SOUTHWALL TECHNOLOGIES INC /DE/
Form 10-Q
November 13, 2006

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(MARK ONE)
x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2006
or
o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from to

Commission File Number: 0-15930

SOUTHWALL TECHNOLOGIES INC.
(Exact name of registrant as specified in its charter)

Delaware	**94-2551470**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
3788 Fabian Way, Palo Alto, California	**94303**
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: **(650) 798-1200**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes o No x

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

As of November 1, 2006, there were 26,957,001 shares of the Registrant's Common Stock outstanding.

SOUTHWALL TECHNOLOGIES INC.

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PART I. FINANCIAL INFORMATION

Item 1--Financial Statements:

SOUTHWALL TECHNOLOGIES INC.
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except per share data)

	September 30, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 5,032	$ 6,600
Restricted cash	206	402
Accounts receivable, net of allowance for doubtful accounts of $170 at September 30, 2006 and $208 at December 31, 2005	4,804	6,780
Inventories, net	5,241	5,879
Other current assets	1,492	982
Total current assets	16,775	20,643
Property, plant and equipment, net	16,689	16,857
Restricted cash loans	1,063	995
Other assets	1,161	1,146
Total assets	$ 35,688	$ 39,641
LIABILITIES, PREFERRED STOCK AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Current portion of long term debt	$ 1,030	$ 1,317
Line of credit	2,996	2,996
Accounts payable	1,543	1,402
Accrued compensation	1,109	1,161
Other accrued liabilities	6,300	5,076
Total current liabilities	12,978	11,952
Term debt	8,544	8,790
Government grants advanced	206	396
Other long term liabilities	2,531	2,564
Total liabilities	24,259	23,702
Commitments and contingencies (Note 5)		
Series A 10% cumulative convertible preferred stock, $0.001 par value; $1.00 stated value; 5,000 shares authorized, 4,893 shares outstanding at September 30, 2006 and December 31, 2005, respectively (Liquidation preference: $5,749 and $5,383 at September 30, 2006 and December 31,	4,810	4,810

2005, respectively)				
Stockholders’ equity:				
Common stock, $0.001 par value per share; 50,000 shares authorized, 26,957 shares and 26,793 shares outstanding at September 30, 2006 and December 31, 2005, respectively		27		27
Capital in excess of par value		78,050		77,828
Accumulated other comprehensive income:				
Accumulated translation adjustment		3,236		2,532
Accumulated deficit		(74,694)		(69,258)
Total stockholders’ equity		6,619		11,129
Total liabilities, preferred stock and stockholders’ equity	$	35,688	$	39,641

See accompanying notes to unaudited condensed consolidated financial statements.

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SOUTHWALL TECHNOLOGIES INC.
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)

	Three months ended		Nine months ended	
	September 30, 2006	October 2, 2005	September 30, 2006	October 2, 2005
Net revenues	$ 9,597	$ 12,025	$ 30,968	$ 42,844
Cost of revenues	5,667	7,921	19,301	28,979
Gross profit	3,930	4,104	11,667	13,865
Operating expenses:				
Research and development	1,659	1,334	5,376	3,047
Selling, general and administrative	4,674	2,104	9,761	6,461
Impairment recoveries for long-lived assets, net	(325)	-	(117)	(170)
Restructuring charges	263	-	974	-
Total operating expenses	6,271	3,438	15,994	9,338
Income (loss) from operations	(2,341)	666	(4,327)	4,527
Interest expense, net	(169)	(210)	(550)	(778)
Other income (expenses), net	(18)	9	161	142
Income (loss) before provision for income tax	(2,528)	465	(4,716)	3,891
Provision for income taxes	193	450	719	782
Net income (loss)	(2,721)	15	(5,435)	3,109
Deemed dividend on preferred stock	123	120	367	363
Net income (loss) attributable to common stockholders	$ (2,844)	$ (105)	$ (5,802)	$ 2,746
Net income (loss) per share:				
Basic	$ (0.11)	$ 0.00	$ (0.22)	$ 0.10
Diluted	$ (0.11)	$ 0.00	$ (0.22)	$ 0.09
Shares used in computing net income (loss) per share:				
Basic	26,957	26,788	26,907	26,727

Diluted	26,957	32,720	26,907	32,999

See accompanying notes to unaudited condensed consolidated financial statements.

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SOUTHWALL TECHNOLOGIES INC.
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Nine months ended	
	September 30, 2006	October 2, 2005
Cash flows from operating activities:		
Net income (loss)	$ (5,435)	$ 3,109
Adjustments to reconcile net income (loss) to net cash (used in) provided by operating activities:		
Deferred income tax	54	-
Impairment recoveries from long-lived assets, net	(117)	(170)
Depreciation and amortization	1,836	1,677
Stock compensation	487	45
Change in assets and liabilities:		
Deferred revenues	(26)	(26)
Accounts receivable, net	1,982	1,456
Inventories, net	638	1,112
Accrued restructuring	124	-
Other current and non current assets	(524)	723
Accrued liabilities - deferred rent	(1,192)	-
Accounts payable and accrued liabilities	2,025	(2,627)
Net cash (used in) provided by operating activities	(148)	5,299
Cash flows from investing activities:		
Restricted cash	181	244
Proceeds from sale of property, plant and equipment	422	170
Expenditures for property, plant and equipment	(781)	(535)
Net cash used in investing activities	(178)	(121)
Cash flows from financing activities:		
Repayments under capital lease	-	(5)
Proceeds from exercise of stock options	32	20
Principal payments on borrowings	(1,133)	(1,354)
Payments on line of credit	-	(2,975)
Borrowings on line of credit	-	2,996
Investment credit in Germany	(219)	(30)
Net cash used in financing activities	(1,320)	(1,348)
Effect of foreign exchange rate changes on cash	78	(311)
Net (decrease) increase in cash and cash equivalents	(1,568)	3,519
Cash and cash equivalents, beginning of period	6,600	4,547

Cash and cash equivalents, end of period	$	5,032	$	8,066

See accompanying notes to unaudited condensed consolidated financial statements.

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SOUTHWALL TECHNOLOGIES INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1--Interim Period Reporting:

The accompanying interim condensed consolidated financial statements of Southwall Technologies Inc. (“Southwall” or the “Company”) are unaudited and have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, certain information and footnote disclosure normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. In the opinion of management, the unaudited condensed consolidated financial statements reflect all adjustments, consisting only of normal recurring adjustments, considered necessary to present fairly the financial position, results of operations and cash flows of Southwall and its subsidiaries for all periods presented. The year-end condensed balance sheet data was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. The Company suggests that these condensed consolidated financial statements be read in conjunction with the consolidated financial statements and notes thereto contained in the Company's Form 10-K for the year ended December 31, 2005 filed with the Securities and Exchange Commission on March 29, 2006. The results of operations for the interim periods presented are not necessarily indicative of the operating results of the full year.

In 2005, the Company used a 52-week fiscal year ending on December 31. In 2006, the Company changed to a fiscal calendar year ending on December 31 with fiscal quarters ending on March 31, June 30, and September 30. The third fiscal quarters of 2006 and 2005 ended on September 30, 2006 and October 2, 2005, respectively. The October 2, 2005 quarter included 13 weeks.

Note 2—Inventories, Net:

In January 2006, the Company changed its inventory valuation method from the first-in, first-out method to the average cost method. With the closing of the Company’s Palo Alto, California manufacturing facility and all production now being performed in our German subsidiary’s facility, the use of the average cost method was deemed preferable as it both accommodates our German subsidiary’s statutory reporting requirements and fairly approximates actual costs. In addition, the impact of the change was $0.3 million which the Company considers immaterial.

Inventories are stated at the lower of cost (determined by the average method) or market. Cost includes materials, labor and manufacturing overhead. The Company establishes provisions for excess and obsolete inventories to reduce such inventories to their estimated net realizable value. Such provisions are charged to cost of revenues. At September 30, 2006 and December 31, 2005, inventories consisted of the following (in thousands):

	September 30, 2006	December 31, 2005
Raw materials	$ 3,165	$ 3,482
Work-in-process	791	1,409
Finished goods	1,285	988
	$ 5,241	$ 5,879

Note 3--Net Income (Loss) Per Share:

Basic net income (loss) per share is computed by dividing net income (loss) attributable to common stockholders (numerator) by the weighted average number of common shares outstanding (denominator) for the period. Diluted net income (loss) per share gives effect to all dilutive common shares potentially outstanding during the period, including stock options, warrants to purchase common stock and redeemable convertible preferred stock. Preferred stock dividends are added back to net income attributable to common stockholders since they would not have been accrued if the preferred stock had been converted to common stock at the beginning of the period.

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The Company excludes options from the computation of diluted weighted average shares outstanding if the exercise price of the options is greater than the average market price of the shares because the inclusion of these options would be anti-dilutive to earnings per share. Accordingly, stock options to purchase 5,985,000 and 5,806,963 shares were excluded from the computation of diluted weighted average shares outstanding for the three and nine-month periods ended September 30, 2006, respectively. Stock options to purchase 2,415,005 and 1,737,505 shares at a weighted average price of $2.74 and $3.35 per share, respectively, were excluded from the computation of diluted weighted average shares outstanding for the three and nine-month periods ended October 2, 2005 respectively.

In net loss periods, the basic and diluted weighted average shares of common stock and common stock equivalents are the same because inclusion of common stock equivalents would be anti-dilutive. Accordingly, for the three and nine-month periods ended September 30, 2006, there was no difference between the denominators used for the calculation of basic and diluted net income (loss) per share. Tables summarizing net income/(loss) attributable to common stockholders, for diluted net income (loss) per share, and shares outstanding are shown below (in thousands):

	Three months ended		Nine months ended	
	September 30, 2006	October 2, 2005	September 30, 2006	October 2, 2005
Net income (loss) attributable to common stockholders-basic	$ (2,844)	$ (105)	$ (5,802)	$ 2,746
Add: Deemed dividend on preferred stock	123	120	367	363
Net income (loss) attributable to common stockholders-diluted	$ (2,721)	$ 15	$ (5,435)	$ 3,109
Weighted average common shares outstanding-basic	26,957	26,788	26,907	26,727
Dilutive effect of warrants	-	356	-	357
Dilutive effect of performance shares	-	-	-	50
Dilutive effect of Series A preferred shares	-	4,893	-	4,893
Dilutive effect of stock options	-	683	-	972
Weighted average common shares outstanding - diluted	26,957	32,720	26,907	32,999

Note 4 - Segment Reporting:

Southwall reports segment information using the management approach to determine segment information. The management approach designates the internal organization that is used by management for making operating decisions and assessing performance as the source of its reportable segments. The Company is organized on the basis of products and services. The total net revenues for the automotive glass, electronic display, window film and architectural product lines for the three and nine-month periods ended September 30, 2006 and October 2, 2005 were as follows (in thousands):

	Three months ended		Nine months ended	
	September 30, 2006	October 2, 2005	September 30, 2006	October 2, 2005
Automotive glass	$ 3,019	$ 3,857	$ 9,726	$ 15,179
Electronic display	2,564	3,049	8,325	10,425

Window film		2,424		3,907		8,880		13,034
Architectural		1,590		1,212		4,037		4,206
Total net revenues	$	9,597	$	12,025	$	30,968	$	42,844

The following is a summary of net revenues by geographic area (based on the location of the Company's customers) for the three and nine-month periods ended September 30, 2006 and October 2, 2005, respectively (in thousands):

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	Three months ended September 30, 2006	Three months ended October 2, 2005	Nine months ended September 30, 2006	Nine months ended October 2, 2005
United States	$ 3,231	$ 3,290	$ 10,408	$ 11,001
Japan	2,639	2,822	7,948	9,252
France	855	1,955	2,283	8,448
Pacific Rim	1,916	2,713	6,617	8,798
Germany	667	693	2,612	3,406
Rest of the world	289	552	1,100	1,939
Total net revenues	$ 9,597	$ 12,025	$ 30,968	$ 42,844

Note 5--Commitments and Contingencies:

Commitments

On January 19, 2006, the Company announced its plans to close its Palo Alto manufacturing facility consisting of two buildings. As a result of this decision, the Company is in negotiation with its landlords to decommission and surrender these premises. During the quarter ended September 30, 2006, the Company has accrued $1.7 million for the estimated costs for decommissioning and surrender of these buildings, which may require an adjustment in the fourth quarter. This amount is included in accrued liabilities in the accompanying balance sheet. The Company believes that it can resolve all issues with its landlords and will complete any potential obligations in the fourth quarter of 2006.

On February 19, 2004, the Company entered into the second amendment to the lease for one of the buildings. The amendment reflected a payment schedule for a rent deferral. In January of 2006, the Company paid off approximately $1.2 million in deferred rent. As of September 30, 2006, there was no deferred rent outstanding.

Contingencies

The Company was named as a defendant, along with Bostik, Inc., in an action captioned WASCO Products, Inc. v. Southwall Technologies, Inc. and Bostik, Inc., Civ. Action No. C 02 2926 SBA, which was filed in Federal District Court for the Northern District of California on June 18, 2002. The Company was served with the Complaint in this matter on July 1, 2002. The plaintiff filed the matter as a class action on behalf of all entities and individuals in the United States who manufactured and/or sold and warranted the service life of insulated glass units manufactured between 1989 and 1999, which contained Southwall Heat Mirror film and were sealed with a specific type of sealant manufactured by Bostik, Inc. The plaintiff alleged that the sealant provided by Bostik, Inc. was defective, resulting in elevated warranty replacement claims and costs. The plaintiff asserted claims against the Company for breach of an implied warranty of fitness, misrepresentation, fraudulent concealment, negligence, and negligent interference with prospective economic advantage, breach of contract, unfair business practices and false or misleading business practices. The plaintiff sought recovery on behalf of the class of $100 million for damages allegedly resulting from elevated warranty replacement claims, restitution, injunctive relief, and non-specific compensation for lost profits. By Order entered December 22, 2003, the Court dismissed all claims against the Company. The plaintiff appealed to the Ninth Circuit Court of Appeals. On January 13, 2006, the Court of Appeals affirmed the lower court decision. On January 26, 2006, the plaintiff filed a petition for rehearing with the Ninth Circuit Court of Appeals. In March of 2006, the Ninth Circuit Court of Appeals denied the plaintiff's petition. On May 26, 2006 the plaintiff filed a petition for writ of certiorari to the United States Supreme Court. On October 2, 2006, the Supreme Court denied Wasco’s petition for writ of certiorari.

The insurance carriers in some of the litigation related to alleged product failures and defects in window products manufactured by others in which the Company was a defendant in the past paid the defense and settlement costs related to such litigation. Certain of those insurance carriers reserved their rights to recover a portion or all of such payments from the Company. As a result, those insurance carriers could seek from us up to an aggregate of $2 million plus defense costs, although any such recovery would be restricted to claims that were not covered by the Company's insurance policies. The Company intends to vigorously defend any attempts by these insurance carriers to seek reimbursement. The Company is not able to estimate the likelihood that these insurance carriers will seek to recover any such payments, the amount, if any, they might seek, or the outcome of such attempts.

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On June 13, 2002, Plaintiff Charles Ikekwere ("Plaintiff") filed a Complaint against the Company in the Superior Court of California in and for the County of Santa Clara, Case No. CV808644. Mr. Ikekwere is a former employee of the Company. Plaintiff's Complaint alleged claims for race discrimination, national origin discrimination, retaliation, medical condition discrimination, breach of contract, breach of fiduciary duty, fraud, negligence, intentional infliction of emotional distress, and punitive damages. In October of 2006 the Company settled this suit with the Plaintiff for an amount not considered material to the financial statements of the Company. The Company has accrued for this settlement in its accompanying financial statements as of September 30, 2006.

In addition, the Company is involved in certain other legal actions arising in the ordinary course of business. The Company believes, however, that none of these actions, either individually or in the aggregate, will have a material adverse effect on its business, consolidated financial position, results of operations or cash flows.

Note 6--Stock-Based Compensation:

The Company has a stock-based compensation program that provides its Board of Directors broad discretion in creating employee equity incentives. The Company has granted stock options under various option plans and agreements in the past and currently grants stock options under the 1997 Stock Incentive Plan and the 1998 Stock Option Plan for employees, board members and consultants. The Board of Directors adopted the 1997 and 1998 Stock Option Plans on May 12, 1997 and August 6, 1998, respectively. The Compensation Committee of the Board of Directors administers the plans and agreements. The exercise price of options granted under the 1997 and 1998 plans must be at least 85% of the fair market value of the stock at the date of grant. Options granted under the 1998 plan prior to October 2004 generally vest at a rate of 25% per year, are non-transferable and expire over terms not exceeding ten years from the date of grant or three months after the optionee terminates his relationship with the Company. Options granted under the 1997 plan prior to October 2004 generally vest at a rate of 25% per year, are non-transferable and expire over terms not exceeding ten years from the date of grant or eighteen months after the optionee terminates his relationship with the Company. Grants from and after October 2004 until April 2006 under both plans vest at a rate of 25% after six months and then evenly monthly thereafter for the remaining 42 months. From and after April 2006 grants under both plans vest at a rate of 25% per year on each anniversary of the grant date.

The Company also has an Employee Stock Purchase Plan (ESPP) that allows employees, subject to certain limitations, to purchase shares at 85% of the lower of the fair market value of the Common Stock at the beginning of the six-month offering period, or the last day of the purchase period.

As of September 30, 2006, the Company had approximately 2,158,000 shares of common stock reserved for future issuance under its stock option plans and ESPP.

On January 1, 2006, the Company adopted the provisions of SFAS 123R, "Shared-Based Payment" (SFAS 123R), requiring it to recognize expense related to the fair value of its stock-based compensation awards. The Company elected to use the modified prospective transition method as permitted by SFAS 123R and therefore has not restated its financial results for prior periods. Under this transition method, stock-based compensation expense for the three and nine-month periods ended September 30, 2006 includes compensation expense for all stock-based compensation awards granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123, "Accounting for Stock-Based Compensation" (SFAS 123). Stock-based compensation expense for all stock-based compensation awards granted subsequent to January 1, 2006 was based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R. The Company is recognizing compensation expense for stock option awards on a graded vesting basis over the requisite service period of the award.

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The following table sets forth the total stock-based compensation expense resulting from stock options included in the condensed consolidated statements of operations (in thousands):

	Three months ended September 30, 2006	Nine months ended September 30, 2006
Cost of sales	$ -	$ 11
Research and development	21	109
Selling, general and administrative	56	296
Stock-based compensation expense before income taxes	77	416
Income tax benefit	-	-
Total stock-based compensation expense after income taxes	$ 77	$ 416

There were no cash proceeds from the exercise of stock options for the three months ended September 30, 2006 and October 2, 2005, respectively, and the amounts were immaterial for the nine months ended September 30, 2006 and October 2, 2005, respectively. No income tax benefit was realized from stock option exercises during the three and nine-month periods ended September 30, 2006, and October 2, 2005. In accordance with SFAS 123R, the Company presents excess tax benefits from the exercise of stock options, if any, as financing cash flows rather than operating cash flows.

Prior to the adoption of SFAS 123R, the Company applied SFAS 123, amended by SFAS No. 148, “Accounting for Stock-Based Compensation - Transition and Disclosure” (SFAS 148), which allowed companies to apply the existing accounting rules under APB 25, “Accounting for Stock Issued to Employees” (APB 25), and related Interpretations. In general, as the exercise price of options granted under these plans was equal to the market price of the underlying common stock on the grant date, no stock-based employee compensation cost was recognized in the Company's net income (loss). As required by SFAS 148 prior to the adoption of SFAS 123R, the Company provided pro forma net income (loss) and pro forma net income (loss) per common share disclosures for stock-based awards, as if the fair-value-based method defined in SFAS 123 had been applied.

The following table illustrates the effect on net income after tax and net income per common share as if the Company had applied the fair value recognition provisions of SFAS 123 to stock-based compensation during the three and nine-month periods ended October 2, 2005 (in thousands, except per share amounts):

	Three months ended October 2, 2005	Nine months ended October 2, 2005
Net income attributable to common stockholders:		
As reported	$ (105)	$ 2,746
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	-	45
Deduct: Total stock-based employee compensation determined under fair value based method for all awards, net of related tax effects	(200)	(502)
Pro forma net income attributable to common stockholders	$ (305)	$ 2,289
Net income attributable to common stockholders per share:		

As reported - basic	$	0.00	$	0.10
Pro forma - basic	$	(0.01)	$	0.09
As reported - diluted	$	0.00	$	0.09
Pro forma - diluted	$	(0.01)	$	0.08

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The fair value of stock-based awards was estimated using the Black-Scholes model with the following weighted-average assumptions for the three and nine-month periods ended September 30, 2006, and October 2, 2005, respectively:

	Three months ended		Nine months ended	
	September 30, 2006	October 2, 2005	September 30, 2006	October, 2, 2005
Expected life (in years)	2.59	2.24	2.44	1.94
Risk-free interest rate	4.84%	4.01%	4.87%	3.82%