, 2006****NOTE 13 SEGMENT INFORMATION:**

We operate in one business segment and sell our products directly to customers in the United States, Asia and Europe. Sales for the geographic regions reported below are based upon the customer headquarter locations. Following is a summary of the geographic information related to revenues for the years ended December 31, 2006, 2005 and 2004 (in thousands):

	Year Ended December 31,		
	2006	2005	2004
<b>Revenue:</b>			
United States	\$ 46,227	\$ 54,952	\$ 44,700
Malaysia	31,632	21,349	
Asia, excluding Malaysia	11,783	4,418	2,037
Other	7,164	1,040	1,096
<b>Total</b>	<b>\$ 96,806</b>	<b>\$ 81,759</b>	<b>\$ 47,833</b>

Substantially all of our long-lived assets are located in the United States of America.

**NOTE 14 EMPLOYEE BENEFIT PLAN:**

We sponsor a 401(k) defined contribution plan covering all employees. Contributions made by us are determined annually by the Board of Directors. To date we have made no contributions to the plan.

**NOTE 15 RELATED PARTY:**

We lease our headquarters facility in Mountain View, California from an affiliate of Berg & Berg Enterprises, LLC, which holds shares of our common stock. During the year ended December 31, 2006, 2005 and 2004, we made lease payments of approximately \$799,000, \$634,000 and \$284,000, respectively, under this lease arrangement.

**Selected Consolidated Quarterly Financial Data (Unaudited)**

The following table presents selected unaudited consolidated financial data for each of the eight quarters in the two-year period ended December 31, 2006. In our opinion, this unaudited information has been prepared on the same basis as the audited information and includes all adjustments (consisting of only normal recurring adjustments) necessary for a fair statement of the financial information for the period presented.

	Quarter			
	First <sup>(1)</sup>	Second	Third	Fourth
	(in thousands, except per share data)			
<b>Year Ended December 31, 2006</b>				
Total revenue	\$ 23,324	\$ 25,831	\$ 26,634	\$ 21,017
Gross profit	\$ 14,388	\$ 15,737	\$ 16,284	\$ 13,635

Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-K

Net income (loss)	\$ (7,324)	\$ 2,938	\$ 3,445	\$ 1,533
Net income (loss) per share basic	\$ (0.39)	\$ 0.15	\$ 0.17	\$ 0.08
Net income (loss) per share diluted	\$ (0.39)	\$ 0.14	\$ 0.16	\$ 0.07

**Table of Contents****NETLOGIC MICROSYSTEMS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****December 31, 2006**

	<b>Quarter</b>			
	<b>First</b>	<b>Second</b>	<b>Third</b>	<b>Fourth</b>
	<b>(in thousands, except per share data)</b>			
<b>Year Ended December 31, 2005</b>				
Total revenue	\$ 21,802	\$ 18,707	\$ 20,029	\$ 21,221
Gross profit	\$ 12,318	\$ 10,487	\$ 12,233	\$ 13,306
Net income	\$ 5,423	\$ 2,425	\$ 3,608	\$ 4,983
Net income per share basic	\$ 0.31	\$ 0.14	\$ 0.20	\$ 0.28
Net income per share diluted	\$ 0.29	\$ 0.13	\$ 0.19	\$ 0.26

<sup>(1)</sup> Net loss in the first quarter of 2006 included a one-time in-process research and development charge of \$10.7 million related to the acquisition of the NSE Business from Cypress Semiconductor Corp.

**Table of Contents**

**ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.**

Not applicable.

**ITEM 9A. CONTROLS AND PROCEDURES**

**Evaluation of Disclosure Controls and Procedures**

Our management evaluated, with the participation of our Chief Executive Officer and Chief Financial Officer, the effectiveness of our disclosure controls and procedures as of December 31, 2006. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934, as amended, is (i) recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and (ii) accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosures as of December 31, 2006.

**Management's Annual Report on Internal Control Over Financial Reporting**

Our management is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting cannot provide absolute assurance of achieving financial reporting objectives because of its inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements may not be prevented or detected on a timely basis by internal control over financial reporting. However, these inherent limitations are known features of the financial reporting process. Therefore, it is possible to design into the process safeguards to reduce, though not eliminate, this risk.

Our management assessed the effectiveness of the company's internal control over financial reporting as of December 31, 2006. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control - Integrated Framework*. Based on this assessment using those criteria, management concluded that, as of December 31, 2006, our internal control over financial reporting was effective. Our management's assessment of the effectiveness of the Company's internal control over financial reporting as of December 31, 2006 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report which appears herein.

**Changes in Internal Control Over Financial Reporting**

There were no changes in our internal control over financial reporting that occurred during fourth fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**ITEM 9B. OTHER INFORMATION**

None.

**Table of Contents**

**PART III**

**ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE.**

Information relating to our executive officers and directors and corporate governance will be presented under the caption "Executive Officers and Directors" and "Corporate Governance" in our definitive proxy statement in connection with our 2007 Annual Meeting of Stockholders to be held on or about May 18, 2007. That information is incorporated into this report by reference. Certain information required by this item concerning executive officers is set forth in Item 1 of Part I of this Report under the caption "Executive Officers of the Registrant."

We have adopted a Code of Conduct and Ethics that applies to our principal executive officer, principal financial officer and all other employees of NetLogic Microsystems, Inc. This Code of Conduct and Ethics is posted in the corporate governance section on our website at [www.netlogicmicro.com](http://www.netlogicmicro.com). We intend to satisfy the disclosure requirement under Item 10 of Form 8-K regarding an amendment to, or waiver from, a provision of this Code of Conduct and Ethics by posting such information in the corporate governance section on our website at [www.netlogicmicro.com](http://www.netlogicmicro.com).

**ITEM 11. EXECUTIVE COMPENSATION.**

Information relating to executive compensation will be presented under the caption "Executive Compensation" in the proxy statement for our 2007 Annual Meeting of Stockholders. That information is incorporated into this report by reference.

**ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS.**

Information relating to the security ownership of our common stock by our management and other beneficial owners will be presented under the caption "Security Ownership of Certain Beneficial Owners and Management" in our definitive proxy statement. That information is incorporated into this report by reference. Information relating to securities authorized for issuance under equity compensation plans will be presented under the caption "Securities Authorized for Issuance under Equity Compensation Plans" in the proxy statement for our 2007 Annual Meeting of Stockholders. That information is incorporated into this report by reference.

**ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE.**

Information required by this Item is incorporated by reference from the information contained under the caption "Certain Relationships and Related Transactions" and "Corporate Governance" in the proxy statement for our 2007 Annual Meeting of Stockholders.

**ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES.**

The information required by this item is incorporated by reference from the information contained under the caption "Ratification of Independent Accountants" "Principal Accounting Fees and Services" and "Ratification of Independent Accountants" "Pre-Approval Policies and Procedures" in the proxy statement for our 2007 Annual Meeting of Stockholders.

**Table of Contents**

**PART IV**

**ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES.**

(a) The following documents are filed as part of this report on Form 10-K:

- (1) *Financial Statements.* Reference is made to the Index to the registrant's the Financial Statements under Item 8 in Part II of this Form 10-K.
- (2) *Financial Statement Schedules.* The following consolidated financial statement schedule of the registrant is filed as part of this report on Form 10-K and should be read in conjunction with the Financial Statements of NetLogic Microsystems, Inc.:  
Schedule II (i) Valuation and Qualifying Accounts for the year ended December 31, 2006.

Schedules not listed above are omitted because they are not required, they are not applicable or the information is already included in the consolidated financial statements or notes thereto.

- (3) *Exhibits.* The exhibits listed on the accompanying index to exhibits in Item 15(c) below are filed as part of, or hereby incorporated by reference into, this report on Form 10-K.

(b) *Exhibits.*

The exhibits listed below are required by Item 601 of Regulation S-K.

<b>Exhibit</b>	<b>Description</b>
2.1	Agreement for the Purchase and Sale of Assets by and between the registrant and Cypress Semiconductor Corporation dated as of January 25, 2006, as amended. (11)
3.1	Restated Certificate of Incorporation of the registrant filed on August 2, 2004 (1)
3.4	Bylaws of the registrant (2)
4.1	Specimen common stock certificate (3)
4.2	Second Amended and Restated Investor Rights Agreement dated August 31, 2001, as amended by the Amendments to Second Amended and Restated Investor Rights Agreement dated March 18, 2004, April 16, 2004 and June 12, 2004 (4)
4.3	Rights Agreement by and between the registrant and Wells Fargo Bank, National Association, dated July 7, 2004 (5)
10.1*	2000 Stock Plan and forms of related agreements (6)
10.2*	2004 Equity Incentive Plan (3)
10.2.1*	Form of Stock Option Agreement under 2004 Equity Incentive Plan (7)
10.2.2*	Form of Restricted Stock Agreement under 2004 Equity Incentive Plan (14)
10.3*	2004 Employee Stock Purchase Plan and forms of related agreements (8)
10.4	Form of Indemnity Agreement (6)

## Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-K

- 10.5 License and Technology Transfer Agreement by and between the registrant and Micron Technology, Inc. dated December 12, 2002 (6)
- 10.9\* Form of Change-In-Control Agreement between the registrant and each of certain officers thereof (12)
- 10.10\* Incentive Bonus Plan effective May 5, 2005 (9)
- 10.11 Form of Master Purchase Agreement by and between the registrant and Cisco Systems, Inc. (10)

**Table of Contents**

<b>Exhibit</b>	<b>Description</b>
10.12	Form of Promissory Note Secured by Pledge of Stock issued to the registrant by certain officers thereof (6)
10.13	Intentionally omitted
10.14	Second Amendment to Lease between Mission West Charleston, LLC and NetLogic Microsystems, Inc. (13)
10.15	Standard Form Lease by and between the registrant and Mission West Properties, L.P. dated May 3, 2004 (2)
10.16*	Employment offer letter, dated April 12, 2000, between the registrant and Ronald Jankov (2)
10.17*	Employment offer letter, dated April 1, 1999, between the registrant and Roland Cortes (4)
10.18*	Employment offer letter, dated March 15, 2002, between the registrant and Ibrahim Korgav, as amended (2)
10.19*	Employment offer letter, dated February 9, 1996, between the registrant and Varadarajan Srinivasan (2)
10.20*	Employment offer letter, dated June 7, 1999, between the registrant and Marcia Zander (2)
10.21*	Employment offer letter, dated December 5, 2003, between the registrant and Donald Witmer (2)
10.22	Description of the registrant's Patent Incentive and Recognition Program (4)
23.1	Consent of PricewaterhouseCoopers LLP, Independent Registered Public Accounting Firm
31.1	Rule 13a-14 certification
31.2	Rule 13a-14 certification
32.1	Section 1350 certification
32.2	Section 1350 certification

- (1) Incorporated by reference to the same-numbered exhibit to the registrant's Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2004, filed with the Securities and Exchange Commission as of August 20, 2004.
- (2) Incorporated by reference to the same-numbered exhibit to Amendment No. 1 to Form S-1 (Registration No. 333-114549) filed by the registrant with the Securities and Exchange Commission as of May 19, 2004.
- (3) Incorporated by reference to the same-numbered exhibit to Amendment No. 3 to Form S-1 (Registration No. 333-114549) filed by the registrant with the Securities and Exchange Commission as of June 21, 2004.
- (4) Incorporated by reference to the same-numbered exhibit to Amendment No. 2 to Form S-1 (Registration No. 333-114549) filed by the registrant with the Securities and Exchange Commission as of June 14, 2004.
- (5) Incorporated by reference to Exhibit (i) to Form 8-A (Registration No. 000-50838) filed by the registrant with the Securities and Exchange Commission as of July 8, 2004.
- (6) Incorporated by reference to the same-numbered exhibit to Form S-1 (Registration No. 333-114549) filed by the registrant with the Securities and Exchange Commission as of April 16, 2004.
- (7) Incorporated by reference to the same-numbered exhibit to the registrant's Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2004, filed with the Securities and Exchange Commission as of November 12, 2004.



Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-K

- (8) Incorporated by reference to the same-numbered exhibit to Form S-8 (Registration No. 333-117619) filed by the registrant with the Securities and Exchange Commission as of July 23, 2004.

**Table of Contents**

- (9) Incorporated by reference to the same-numbered exhibit to the registrant's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2005, filed with the Securities and Exchange Commission as of May 09, 2005.
  
- (10) Incorporated by reference to Exhibit 17.1 the same-numbered exhibit to the registrant's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2005, filed with the Securities and Exchange Commission as of November 8, 2005.
  
- (11) Incorporated by reference to the same-numbered exhibit to the registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission as of February 21, 2005.
  
- (12) Incorporated by reference to the same-numbered exhibit to the registrant's Annual Report on Form 10-K for the year ended December 31, 2004, filed with the Securities and Exchange Commission as of March 11, 2005.
  
- (13) Incorporated by reference to the same-numbered exhibit to the registrant's Quarterly Report on Form 10-Q for the quarterly period ended March 30, 2006, filed with the Securities and Exchange Commission as of May 09, 2006.
  
- (14) Incorporated by reference to the same-numbered exhibit to the registrant's Annual Report on Form 10-K for the year ended December 31, 2005, filed with the Securities and Exchange Commission as of February 28, 2006.

\* Indicates management contract or compensatory plan or arrangement.

Confidential treatment has been requested for certain portions of this exhibit.

(c) *Financial statements and schedules.*  
Reference is made to Item 15(a) above.

**Table of Contents**

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Dated: March 2, 2007

NETLOGIC MICROSYSTEMS, INC.

By /s/ RONALD JANKOV

**Ronald Jankov**

*President and Chief Executive Officer*

**POWER OF ATTORNEY**

**KNOW ALL MEN BY THESE PRESENTS**, that each person whose signature appears below constitutes and appoints Ronald Jankov and Donald Witmer as his true and lawful attorneys-in-fact and agents, with full power of substitution and resubstitution, for him and in his name, place and stead, in any and all capacities, to sign any and all amendments to this Report on Form 10-K, and to file the same, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents full power and authority to do and perform each and every act and thing requisite and necessary to be done in connection therewith, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all that said attorneys-in-fact and agents, or their substitute or substitutes, may lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

Name	Title	Date
/s/ RONALD JANKOV <b>Ronald Jankov</b>	Chief Executive Officer and Director (Principal Executive Officer)	March 2, 2006
/s/ DONALD WITMER <b>Donald Witmer</b>	Vice President Finance and Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer)	March 2, 2006
/s/ LEONARD PERHAM <b>Leonard Perham</b>	Director	March 2, 2006
/s/ NORMAN GODINHO <b>Norman Godinho</b>	Director	March 2, 2006
/s/ ALAN KROCK <b>Alan Krock</b>	Director	March 2, 2006
/s/ DOUGLAS BROYLES <b>Douglas Broyles</b>	Director	March 2, 2006

/s/ STEVE DOMENIK

Director

March 2, 2006

**Steve Domenik**

**Table of Contents****SCHEDULE II (i)****VALUATION AND QUALIFYING ACCOUNTS****FOR THE YEAR ENDED DECEMBER 31, 2006**

	<b>Balance at Beginning of Period</b>	<b>Additions Charged to Costs and Expenses</b>	<b>Write-offs/ Adjustments</b>	<b>Balance at End of Period</b>
Year ended December 31, 2006				
Allowance for doubtful accounts	\$ 60,000	\$ 62,000	\$ (78,000)	\$ 44,000
Year ended December 31, 2005				
Allowance for doubtful accounts	\$ 285,000	\$ 22,000	\$ (247,000)	\$ 60,000
Year ended December 31, 2004				
Allowance for doubtful accounts	\$ 93,000	\$ 192,000		\$ 285,000

**Table of Contents****EXHIBIT INDEX**

<b>Exhibit</b>	<b>Description</b>
2.1	Agreement for the Purchase and Sale of Assets by and between the registrant and Cypress Semiconductor Corporation dated as of January 25, 2006. (11)
3.1	Restated Certificate of Incorporation of the registrant filed on August 2, 2004 (1)
3.4	Bylaws of the registrant (2)
4.1	Specimen common stock certificate (3)
4.2	Second Amended and Restated Investor Rights Agreement dated August 31, 2001, as amended by the Amendments to Second Amended and Restated Investor Rights Agreement dated March 18, 2004, April 16, 2004 and June 12, 2004 (4)
4.3	Rights Agreement by and between the registrant and Wells Fargo Bank, National Association, dated July 7, 2004 (5)
10.1*	2000 Stock Plan and forms of related agreements (6)
10.2*	2004 Equity Incentive Plan (3)
10.2.1*	Form of Stock Option Agreement under 2004 Equity Incentive Plan (7)
10.2.2*	Form of Restricted Stock Agreement under 2004 Equity Incentive Plan (14)
10.3*	2004 Employee Stock Purchase Plan and forms of related agreements (8)
10.4	Form of Indemnity Agreement (6)
10.5	License and Technology Transfer Agreement by and between the registrant and Micron Technology, Inc. dated December 12, 2002 (6)
10.9*	Form of Change-In-Control Agreement between the registrant and each of certain officers thereof (12)
10.10*	Incentive Bonus Plan effective May 5, 2005 (9)
10.11	Form of Master Purchase Agreement by and between the registrant and Cisco Systems, Inc. (10)
10.12	Form of Promissory Note Secured by Pledge of Stock issued to the registrant by certain officers thereof (6)
10.13	Intentionally omitted
10.14	Second Amendment to Lease between Mission West Charleston, LLC and NetLogic Microsystems, Inc. (13)
10.15	Standard Form Lease by and between the registrant and Mission West Properties, L.P. dated May 3, 2004 (2)
10.16*	Employment offer letter, dated April 12, 2000, between the registrant and Ronald Jankov (2)
10.17*	Employment offer letter, dated April 1, 1999, between the registrant and Roland Cortes (4)
10.18*	Employment offer letter, dated March 15, 2002, between the registrant and Ibrahim Korgav, as amended (2)
10.19*	Employment offer letter, dated February 9, 1996, between the registrant and Varadarajan Srinivasan (2)
10.20*	Employment offer letter, dated June 7, 1999, between the registrant and Marcia Zander (2)
10.21*	Employment offer letter, dated December 5, 2003, between the registrant and Donald Witmer (2)
10.22	Description of the registrant's Patent Incentive and Recognition Program (4)

**Table of Contents**

<b>Exhibit</b>	<b>Description</b>
23.1	Consent of PricewaterhouseCoopers LLP, Independent Registered Public Accounting Firm
31.1	Rule 13a-14 certification
31.2	Rule 13a-14 certification
32.1	Section 1350 certification
32.2	Section 1350 certification

- 
- (1) Incorporated by reference to the same-numbered exhibit to the registrant's Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2004, filed with the Securities and Exchange Commission as of August 20, 2004.
  
  - (2) Incorporated by reference to the same-numbered exhibit to Amendment No. 1 to Form S-1 (Registration No. 333-114549) filed by the registrant with the Securities and Exchange Commission as of May 19, 2004.
  
  - (3) Incorporated by reference to the same-numbered exhibit to Amendment No. 3 to Form S-1 (Registration No. 333-114549) filed by the registrant with the Securities and Exchange Commission as of June 21, 2004.
  
  - (4) Incorporated by reference to the same-numbered exhibit to Amendment No. 2 to Form S-1 (Registration No. 333-114549) filed by the registrant with the Securities and Exchange Commission as of June 14, 2004.
  
  - (5) Incorporated by reference to Exhibit (i) to Form 8-A (Registration No. 000-50838) filed by the registrant with the Securities and Exchange Commission as of July 8, 2004.
  
  - (6) Incorporated by reference to the same-numbered exhibit to Form S-1 (Registration No. 333-114549) filed by the registrant with the Securities and Exchange Commission as of April 16, 2004.
  
  - (7) Incorporated by reference to the same-numbered exhibit to the registrant's Quarterly Report on Form 10-Q for the quarterly period ended December 31, 2004, filed with the Securities and Exchange Commission as of November 12, 2004.
  
  - (8) Incorporated by reference to the same-numbered exhibit to Form S-8 (Registration No. 333-117619) filed by the registrant with the Securities and Exchange Commission as of July 23, 2004.
  
  - (9) Incorporated by reference to the same-numbered exhibit to the registrant's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2005, filed with the Securities and Exchange Commission as of May 09, 2005.
  
  - (10) Incorporated by reference to Exhibit 17.1 the same-numbered exhibit to the registrant's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2005, filed with the Securities and Exchange Commission as of November 8, 2005.
  
  - (11) Incorporated by reference to the same-numbered exhibit to the registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission as of February 21, 2005.

## Edgar Filing: NETLOGIC MICROSYSTEMS INC - Form 10-K

- (12) Incorporated by reference to the same-numbered exhibit to the registrant's Annual Report on Form 10-K for the year ended December 31, 2004, filed with the Securities and Exchange Commission as of March 11, 2005.
- (13) Incorporated by reference to the same-numbered exhibit to the registrant's Quarterly Report on Form 10-Q for the quarterly period ended March 30, 2006, filed with the Securities and Exchange Commission as of May 09, 2006.
- (14) Incorporated by reference to the same-numbered exhibit to the registrant's Annual Report on Form 10-K for the year ended December 31, 2005, filed with the Securities and Exchange Commission as of February 28, 2006

\* Indicates management contract or compensatory plan or arrangement.

Confidential treatment has been requested for certain portions of this exhibit.