

NATUS MEDICAL INC
Form 10-Q
November 08, 2007
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended September 30, 2007

.. **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from _____ to _____

Commission file number: 000-33001

NATUS MEDICAL INCORPORATED

(Exact name of registrant as specified in its charter)

| | |
|--|--|
| Delaware (State or other jurisdiction of incorporation or organization) | 77-0154833 (I.R.S. Employer Identification No.) |
| 1501 Industrial Road, San Carlos, CA 94070 (Address of principal executive offices) (Zip Code) | |
| (650) 802-0400 (Registrant's telephone number, including area code) | |

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

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

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

Large Accelerated filer Accelerated filer 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

The number of issued and outstanding shares of the registrant's Common Stock, \$0.001 par value, as of November 1, 2007, was 21,681,494.

Table of Contents

NATUS MEDICAL INCORPORATED

TABLE OF CONTENTS

| | Page No. |
|--|-----------------|
| PART I. <u>FINANCIAL INFORMATION</u> | 3 |
| Item 1. <u>Financial Statements</u> | 3 |
| <u>Condensed Consolidated Balance Sheets as of September 30, 2007 and December 31, 2006 (unaudited)</u> | 3 |
| <u>Condensed Consolidated Statements of Operations for the three and nine months ended September 30, 2007 and 2006 (unaudited)</u> | 4 |
| <u>Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2007 and 2006 (unaudited)</u> | 5 |
| <u>Notes to Condensed Consolidated Financial Statements (unaudited)</u> | 6 |
| Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 14 |
| Item 3. <u>Quantitative and Qualitative Disclosures about Market Risk</u> | 21 |
| Item 4. <u>Controls and Procedures</u> | 22 |
| PART II. <u>OTHER INFORMATION</u> | 23 |
| Item 1A. <u>Risk Factors</u> | 23 |
| Item 6. <u>Exhibits</u> | 32 |
| <u>Signatures</u> | 33 |

Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****NATUS MEDICAL INCORPORATED AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS (unaudited)**

(in thousands, except share amounts)

| | September 30, 2007 | December 31, 2006 |
|--|-----------------------|----------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 22,447 | \$ 15,392 |
| Accounts receivable, net of allowance for doubtful accounts of \$501 and \$552 | 21,783 | 20,347 |
| Inventories | 15,662 | 11,743 |
| Prepaid expenses and other current assets | 2,506 | 1,874 |
| Deferred income taxes | 2,240 | 2,240 |
| Total current assets | 64,638 | 51,596 |
| Property and equipment, net | 8,024 | 7,897 |
| Intangible assets | 35,299 | 37,297 |
| Goodwill | 28,305 | 25,790 |
| Other non-current assets | 549 | 1,583 |
| Total assets | \$ 136,815 | \$ 124,163 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 7,047 | \$ 8,236 |
| Accrued liabilities | 11,829 | 10,470 |
| Deferred revenue | 2,015 | 2,087 |
| Total current liabilities | 20,891 | 20,793 |
| Deferred income taxes | 3,236 | 2,344 |
| Other non-current liabilities | 898 | |
| Total liabilities | 25,025 | 23,137 |
| Stockholders' equity: | | |
| Common Stock, \$0.001 par value, 120,000,000 shares authorized; shares | | |
| issued and outstanding 21,652,990 and 21,391,091 | 136,916 | 133,071 |
| Accumulated deficit | (25,593) | (31,677) |
| Accumulated other comprehensive income (loss) | 467 | (368) |
| Total stockholders' equity | 111,790 | 101,026 |
| Total liabilities and stockholders' equity | \$ 136,815 | \$ 124,163 |

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

Table of Contents

NATUS MEDICAL INCORPORATED AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (unaudited)

(in thousands, except per share amounts)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|--|---------------|------------------------------------|---------------|
| | 2007 | 2006 | 2007 | 2006 |
| Revenue | \$ 28,830 | \$ 21,806 | \$ 84,140 | \$ 61,156 |
| Cost of revenue | 10,129 | 8,299 | 30,454 | 22,809 |
| Gross profit | 18,701 | 13,507 | 53,686 | 38,347 |
| Operating expenses: | | | | |
| Marketing and selling | 6,752 | 4,809 | 20,147 | 14,965 |
| Research and development | 3,879 | 2,438 | 12,076 | 7,387 |
| General and administrative | 3,662 | 2,994 | 11,359 | 7,928 |
| Acquired in-process research and development | | | | 5,900 |
| Total operating expenses | 14,293 | 10,241 | 43,582 | 36,180 |
| Income from operations | 4,408 | 3,266 | 10,104 | 2,167 |
| Other income, net | 213 | 146 | 688 | 16 |
| Income before provision for income tax | 4,621 | 3,412 | 10,792 | 2,183 |
| Provision for income tax | 1,465 | 1,543 | 3,791 | 3,622 |
| Net income (loss) | \$ 3,156 | \$ 1,869 | \$ 7,001 | \$ (1,439) |
| Earnings (loss) per share: | | | | |
| Basic | \$ 0.15 | \$ 0.09 | \$ 0.32 | \$ (0.08) |
| Diluted | \$ 0.14 | \$ 0.09 | \$ 0.31 | \$ (0.08) |
| Weighted average shares used in the calculation of net income (loss) per share: | | | | |
| Basic | 21,646 | 19,749 | 21,568 | 18,949 |
| Diluted | 22,965 | 20,860 | 22,798 | 18,949 |

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

Table of Contents

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

(in thousands)

| | Nine Months Ended September 30, | |
|--|--|------------------|
| | 2007 | 2006 |
| Operating activities: | | |
| Net income (loss) | \$ 7,001 | \$ (1,439) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | |
| Acquired in-process research and development | | 5,900 |
| Depreciation and amortization | 3,481 | 2,914 |
| Accounts receivable reserves | 138 | 60 |
| Inventory reserves | 550 | 262 |
| Warranty reserves | 203 | 479 |
| Share-based compensation | 1,485 | 965 |
| Excess tax benefits on the exercise of options | (922) | (730) |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (1,574) | (3,174) |
| Inventories | (4,469) | (2,286) |
| Prepaid expenses and other assets | 402 | (280) |
| Accounts payable | (1,189) | 434 |
| Accrued liabilities and deferred revenue | 569 | (510) |
| Net cash provided by operating activities | 5,675 | 2,595 |
| Investing activities: | | |
| Acquisition of property and equipment | (1,612) | (2,204) |
| Acquisition of business, net of cash acquired | (204) | (56,478) |
| Deposits and other assets | | 626 |
| Sale of land, net of costs | | 2,492 |
| Sales of short-term investments | | 12,165 |
| Net cash used in investing activities | (1,816) | (43,399) |
| Financing activities: | | |
| Proceeds from stock option exercises and ESPP | 1,439 | 1,078 |
| Excess tax benefits upon the exercise of options | 922 | 730 |
| Proceeds from issuance of common stock, net of issuance cost | | 29,313 |
| Borrowing on credit facility | | 10,000 |
| Payment on borrowings | | (2,875) |
| Net cash provided by financing activities | 2,361 | 38,246 |
| Exchange rate effect on cash and cash equivalents | 835 | (333) |
| Net increase (decrease) in cash and cash equivalents | 7,055 | (2,891) |
| Cash and cash equivalents, beginning of period | 15,392 | 40,046 |
| Cash and cash equivalents, end of period | \$ 22,447 | \$ 37,155 |

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

Supplemental disclosure of cash flow information:

| | | | |
|----------------------------|----|-------|----------|
| Cash paid for interest | \$ | \$ | 498 |
| Cash paid for income taxes | \$ | 1,248 | \$ 1,094 |

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

Table of Contents**NATUS MEDICAL INCORPORATED AND SUBSIDIARIES****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)****1- Basis of Presentation**

The accompanying interim condensed consolidated financial statements of Natus Medical Incorporated (Natus, we, us, or the Company) have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). Except as updated below, the accounting policies followed in the preparation of the interim condensed consolidated financial statements are consistent in all material respects with those presented in Note 1 to the consolidated financial statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2006.

Interim financial reports are prepared in accordance with the rules and regulations of the Securities and Exchange Commission, accordingly they do not include all of the information and notes required by GAAP for annual financial statements. The interim financial information is unaudited, but reflects all normal adjustments that are, in the opinion of management, necessary for the fair presentation of our financial position, results of operations, and cash flows for the interim periods presented. Operating results for the three and nine months ended September 30, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007. A reclassification has been made to the prior period condensed consolidated statement of cash flows to properly reflect the impact on cash flows from operating activities of excess tax benefits on the exercise of options.

The accompanying condensed consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries; intercompany transactions have been eliminated in consolidation.

Comprehensive Income

The following are the components of comprehensive income (loss) (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|---|-------------|--|-------------|
| | 2007 | 2006 | 2007 | 2006 |
| Net income (loss) | \$ 3,156 | \$ 1,869 | \$ 7,001 | \$ (1,439) |
| Unrealized gain on available-for-sale securities | | 3 | | 5 |
| Foreign currency translation adjustment | 375 | (38) | 835 | (333) |
| Comprehensive income (loss) | \$ 3,531 | \$ 1,834 | \$ 7,836 | \$ (1,767) |

Stockholders Equity

The following are the changes in stockholders equity (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|-------------|--|-------------|
| | 2007 | 2006 | 2007 | 2006 |
| Balance, beginning of period | \$ 107,412 | \$ 67,636 | \$ 101,026 | \$ 68,965 |
| Net income (loss) | 3,156 | 1,869 | 7,001 | (1,439) |
| Proceeds from stock option exercises and ESPP | 113 | 37 | 1,439 | 1,078 |
| Proceeds from stock offering | | 29,313 | | 29,313 |
| Share-based compensation expense | 696 | 419 | 1,485 | 965 |
| Tax effect of option exercises | 38 | 45 | 922 | 730 |
| Adoption of FIN 48 | | | (918) | |

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

| | | | | |
|-----------------------------|------------|-----------|------------|-----------|
| Comprehensive income (loss) | 375 | (35) | 835 | (328) |
| Balance, end of period | \$ 111,790 | \$ 99,284 | \$ 111,790 | \$ 99,284 |

-6-

Table of Contents

Recent Accounting Pronouncements

In February 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. (SFAS) 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. SFAS 159 allows entities to voluntarily choose to measure certain financial assets and liabilities at fair value (fair value option). The fair value option may be elected on an instrument-by-instrument basis and is irrevocable, unless a new election date occurs. If the fair value option is elected for an instrument, SFAS 159 specifies that unrealized gains and losses for that instrument shall be reported in earnings at each subsequent reporting date. SFAS 159 is effective January 1, 2008. The Company does not believe the adoption of SFAS 159 will have a material impact on the consolidated financial statements.

In September 2006, the FASB issued SFAS 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 is effective January 1, 2008. The Company does not believe the adoption of SFAS 157 will have a material impact on the consolidated financial statements.

Recently Adopted Standards

In June 2006, the FASB issued Interpretation No. (FIN) 48, *Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109*. FIN 48, establishes a single model to address accounting for uncertain tax positions. FIN 48 clarifies the accounting for income taxes by prescribing a minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure, and transition. The Company adopted FIN 48 on January 1, 2007. For additional information about the adoption of FIN 48, refer to Note 9 *Income Taxes*.

In March 2006, FASB Emerging Issues Task Force (EITF) issued EITF 06-03, *How Sales Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement*. A consensus was reached that entities may adopt a policy of presenting sales taxes in the income statement on either a gross or net basis. If taxes are significant, an entity should disclose its policy of presenting taxes. The guidance is effective for periods beginning after December 15, 2006. The Company presents sales net of sales taxes, and as such, EITF 06-03 had no impact on the Company's method for recording sales taxes in the consolidated financial statements.

2- Business Combinations

Olympic The Company acquired privately-held Olympic Medical Corp. (Olympic) in October 2006, for \$16.9 million cash, including direct costs of the acquisition. In addition, the Company assumed and immediately paid \$2.7 million of Olympic obligations associated with the acquisition. Olympic, based in Seattle, Washington develops and markets medical products used in the neonatal intensive care unit and pediatric department of the hospital, including devices for the detection of neurological function of newborns.

The Company is obligated to make future payments pursuant to an earnout provision of the purchase agreement of up to \$3.1 million over a three-year period based primarily on the achievement of certain revenue targets for the Olympic Cool-Cap System. The Company recorded \$209,000 and \$462,000 of additional purchase consideration during the three and nine months ended September 30, 2007, respectively, pursuant to the earnout provision that was recorded as an increase of goodwill.

The Company made adjustments to the preliminary purchase price allocation of \$12,000 and \$204,000 during the three and nine months ended September 30, 2007, respectively, associated primarily with royalty arrangements and employee compensation. The adjustments resulted in offsetting increases in goodwill.

Deltamed The Company purchased all the common stock of privately held Deltamed S.A. headquartered in Paris, France, and its wholly-owned subsidiaries, Raciar-Alvar, located in Bordeaux, France, and IT-Med, located near Frankfurt, Germany (collectively Deltamed) in September 2006 for approximately \$4.1 million cash including direct costs of the acquisition. Deltamed is a European manufacturer of medical devices used in the detection of neurological dysfunction, epilepsy, and sleep disorders through the use of electroencephalography (EEG) and polysomnography (PSG) technologies. The acquisition adds to the Company's international growth opportunities by broadening its product offerings and leveraging its distribution organization.

Table of Contents

The Company recorded an increase to goodwill of \$328,000 during the three months ended September 30, 2007, associated with an increase in accrued liabilities related to employee severance costs. The severance plan was formulated at the time of the acquisition and was finalized during the three months ended September 30, 2007.

Nascor The Company completed the purchase of certain product rights, manufacturing and distribution contracts, inventory, and intangible assets from Nascor Pty. Ltd. (the Nascor assets) in September 2006 for \$953,000 cash, including direct costs of the acquisition. The Company previously distributed certain Nascor products in the United States and certain other countries. This acquisition provides the Company with worldwide distribution rights and is expected to improve its margins.

The Company is obligated to make future payments pursuant to an earnout provision of the purchase agreement of up to \$675,000 over a three-year period based primarily on the achievement of certain revenue targets. The Company recorded \$307,000 of additional purchase consideration during the nine months ended September 30, 2007 that was recorded as an increase of goodwill.

Bio-logic The Company acquired Bio-logic Systems Corp. (Bio-logic) in January 2006 for \$69.3 million cash including direct costs of the acquisition. The Company made this acquisition to supplement its hearing screening business with the addition of Bio-logic s diagnostic hearing products as well as to open up new market opportunities in the areas of EEG diagnosis and monitoring of neurological dysfunction and sleep disorders.

The Company recorded an increase to goodwill of \$503,000 during the three months ended March 31, 2007 associated with a reduction in deferred tax assets as of the acquisition date related to the Company s research and development tax credit carryforwards, as more fully described in Note 9 *Income Taxes*.

Fischer-Zoth The Company purchased all the common stock of privately held Fischer-Zoth Diagnosesysteme GmbH and affiliated entities (Fischer-Zoth), as well as intangible assets held individually by the owners of Fischer-Zoth in September 2004 for \$5.7 million cash including direct costs of the acquisition. Fischer-Zoth is a manufacturer of otoacoustic emissions (OAE) products used to detect hearing impairment in newborns through adults. The acquisition added to the Company s growth opportunities by broadening its product offerings in hearing screening and supporting expansion into new markets.

The Company recorded \$711,000 of additional purchase consideration during the three months ended September 30, 2007 pursuant to earnout provisions of the purchase agreement associated with sales results of Fischer-Zoth products during the twelve months ended September 30, 2007. The additional purchase consideration was recorded as an increase of goodwill. No further purchase consideration is payable under the terms of the purchase agreement.

Amortization of Intangible Assets Acquired Through Business Combinations

Amortization of intangible assets associated with the Company s business combinations was \$671,000 and \$2.0 million for the three and nine months ended September 30, 2007, respectively, and was \$517,000 and \$1.7 million, for the three and nine months ended September 30, 2006, respectively.

3- Basic and Diluted Net Income (Loss) Per Common Share

Net income (loss) per share is computed in accordance with SFAS 128, *Earnings per Share*. Basic net income (loss) per share is based upon the weighted average number of common shares outstanding during the period. Diluted net income (loss) per share is based upon the weighted average number of common shares outstanding and dilutive common stock equivalents outstanding during the period. Common stock equivalents are options granted and shares of restricted stock issued under the Company s stock awards plans and are calculated under the treasury stock method. Common equivalent shares from unexercised stock options and restricted stock are excluded from the computation when there is a loss as their effect is anti-dilutive or if the exercise price of such options is greater than the average market price of the stock for the period.

For the three and nine months ended September 30, 2007, common stock equivalents of 1,319,344 and 1,229,984 shares, respectively, were included in the weighted average shares outstanding used to calculate diluted income per share. For the three and nine months ended September 30, 2007, common stock equivalents of approximately 506,000 and 38,000 shares, respectively, were excluded from the calculation of diluted income per share because the exercise price of such options was greater than the average market price of the stock for the periods.

Table of Contents

For the three months ended September 30, 2006, common stock equivalents of approximately 1,111,000 shares were included in the weighted average shares outstanding used to calculate diluted income per share. For the three months ended September 30, 2006, common stock equivalents of approximately 174,000 shares were excluded from the calculation of diluted income per share because the exercise price of such options were greater than the average market price of the stock for the period. For the nine months ended September 30, 2006, common stock equivalents of approximately 1,350,000 shares were not used to calculate diluted net loss per share because of their anti-dilutive effect.

4- Inventories

Inventories consisted of (in thousands):

| | September 30, 2007 | December 31, 2006 |
|---------------------------------|-----------------------|----------------------|
| Raw materials and subassemblies | \$ 10,761 | \$ 7,246 |
| Finished goods | 4,901 | 4,497 |
| Total | \$ 15,662 | \$ 11,743 |

5- Property and Equipment

Property and equipment consisted of (in thousands):

| | September 30, 2007 | December 31, 2006 |
|------------------------------------|-----------------------|----------------------|
| Land | \$ 900 | \$ 900 |
| Building | 2,200 | 2,200 |
| Leasehold improvements | 855 | 828 |
| Office furniture and equipment | 4,596 | 3,942 |
| Computer software and hardware | 3,542 | 3,022 |
| Demonstration and loaned equipment | 3,699 | 3,289 |
| | 15,792 | 14,181 |
| Accumulated depreciation | (7,768) | (6,284) |
| Total | \$ 8,024 | \$ 7,897 |

Depreciation and amortization of property and equipment was \$655,000 and \$1.5 million for the three and nine months ended September 30, 2007, respectively, and was \$358,000 and \$1.2 million for the three and nine months ended September 30, 2006, respectively.

6- Reserve For Product Warranties

The Company provides a warranty on all medical device products that is generally one year in length. The Company also sells extended service agreements on its medical device products. Service for domestic customers is provided by Company-owned service centers that perform all service, repair and calibration services. Service for international customers is provided by a combination of Company-owned facilities and third-party vendors on a contract basis.

The Company has accrued a warranty reserve, included in accrued liabilities on the accompanying balance sheets, for the expected future costs of servicing products during the initial warranty period. Amounts are added to the reserve on a per-unit basis by reference to historical

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

experience in honoring warranty obligations. On new products, where the Company does not have historical experience to determine expected warranty cost, additions to the reserve are based on a combination of factors including the standard cost of the product and other judgments, such as the degree to which the product incorporates new technology. The reserve is reduced as warranty costs are incurred.

-9-

Table of Contents

Activity in the warranty reserve during the three and nine months ended September 30, 2007 and 2006 consisted of (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|--------|------------------------------------|--------|
| | 2007 | 2006 | 2007 | 2006 |
| Balance, beginning of period | \$ 848 | \$ 703 | \$ 877 | \$ 248 |
| Warranty accrued for the period | 77 | 179 | 203 | 479 |
| Warranty obligations of acquired business | | 58 | | 364 |
| Repairs for the period | (47) | (74) | (202) | (225) |
| Balance, end of period | \$ 878 | \$ 866 | \$ 878 | \$ 866 |

7- Share-Based Compensation

At September 30, 2007, the Company has the following plans that give rise to share-based compensation: (i) two active stock option plans, the Amended and Restated 2000 Stock Awards Plan and the 2000 Director Stock Option Plan, and (ii) the 2000 Employee Stock Purchase Plan. The terms of awards granted during the nine months ended September 30, 2007 and the Company's methods for determining grant-date fair value of the awards were consistent with those described in our December 31, 2006 annual consolidated financial statements. Following is a recap of activity in our stock option plans during the nine months ended September 30, 2007:

| | Shares | Weighted Average Exercise Price | Weighted- average remaining contractual life (years) | Aggregate intrinsic value (\$,000 s) |
|----------------------------------|-----------|--|--|--|
| Outstanding, beginning of period | 2,910,015 | \$ 7.11 | | |
| Granted | 350,500 | 15.99 | | |
| Exercised | (246,045) | 4.82 | | |
| Cancelled | (73,751) | 13.58 | | |
| Outstanding, end of period | 2,940,719 | \$ 8.21 | 5.95 | \$ 22,867 |
| Exercisable, end of period | 1,932,731 | \$ 6.40 | 5.95 | \$ 18,513 |

During the nine months ended September 30, 2007 the intrinsic value of options exercised amounted to \$3.9 million.

Share-based compensation expense was recognized as follows, (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|----------------------------|-------------------------------------|--------|------------------------------------|--------|
| | 2007 | 2006 | 2007 | 2006 |
| Cost of revenue | \$ 45 | \$ 42 | \$ 109 | \$ 105 |
| Marketing and sales | 129 | 103 | 314 | 265 |
| Research and development | 20 | 39 | 82 | 96 |
| General and administrative | 501 | 235 | 980 | 499 |
| Total | \$ 695 | \$ 419 | \$ 1,485 | \$ 965 |

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

The Company granted 160,350 shares of restricted stock during the nine months ended September 30, 2007 with a weighted average value of \$15.96 per share. Of these shares, 147,850 shares were granted to employees of the Company that vest 50% upon the second anniversary of the grant and 25% upon each of the following two anniversaries, and 12,500 shares were granted to non-employee directors of the Company that vest on the first anniversary of the grant.

At September 30, 2007, 225,684 shares of restricted stock were outstanding with \$2.8 million of total cost related to share based compensation that is expected to be recognized. The total fair value of restricted stock vested during the three and nine months ended September 30, 2007 was \$71,000.

Table of Contents**8- Other income (expense), net**

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---------------------------------------|-------------------------------------|--------|------------------------------------|--------|
| | 2007 | 2006 | 2007 | 2006 |
| Investment income | \$ 182 | \$ 247 | \$ 552 | \$ 491 |
| Interest expense | | (160) | | (498) |
| Foreign currency exchange gain (loss) | | 64 | 14 | (64) |
| Other | 31 | (5) | 122 | 87 |
| Total | \$ 213 | \$ 146 | \$ 688 | \$ 16 |

9- Income Taxes**Provision for Income Tax**

The Company recorded a provision for income tax of \$1.5 million and \$3.8 million for the three and nine months ended September 30, 2007, respectively. The Company's effective tax rate was 32.0% and 35.2%, for the three and nine months ended September 30, 2007, respectively. The company expects that its effective tax rate for the full year 2007 will be approximately 41%. The effective rate through September 30, 2007 is lower than the projected annual effective tax rate because of discrete tax adjustments associated with true-ups of research and development tax credits, tax deductions associated with disqualifying dispositions of stock purchased by the Company's employees under its stock option and stock purchase plans, and the reversal of uncertain tax positions recorded under FIN 48.

The Company's effective tax rate for the three and nine months ended September 30, 2006 was 45.2% and 44.8%, taking into account the \$5.9 million of in-process research and development associated with the January 2006 acquisition of Bio-logic, which is not tax deductible.

Deferred Income Taxes

The Company accounts for income taxes in accordance with SFAS 109, *Accounting for Income Taxes*, which requires that deferred tax assets and liabilities be recognized using enacted tax rates for the effect of temporary differences between the book and tax bases of recorded assets and liabilities. SFAS 109 also requires that deferred tax assets be reduced by a valuation allowance if it is more likely than not that some or all of the deferred tax assets will not be realized. A valuation allowance is not provided for the majority of the Company's deferred tax assets, as the Company believes that it is more likely than not that those deferred tax assets will be fully realized.

During the three months ended March 31, 2007, the Company performed a formal study of its research and development credit carryforwards and determined that the credit carryforwards were overstated by approximately \$503,000 as of December 31, 2005. The Company recorded an adjustment to reduce deferred tax assets by \$503,000 during the three months ended March 31, 2007, offset by an increase in goodwill associated with the acquisition of Bio-logic. The Company recorded no such adjustments during the nine months ended September 30, 2007. At September 30, 2007, the Company's deferred tax assets and liabilities consisted of net current deferred tax assets of \$2.2 million and net non-current deferred tax liabilities of \$3.2 million.

Uncertain Tax Positions

The Company adopted FASB Interpretation No. (FIN) 48, *Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement 109* on January 1, 2007. This interpretation clarifies what criteria must be met prior to recognition of the financial statement benefit, in accordance with SFAS 109, *Accounting for Income Taxes*, of a position taken in a tax return. Prior to adopting FIN 48 the Company's policy was to establish reserves that reflected the probable outcome of known tax contingencies. Favorable resolution was recognized as a reduction to the effective income tax rate in the period of resolution. As compared to a contingency approach, FIN 48 is based on a benefit-recognition model. Provided that the tax position is deemed more likely than not of being sustained, FIN 48 permits a company to recognize the largest amount of tax benefit that is greater than 50 percent likely of being ultimately realized upon settlement. The tax position must be derecognized when it is no longer more likely than not of being sustained.

Table of Contents

The initial application of FIN 48 resulted in a reversal of existing reserves accrued under SFAS 5, *Accounting for Contingencies*, of \$523,000. The total amount of uncertain tax positions recorded on January 1, 2007 was \$1.4 million, exclusive of interest and penalties of \$177,000. Interest and penalties associated with uncertain tax positions are reported as a component of income tax expense. If all of our uncertain tax positions were sustained in our favor, we would recognize an aggregate tax benefit of \$1.4 million in the future periods in which the positions were sustained.

During the three and nine months ended September 30, 2007, the liability related to uncertain tax positions decreased by \$154,000 to \$898,000 based upon the favorable final determination by tax authorities of uncertain tax positions. The Company is currently unaware of any uncertain tax positions that could result in significant additional payments, accruals, or other material deviation in this estimate.

Tax years 2003 through 2006 remain open to examination by the major taxing jurisdictions to which the Company is subject.

10- Segment, Customer and Geographic Information

The Company operates in one reportable segment in which it provides healthcare products used for the screening, detection, treatment, monitoring and tracking of common medical ailments such as hearing impairment, neurological dysfunction, epilepsy, sleep disorders, and newborn care, including jaundice, brain injury, and metabolic testing.

Our end-user customer base includes hospitals, clinics, laboratories, physicians, nurses, audiologists, and governmental agencies. Most of our international sales are to distributors, who in turn, resell our products to end users or sub-distributors.

Revenue and long-lived asset information by geographic region is as follows (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|-------------------|----------------------------------|-----------|---------------------------------|-----------|
| | 2007 | 2006 | 2007 | 2006 |
| Revenue: | | | | |
| United States | \$ 19,738 | \$ 16,298 | \$ 57,122 | \$ 44,938 |
| Foreign countries | 9,092 | 5,508 | 27,018 | 16,218 |
| Totals | \$ 28,830 | \$ 21,806 | \$ 84,140 | \$ 61,156 |

| | September 30, | December 31, |
|--------------------|---------------|--------------|
| | 2007 | 2006 |
| Long lived assets: | | |
| United States | \$ 59,446 | \$ 58,278 |
| Foreign countries | 11,693 | 11,127 |
| Totals | \$ 71,139 | \$ 69,405 |

Long-lived assets include long-term receivables, property and equipment (net), intangible assets, deposits and goodwill. During the three and nine months ended September 30, 2007, no single customer or foreign country contributed to more than 10% of revenue.

11- Subsequent Events

Excel-Tech Ltd. Definitive Agreement

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

On October 9, 2007, the Company signed a definitive agreement to acquire Excel-Tech Ltd. (XLTEK). Canadian based XLTEK develops and markets computer-based electro diagnostic systems and disposable supplies used by medical practitioners to aid in the detection, diagnosis, and monitoring of neurologic and sleep disorders.

-12-

Table of Contents

The acquisition is to be completed by way of a statutory plan of arrangement in Canada under which the Company will acquire all of the outstanding common shares of XLTEK at a cash price of \$3.25 Canadian Dollars (CAD) per share. In addition, each share subject to an XLTEK stock option will convert into an amount equal to the excess of CAD \$3.25 over the exercise price of the option. The transaction is valued at approximately CAD \$62.5 million based on approximately 19.4 million XLTEK shares outstanding on a diluted basis. XLTEK reported revenue of CAD \$32.5 million in the twelve months ended July 31, 2007, cash and cash equivalents of CAD \$16.4 million as of July 31, 2007, and owns the land and building housing their corporate facility in Oakville, a suburb of Toronto. The transaction is expected to close in the last week in November 2007, subject to XLTEK shareholder approval, customary regulatory approvals, and other closing conditions.

Table of Contents

ITEM 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations

Natus®, *AABR®*, *AOAE®*, *ALGO®*, *Cochlea-Scan®*, *Echo-Screen®*, *Ear Couplers®*, *Flexicoupler®*, *MiniMuffs®* and *neoBLUE®* are registered trademarks of Natus Medical Incorporated. *EchoLink*, *Neometrics*, and *Accuscreen* are non-registered trademarks of Natus. *Solutions for Newborn CareSM* is a non-registered service mark of Natus. *Bio-logic®*, *AuDX®*, *ABaer®*, *Ceegrath®*, *MASTER®*, *Navigator®*, *Sleepscan®*, and *Traveler®* are registered trademarks of Bio-logic Systems Corp. *CHAMP* and *Smartpack* are non-registered trademarks of Bio-logic. *Coherence* is a non-registered trademark of Deltamed. *Cool-Cap®* is a registered trademark of Tiara Medical Systems, Inc. *VAC-PAC®* is a registered trademark of Olympic Medical Bili-Lite Pad, *Bili-Lite*, *Billi-Bassinet*, *Bili-Mask*, *Bili-Meter*, *Papoose Boards*, *Circumstraint*, *Warm-Lamp*, and *Warmettes* are non-registered trademarks of Olympic Medical.

Overview

The following Management’s Discussion and Analysis of Financial Condition and Results of Operations (MD&A) supplements the MD&A in the Company’s Annual Report on Form 10-K for the year ended December 31, 2006, and presumes that readers have read or have access to the discussion and analysis in the Company’s Annual Report. Management’s discussion and analysis should be read in conjunction with the Company’s condensed consolidated financial statements and accompanying footnotes, the discussion of certain risks and uncertainties contained in Part II, Item 1A of this report, and the cautionary information regarding forward-looking statements at the end of this section. MD&A includes the following sections:

Our Business. A general description of the Company’s business;

2007 Third Quarter Overview. A summary of key information concerning the financial results for the three months ended September 30, 2007;

Application of Critical Accounting Policies. A discussion of the accounting policies that are most important to the portrayal of the Company’s financial condition and results of operations and that require significant estimates, assumptions, and judgments;

Results of Operations. An analysis of the Company’s results of operations for the periods presented in the financial statements;

Liquidity and Capital Resources. An analysis of capital resources, sources and uses of cash, investing and financing activities, off-balance sheet arrangements, contractual obligations and interest rate hedging;

Recent Accounting Pronouncements. A recap of recently issued accounting pronouncements that may have an impact upon the Company’s results of operations, financial position or cash flows; and

Cautionary Information Regarding Forward-Looking Statements. Cautionary information about forward-looking statements.

Business

Natus is a provider of healthcare products used for the screening, detection, treatment, monitoring and tracking of common medical ailments such as hearing impairment, neurological dysfunction, epilepsy, sleep disorders, and newborn care. We develop, manufacture, and market advanced neurodiagnostic and newborn care products to healthcare professionals in over 80 countries. Our product offerings include computerized neurodiagnostic systems for audiology, neurology, polysomnography, and neonatology, as well as newborn care products such as hearing screening systems, phototherapy devices for the treatment of newborn jaundice, head-cooling products for the treatment of brain injury in newborns, and software systems for managing and tracking disorders and diseases for public health laboratories.

We have completed a number of acquisitions since 2003, consisting of either the purchase of a company, substantially all of the assets of the company, or individual products or product lines. The businesses we have acquired include Neometrics in 2003, Fischer-Zoth in 2004, and

Bio-logic, Deltamed, and Olympic in 2006.

Table of Contents**Product Families**

We categorize our products into the following product families, which are more fully described in our Annual Report on Form 10-K:

Newborn Hearing Screening

Diagnostic Hearing Assessment

Monitoring Systems for Neurology (Electroencephalography or EEG)

Diagnostic Sleep Analysis (Polysomnography or PSG)

Newborn Care, including treatment for Brain Injury and Jaundice

Segment and Geographic Information

We operate in one reportable segment in which we provide healthcare products used for the screening, detection, treatment, monitoring and tracking of common medical ailments such as hearing impairment, neurological dysfunction, epilepsy, sleep disorders, and newborn care, including jaundice, brain injury, and metabolic testing.

Our end-user customer base includes hospitals, clinics, laboratories, physicians, nurses, audiologists, and governmental agencies. Most of our international sales are to distributors who resell our products to end users or sub-distributors.

Information regarding our sales and long-lived assets in the U.S. and in countries outside the U.S. is contained in Note 10 *Segment, Customer and Geographic Information* of our consolidated financial statements included in this report.

Revenue by Product Category

We generate our revenue either from sales of Devices and Systems, which are generally non-recurring, and related Supplies and Services, which are generally recurring. The products that are attributable to these categories are described in our Annual Report on Form 10-K. Revenue from Devices and Systems, and Supplies and Services, as a percent of total revenue for the three and nine months ended September 30, 2007 and 2006 is as follows:

| | Devices and Systems | Supplies and Services | Other | Total |
|----------------------------------|---------------------------|-----------------------------|-------|-------|
| Three months ended September 30, | | | | |
| 2007 | 62% | 37% | 1% | 100% |
| 2006 | 58% | 41% | 1% | 100% |
| Nine months ended September 30, | | | | |
| 2007 | 60% | 38% | 2% | 100% |
| 2006 | 56% | 42% | 2% | 100% |

Sales to no single end-user customer comprised more than 10% of our revenue, and revenue from services was less than 10% of our revenue in all periods presented.

We sell our products through a direct sales force in the United States (U.S.), and to distributors who sell our products in over 80 other countries. We intend to continue expansion of our international operations because we believe international markets represent a significant growth

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

opportunity. International sales made to distributors are characterized by lower gross profits due to the discount from our list prices that the distributors receive. International sales contributed to 31% and 32% of our revenue during the three and nine months ended September 30, 2007, respectively, and 25% and 26% of our revenue during the same periods in 2006. The increase in international sales as a percent of total sales for the three and nine months ended September 30, 2007 was primarily attributable to our acquisition of Deltamed, as all of their sales are in international markets. We anticipate that international revenue will increase as a percent of revenue in the future.

-15-

Table of Contents

2007 Third Quarter Overview

Natus recognized \$28.8 million of revenue during the three months ended September 30, 2007, an increase of 32% or \$7.0 million, from \$21.8 million in the comparable quarter of the previous year. Revenue from sales outside the U.S. increased 65% to \$9.1 million for the 2007 period, compared with \$5.5 million in the third quarter of 2006.

Our gross profit improved to 64.9% for the three months ended September 30, 2007, compared to 61.9% for the third quarter of 2006. For the three months ended September 30, 2007, total operating expenses increased by \$4.1 million, or 40% to \$14.3 million, or 49.6% of total revenue, compared with \$10.2 million, or 46.9% of total revenue for the third quarter of 2006.

The company's effective tax rate for the three and nine months ended September 30, 2007 was 32.0% and 35.2% respectively.

We reported net income of \$3.2 million in the third quarter of 2007, compared to net income of \$1.8 million in the third quarter of 2006.

Subsequent Event

On October 9, 2007, we signed a definitive agreement to acquire Excel-Tech Ltd. (XLTEK). Canadian based XLTEK develops and markets computer-based electro diagnostic systems and disposable supplies used by medical practitioners to aid in the detection, diagnosis, and monitoring of neurologic and sleep disorders.

The acquisition is to be completed by way of a statutory plan of arrangement in Canada under which the Company will acquire all of the outstanding common shares of XLTEK at a cash price of \$3.25 Canadian Dollars (CAD) per share. In addition, each share subject to an XLTEK stock option will convert into an amount equal to the excess of CAD \$3.25 over the exercise price of the option. The transaction is valued at approximately CAD \$62.5 million based on approximately 19.4 million XLTEK shares outstanding on a diluted basis. XLTEK reported revenue of CAD \$32.5 million in the twelve months ended July 31, 2007, cash and cash equivalents of CAD \$16.4 million as of July 31, 2007, and owns the land and building housing their corporate facility in Oakville. The transaction is expected to close in the last week in November 2007, subject to XLTEK shareholder approval, customary regulatory approvals, and other closing conditions.

Application of Critical Accounting Policies

We prepare our financial statements in accordance with accounting principles generally accepted in the United States of America (GAAP). In so doing, we must often make estimates and use assumptions that can be subjective and, consequently, our actual results could differ from those estimates. For any given individual estimate or assumption we make, there may also be other estimates or assumptions that are reasonable.

We believe that the following critical accounting policies require the use of significant estimates, assumptions, and judgments. The use of different estimates, assumptions, and judgments could have a material affect on the reported amounts of assets, liabilities, revenue, expenses, and related disclosures as of the date of the financial statements and during the reporting period.

Revenue recognition

Allowance for doubtful accounts

Inventory is carried at the lower of cost or market value

Carrying value of intangible assets

Liability for product warranties

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

Share-based compensation

These critical accounting policies are described in more detail in our Annual Report on Form 10-K for the year ended December 31, 2006, under Item 7, *Management's Discussion and Analysis of Financial Condition and Results of Operations*. There have been no changes to these policies during the three and nine months ended September 30, 2007.

Table of Contents**Results of Operations**

The following table sets forth, for the periods indicated, selected consolidated statements of operations data as a percentage of total revenue. Our historical operating results are not necessarily indicative of the results for any future period.

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|--------|------------------------------------|--------|
| | 2007 | 2006 | 2007 | 2006 |
| Revenue | 100.0% | 100.0% | 100.0% | 100.0% |
| Cost of revenue | 35.1 | 38.1 | 36.2 | 37.3 |
| Gross profit | 64.9 | 61.9 | 63.8 | 62.7 |
| Operating expenses: | | | | |
| Marketing and selling | 23.4 | 22.1 | 23.9 | 25.4 |
| Research and development | 13.5 | 11.2 | 14.4 | 12.1 |
| General and administrative | 12.7 | 13.7 | 13.5 | 13.0 |
| Acquired in-process research and development | | | | 9.6 |
| Total operating expenses | 49.6 | 47.0 | 51.8 | 59.2 |
| Income from operations | 15.3 | 14.9 | 12.0 | 3.5 |
| Other income (expense), net | 0.7 | 0.7 | 0.8 | |
| Income before provision for income taxes | 16.0 | 15.6 | 12.8 | 3.5 |
| Income tax provision | 5.0 | 7.0 | 4.5 | 5.9 |
| Net income (loss) | 11.0% | 8.6% | 8.3% | (2.4)% |

Three Months Ended September 30, 2007 and 2006

We completed the acquisitions of Deltamed in September 2006 and Olympic in October 2006. Where significant, we have noted the impact of these acquisitions on our results of operations for the three months ended September 30, 2007, as compared to the same period in 2006.

Revenue increased \$7.0 million, or 32%, to \$28.8 million in the three months ended September 30, 2007, from \$21.8 million in the same period in 2006. Olympic and Deltamed contributed to \$6.1 million of the increase.

Revenue from devices and systems increased \$5.3 million, or 42%, to \$17.9 million in the three months ended September 30, 2007, from \$12.6 million reported in 2006. Olympic and Deltamed contributed to \$5.4 million of this increase. Revenue from the Company's Echo Screen and various Olympic devices increased \$6.9 million, which was partially offset by a \$1.8 million decrease in revenue from the Bio-logic EEG and PSG product lines.

Revenue from supplies and services increased \$1.7 million, or 19%, to \$10.6 million in the third quarter of 2007 from \$8.9 million in the 2006 quarter. Olympic and Deltamed contributed to \$693,000 of the increase. Revenue from disposable supplies used with the Company's newborn hearing screening devices increased 9%, to \$7.8 million.

Revenue from sales outside the U.S. was \$9.1 million for the three months ended September 30, 2007, up \$3.6 million, or 65%, from \$5.5 million for the comparable period in 2006. Olympic and Deltamed contributed to \$1.9 million of the increase. Revenue from disposable supplies used with the Company's newborn hearing screening devices sold in international markets increased 23% to \$1.8 million.

Cost of revenue increased \$1.8 million, or 22%, to \$10.1 million in the three months ended September 30, 2007, from \$8.3 million in 2006. Gross profit increased \$5.2 million, or 38%, to \$18.7 million in 2007 from \$13.5 million in 2006. Gross profit as a percentage of revenue was 64.9% and 61.9% for the three months ended September 30, 2007 and 2006, respectively.

Table of Contents

Total operating costs increased by \$4.1 million, or 40%, to \$14.3 million in the three months ended September 30, 2007, compared to \$10.2 million in the same period in 2006. The operations of Olympic and Deltamed contributed to \$2.6 million of the increase in operating costs. The net increase in total operating costs from factors other than the foregoing was primarily attributable to increases in outside consulting costs and employee compensation.

Marketing and selling expenses increased \$1.9 million, or 40%, to \$6.8 million in the three months ended September 30, 2007 from \$4.8 million in the same period in 2006. Olympic and Deltamed contributed to \$1.3 million of the increase, with the remainder coming primarily from increases in sales compensation and travel expenses.

Research and development expenses increased \$1.4 million, or 59%, to \$3.9 million in the three months ended September 30, 2007 from \$2.4 million in the same period in 2006. Olympic and Deltamed contributed to \$764,000 of the increase, with the remainder attributable to employee compensation and outside consulting costs associated with product development of our hearing and EEG product lines.

General and administrative expenses increased \$668,000, or 22%, to \$3.7 million in the three months ended September 30, 2007 from \$3.0 million in the same period in 2006. Olympic and Deltamed contributed to \$490,000 of the increase.

Other income (expense), net consists of investment income and net capital gains and losses from our investment portfolio, interest expense, net currency exchange gains and losses, and other miscellaneous income and expenses. We reported net other income of \$213,000 in the three months ended September 30, 2007, compared to \$146,000 in the same period in 2006. The increase in our other income resulted primarily from a decrease in interest expense related to a note payable that was paid off in November 2006.

We recorded income tax expense of \$1.5 million in the three months ended September 30, 2007 and 2006. Our effective tax rate in the third quarter of 2007 was 32.0% compared to an effective rate of 45.2% in the third quarter of 2006. The effective rate for the three months ended September 30, 2007 is lower than the projected annual effective tax rate because of discrete tax adjustments associated with true-ups of research and development tax credits, tax deductions associated with disqualifying dispositions of stock purchased by the Company's employees under its stock option and stock purchase plans, and the reversal of uncertain tax positions recorded under FIN 48.

Nine Months Ended September 30, 2007 and 2006

Revenue increased \$23.0 million, or 38%, to \$84.1 million in the nine months ended September 30, 2007, from \$61.1 million in the same period in 2006. Olympic and Deltamed contributed to \$20.1 million of the increase.

Revenue from devices and systems increased \$16.5 million, or 48%, to \$50.7 million in the nine months ended September 30, 2007 from \$34.2 million in 2006. Olympic and Deltamed contributed to \$16.0 million of the increase.

Revenue from supplies and services increased \$6.3 million, or 24%, to \$32.2 million for the nine months ended September 30, 2007, from \$26.0 million for the same period in 2006. Olympic and Deltamed contributed to \$4.0 million of the increase. Revenue from disposable supplies used with the Company's newborn hearing screening devices increased 8% to \$22.5 million.

Revenue from sales outside the U.S. was \$27.0 million for the nine months ended September 30, 2007, up \$10.8 million, or 66%, from \$16.2 million for the same period in 2006. Olympic and Deltamed contributed to \$7.0 million of the increase while international sales of the Echo-Screen product increased \$3.3 million. Revenue from sales of supplies used with the Company's newborn hearing screen devices sold in international markets increased 33% to \$5.7 million.

Cost of revenue increased \$7.6 million, or 33%, to \$30.5 million in the nine months ended September 30, 2007, from \$22.8 million in 2006. Gross profit increased \$15.3 million, or 40.0%, to \$53.7 million in 2007 from \$38.3 million in 2006. Gross profit as a percentage of revenue was 63.8% for the nine months ended September 30, 2007, and 62.7% for the nine months ended September 30, 2006.

Total operating costs increased by \$7.4 million, or 20%, to \$43.6 million in the nine months ended September 30, 2007, compared to \$36.2 million in the same period in 2006. Operating costs for the nine months ended September 30, 2006 included a \$5.9 million charge for in-process research and development associated with the acquisition of Bio-logic. Total operating expenses for the nine months ended September 30, 2007, exceeded the 2006 amount exclusive of the IPR&D charge by \$14.7 million. The operations of Olympic and Deltamed contributed to \$8.8 million of the increase in operating costs.

Table of Contents

Marketing and selling expenses increased \$5.2 million, or 35%, to \$20.1 million in the nine months ended September 30, 2007 from \$15.0 million in the same period in 2006. Olympic and Deltamed contributed to \$3.5 million of the increase, with the remainder coming primarily from increases in sales compensation and travel expenses resulting from higher sales.

Research and development expenses increased \$4.7 million, or 63%, to \$12.0 million in the nine months ended September 30, 2007, from \$7.4 million in the same period in 2006. Olympic and Deltamed contributed to \$2.7 million of the increase, while the remainder was attributable to employee compensation and outside consulting costs associated with product development of our hearing and EEG product lines.

General and administrative expenses increased \$3.4 million, or 43%, to \$11.3 million in the nine months ended September 30, 2007 from \$7.9 million in the same period in 2006. Olympic and Deltamed contributed to \$2.0 million of the increase. Outside consulting costs associated with improvements to our information technology infrastructure, tax planning and compliance, and higher compensation costs accounted for the remainder of the cost increases.

During the nine months ended September 30, 2006, the Company recorded a \$5.9 million charge for in-process research and development associated with our acquisition of Bio-logic. There was no such charge in 2007.

Other income (expense), net consists of investment income and net capital gains and losses from our investment portfolio, interest expense, net currency exchange gains and losses, and other miscellaneous income and expenses. We reported net other income of \$688,000 in the nine months ended September 30, 2007, compared to net other income of \$16,000 in the same period in 2006. The increase in our other income resulted primarily from a decrease in interest expense related to a note payable that was paid off in November 2006.

We recorded income tax expense of \$3.8 million in the nine months ended September 30, 2007, compared to \$3.6 million in the nine months ended September 30, 2006. Our effective tax rate was 35.2% in the first nine months of 2007, compared to 44.8% in the first nine months of 2006, taking into account the \$5.9 million of IPR&D expense recorded in the 2006 period, which was on an after-tax basis.

Liquidity and Capital Resources

Liquidity is our ability to generate sufficient cash flows from operating activities to meet our obligations and commitments. In addition, liquidity includes the ability to obtain appropriate financing or to raise capital. Therefore, liquidity cannot be considered separately from capital resources that consist of our current funds and the potential to increase those funds in the future. We plan to use our capital resources in meeting our commitments and in achieving our business objectives.

As of September 30, 2007, we had cash and cash equivalents of \$22.4 million, stockholders' equity of \$111.8 million, and working capital of \$43.7 million, compared with cash and cash equivalents of \$15.4 million, stockholders' equity of \$101.0 million, and working capital of \$30.8 million as of December 31, 2006.

Subject to our completion of the financing for the Excel-Tech acquisition that is further discussed below, we believe that our current cash, cash equivalents, and short-term balances, and any cash generated from operations will be sufficient to meet our ongoing operating and capital requirements for the foreseeable future. We completed three acquisitions in 2006. We intend to continue to acquire additional technologies, products or businesses, and these acquisitions could be significant. These actions would likely affect our future capital requirements and the adequacy of our available funds. We may be required to raise additional funds through public or private financings, strategic relationships, or other arrangements. Any equity financing may be dilutive to stockholders, and debt financing, if available, may involve restrictive covenants and increase our cost of capital.

We currently have a revolving credit facility with Wells Fargo Bank, pursuant to which Wells Fargo has committed to advance to us a maximum of \$15 million. This commitment is evidenced by a revolving credit agreement with Wells Fargo Bank, National Association (Wells Fargo), a credit commitment note in favor of Wells Fargo, and a security agreement in favor of Wells Fargo. At September 30, 2007 there was no outstanding borrowing under the facility.

On October 9, 2007, we signed a definitive agreement to acquire Excel-Tech Ltd. (XLTEK). Canadian based XLTEK develops and markets computer-based electro diagnostic systems and disposable supplies used by medical practitioners to aid in the detection, diagnosis, and monitoring of neurologic and sleep disorders. The transaction is valued at approximately CAD \$62.5 million based on approximately 19.4 million XLTEK shares outstanding on a diluted basis. We expect to complete the acquisition of XLTEK during November 2007. In addition to available cash on hand, we intend to finance a portion of the purchase price through a commitment we have secured from Wells Fargo Bank, subject to customary closing conditions, to provide us an additional \$35 million of new senior term and revolving credit facilities.

Table of Contents

Cash provided by operations increased by \$3.1 million for the nine months ended September 30, 2007 to \$5.7 million, compared to \$2.6 million for the same period in 2006. The sum of our net income and non-cash expense items, such as reserves, depreciation and amortization, and stock based compensation, was approximately \$11.9 million in the 2007 period, compared to \$8.4 million in 2006. The overall impact of changes in certain operating assets and liabilities on total operating cash flows resulted in a cash outflow of \$6.3 million in the 2007 period compared to an outflow of \$5.8 million in 2006.

We used cash for investing purposes of \$1.8 million for the nine months ended September 30, 2007, compared to \$43.4 million in the same period in 2006. We used \$1.6 million and \$2.2 million of cash to acquire property and equipment, during the nine months ended September 30, 2007 and 2006, respectively, including \$409,000 and \$788,000 during the respective periods for demonstration equipment used by our sales personnel. In the nine months ended September 30, 2006, we used \$56.5 million of cash to acquire businesses and generated \$12.2 million of cash through the sale of short-term investments; we had no similar sources or uses of cash for investing purposes in the nine months ended September 30, 2007.

Cash provided by financing activities was \$2.4 million in the nine months ended September 30, 2007, compared to \$38.2 million in the same period in 2006. In the 2006 period, we borrowed \$10 million on a senior secured credit facility with Wells Fargo Bank related to our acquisition of Bio-logic; we had no such borrowing in the 2007 period. We raised cash through sales of our stock pursuant to our stock option plans and our employee stock purchase plan in the amount of \$1.4 million and \$1.1 million in the nine months ended September 30, 2007 and 2006, respectively.

Our future liquidity and capital requirements will depend on numerous factors, including the:

Amount and timing of revenue;

Extent to which our existing and new products gain market acceptance;

Extent to which we make acquisitions;

Cost and timing of product development efforts and the success of these development efforts;

Cost and timing of marketing and selling activities; and

Availability of borrowings under line of credit arrangements and the availability of other means of financing.

Commitments and Contingencies

In the normal course of business, we enter into obligations and commitments that require future contractual payments. The commitments primarily result from firm, noncancellable purchase orders placed with contract vendors that manufacture some of the components used in our medical devices and related disposable supply products, as well as commitments for leased office, manufacturing, and warehouse facilities. There have been no material changes to the table of contractual obligations presented in Item 7 of the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

Under its bylaws, the Company has agreed to indemnify its officers and directors for certain events or occurrences arising as a result of the officer or director serving in such capacity. We have a directors' and officers' liability insurance policy that limits our exposure and enables us to recover a portion of any amounts paid resulting from the indemnification of our directors and officers. In addition, we enter into indemnification agreements with other parties in the ordinary course of business. We believe the estimated fair value of these indemnification agreements is minimal and we have not recorded a liability for these agreements.

Recent Accounting Pronouncements

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

In February 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. (SFAS) 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. SFAS 159 allows entities to voluntarily choose to measure certain financial assets and liabilities at fair value (fair value option). The fair value option may be elected on an instrument-by-instrument basis and is irrevocable, unless a new election date occurs.

-20-

Table of Contents

If the fair value option is elected for an instrument, SFAS 159 specifies that unrealized gains and losses for that instrument shall be reported in earnings at each subsequent reporting date. SFAS 159 is effective January 1, 2008. We do not believe the adoption of SFAS 159 will have a material impact on the consolidated financial statements.

In September 2006, the FASB issued SFAS 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 is effective January 1, 2008. We do not believe the adoption of SFAS 157 will have a material impact on the consolidated financial statements.

Recently Adopted Standards

In June 2006, the FASB issued Interpretation No. (FIN) 48, *Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109*. FIN 48, establishes a single model to address accounting for uncertain tax positions. FIN 48 clarifies the accounting for income taxes by prescribing a minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on derecognizing, measurement, classification, interest and penalties, accounting in interim periods, disclosure, and transition. The Company adopted FIN 48 on January 1, 2007. For additional information about the adoption of FIN 48, refer to Note 9 *Income Taxes*, in Item 1 Financial Statements, contained herein.

In March 2006, FASB Emerging Issues Task Force (EITF) issued EITF 06-03, *How Sales Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement*. A consensus was reached that entities may adopt a policy of presenting sales taxes in the income statement on either a gross or net basis. If taxes are significant, an entity should disclose its policy of presenting taxes. The guidance is effective for periods beginning after December 15, 2006. The Company presents sales net of sales taxes, and as such, EITF 06-03 had no impact on the Company's method for recording sales taxes in the consolidated financial statements.

Cautionary Information Regarding Forward Looking Statements

This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 about Natus Medical Incorporated (Natus, we, us, or our Company). These statements include, among other things, statements concerning our expectations, beliefs, plans, intentions, future operations, financial condition and prospects, and business strategies. The words may, will, continue, estimate, project, intend, believe, expect, anticipate, and other similar expressions generally identify forward-looking statements. Forward-looking statements in this Item 2 include, but are not limited to, statements regarding the following: our expectation regarding growth in international sales, our expectations of future profitability and the generation of positive operating cash flows, the effectiveness and advantages of our products, factors relating to demand for and economic advantages of our products, our plan to develop and acquire additional technologies, products or businesses, our marketing, technology enhancement, and product development strategies, our intention to enter into agreements with group purchasing organizations, our intention to introduce new products and extend existing product lines, our intention to seek strategic partners, our belief that we bring products to market efficiently, development of technologies into successful products, our estimate of the length of time for patents to issue, identity of our competition and factors for competition, our compliance with regulatory requirements and laws; and our plan to seek approval to sell our products in additional countries.

Forward-looking statements are not guarantees of future performance and are subject to substantial risks and uncertainties that could cause the actual results predicted in the forward-looking statements as well as our future financial condition and results of operations to differ materially from our historical results or currently anticipated results. Investors should carefully review the information contained under the caption Risk Factors contained in Part II, Item 1A of this report for a description of risks and uncertainties. All forward-looking statements are based on information available to us on the date hereof, and we assume no obligation to update forward-looking statements.

ITEM 3. Quantitative and Qualitative Disclosures about Market Risk

We develop products in the U.S. and sell those products primarily in the U.S., Europe, Asia, and Oceania. As a result, our financial results could be affected by factors such as changes in foreign currency exchange rates or weak economic conditions in foreign markets. Most of our sales in Europe and Asia are denominated in U.S. dollars. With the acquisition of Fischer-Zoth and Deltamed in September 2004 and September 2006, respectively, a portion of our sales are now denominated in the Euro. With our anticipated closing of the Excel-Tech acquisition in the fourth quarter of

Table of Contents

2007, an increasing amount of our costs will be incurred in currencies other than the U.S. dollar. As our sales in currencies other than the U.S. dollar increase, or as our incurrence of operating costs in currencies other than the U.S. dollar increases, our exposure to foreign currency fluctuations may increase.

In addition, changes in exchange rates also may affect the end-user prices of our products compared to those of our foreign competitors, who may be selling their products based on local currency pricing. These factors may make our products less competitive in some countries.

If the U.S. dollar uniformly increased or decreased in strength by 10% relative to the currencies in which our sales were denominated, our net income would have correspondingly increased or decreased by an immaterial amount for the nine months ended September 30, 2007. Our interest income is sensitive to changes in the general level of interest rates in the U.S., particularly since the majority of our investments are in short-term instruments. However, as substantially all of our short-term investments and cash-equivalents carry a fixed rate of interest, a hypothetical decrease of 10% in market interest rates would not result in a material decrease in interest income earned on investments held at September 30, 2007 through the date of maturity on those investments.

The fair value of our available-for-sale securities and cash equivalents is also sensitive to changes in the general level of interest rates in the U.S., and the fair value of our portfolio will fall if market interest rates increase. However, since we generally have the ability to hold these investments to maturity, these declines in fair value may never be realized. If market interest rates were to increase by 10% from levels at September 30, 2007, the fair value of our portfolio would decline by an immaterial amount.

All of the potential changes noted above are based on sensitivity analyses performed on our financial position as of September 30, 2007. Actual results may differ as our analysis of the effects of changes in interest rates does not account for, among other things, sales of securities prior to maturity and repurchase of replacement securities, the change in mix or quality of the investments in the portfolio, and changes in the relationship between short-term and long-term interest rates.

ITEM 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Under the rules of the Securities and Exchange Commission, disclosure controls and procedures are controls and other procedures that are designed to ensure that information required to be disclosed in the reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in our reports that we file or submit under the Securities Exchange Act of 1934 is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate, to allow timely decisions regarding required disclosure.

Our company's management, with the participation of our chief executive officer and our chief financial officer, has evaluated the effectiveness of our disclosure controls and procedures as of September 30, 2007. Our chief executive officer and chief financial officer determined that as of September 30, 2007 our disclosure controls and procedures were effective for the purpose set forth above.

Changes in Internal Control over Financial Reporting

Under the rules of the Securities and Exchange Commission, internal control over financial reporting is defined as a process designed by, or under the supervision of, an issuer's principal executive and principal financial officers, and effected by the issuer's board of directors, management and other personnel, to provide reasonable assurances regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

There was no change in the Company's internal control over financial reporting that occurred during the fiscal quarter ended September 30, 2007, that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

Table of Contents

PART II. OTHER INFORMATION

ITEM 1A. Risk Factors

We have completed a number of acquisitions and expect to complete additional acquisitions in the future. There are numerous risks associated with acquisitions and we may not achieve the expected benefit of any of our acquisitions

We acquired intellectual property assets and technology patents from Pemstar Pacific Consultants during 2002; we acquired the assets of Neometrics Inc. and affiliated entities during 2003; and we acquired Fischer-Zoth in 2004. In January 2006 we completed the acquisition of Bio-logic. In September and October 2006 we completed the acquisitions Deltamed and Olympic and certain assets from Nascor.

We expect to continue to pursue opportunities to acquire other businesses in future periods. The acquisitions that we have completed may not result in improved operating results for us, or in our achieving a financial condition superior to that which we would have achieved had we not completed them. Our results of operations may be adversely impacted by costs associated to our acquisitions, including one-time charges associated with restructurings or in-process research and development assets. Our acquisitions could fail to produce the benefits that we anticipate, or could have other adverse effects that we currently do not foresee. In addition, some of the assumptions that we have relied upon, such as achievement of operating synergies, may not be realized. In this event, one or more of the acquisitions could result in reduced earnings of Natus as compared to the earnings that would have been achieved by Natus if the acquisition had not occurred.

If we fail to successfully manage the combined operations of Natus and the businesses we have acquired, we may not realize the potential benefits of the acquisition. Our corporate headquarters are located in San Carlos, California. Bio-logic's primary offices are located in Illinois, Olympics' operations are in Washington, Neometrics' operations are located in New York, Deltamed's operations are in France, and Fischer-Zoth's operations are in Germany. The geographical distance between our various facilities may further adversely affect our ability to manage these operations. If we fail to manage these disparate operations effectively, our results of operations could be harmed, employee morale could decline, key employees could leave, and customers could cancel existing orders or choose not to place new ones. In addition, we may not achieve the synergies or other benefits of the acquisition that we anticipate. We may encounter the following difficulties, costs, and delays involved in integrating and managing these operations, and the operations of companies we may acquire:

Failure to realize expected synergies;

Inability to effectively integrate acquired products into our business;

Failure to successfully manage relationships with customers and other important business partners;

Failure of customers to continue using the products and services of the combined company;

Failure to successfully develop the acquired technology into the desired products or enhancements;

Challenges encountered in managing larger, more geographically dispersed operations;

The loss of key employees;

Assumption of unknown liabilities;

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

Failure to understand and compete effectively in markets and with products or technologies with which we have limited previous experience;

Impairment charges incurred to write down the carrying amount of intangible assets, including goodwill, generated as a result of the acquisition;

Decreased liquidity, restrictive bank covenants, and incremental financing costs associated with debt we may incur to complete future acquisitions; and

Diversion of the attention of management from other ongoing business concerns.

Indicative of the types of risks associated with our acquisitions, on October 15, 2007 we received a warning letter from the United States Food and Drug Administration, or the FDA, related to the operations of our Olympic Medical manufacturing facility in Seattle, Washington. The letter focused on process deficiencies that were identified during an

Table of Contents

FDA inspection in April 2007. In November 2007 we instituted a voluntary suspension of operations at the Olympic Medical facility in order to better enable us to continue to address the findings identified by the FDA in its warning letter and expect to successfully respond to these findings. However, we cannot be assured of the ultimate outcome of the FDA's action or that our business will not be adversely affected by these actions. A more comprehensive discussion of risks associated with FDA oversight of our business and our regulatory environment is contained in this Item 1A, Risk Factors.

Our acquisitions of products, technology assets, or businesses may have a negative impact on our business if we fail to achieve the anticipated financial, strategic, and other benefits of acquisitions or investments, and our operating results may suffer because of this.

On October 10, 2007 we announced that we had entered into an agreement to acquire Excel-Tech Ltd. (XLTEK) for cash in a transaction wherein XLTEK would become our wholly owned subsidiary (the acquisition). There are numerous risks associated with our having entered into this agreement

We have entered into an agreement to acquire XLTEK in a transaction that we expect to complete in the fourth quarter of 2007. The acquisition is subject to the satisfaction of closing conditions, including the approval of XLTEK's stockholders, and we cannot assure you that the acquisition will be completed. In the event the acquisition is not completed, we may be subject to many risks, including potential damages to XLTEK and its stockholders, and the costs related to the proposed acquisition, such as legal, accounting and advisory fees, which must be paid even if the acquisition is not completed.

The acquisition could fail to produce the benefits that we anticipate, or could have other adverse effects that we currently do not foresee. In addition, some of the assumptions that we have relied upon, such as the achievement of operating synergies, may not be realized. Additionally, since XLTEK is based in Canada, we will be subject to an increased risk that foreign currency fluctuations could impact the profitability of operations carried out in Canada. Consequently, the acquisition could result in reduced earnings of Natus as compared to the per-share earnings that would have been achieved by Natus if the acquisition had not occurred.

We will use virtually all of our existing cash resources to complete the acquisition, and will also incur indebtedness under a new bank facility for a portion of the purchase price. This usage of cash will have an adverse impact on our liquidity, and will force us to place more reliance on cash flow from operations for our liquidity. If our cash flow from operations is not sufficient for our needs, our business could be adversely affected. If we are required to seek additional external financing to support our need for cash, we may not have access to financing on terms that are acceptable to us, or at all. Alternatively, we may feel compelled to access additional financing on terms that are dilutive to existing holders of our common stock or that include covenants that restrict our business, or both.

We will enter into a senior secured borrowing facility to obtain a portion of the funds needed to complete the acquisition. This loan will cause us to incur interest charges for such time as the loan is outstanding. In addition, the loan will contain various covenants by us that will directly or indirectly restrict our ability to engage in activities that we may otherwise believe to be in the best interest of the company. The loan will be secured by the assets of the company, and this security interest may also negatively effect our flexibility to engage in financing or other activities in future periods.

Future changes in technology or market conditions could result in adjustments to our recorded asset balance for intangible assets, including goodwill, resulting in additional charges that could significantly impact our operating results

At December 31, 2006, we had significant intangible assets, including goodwill and other acquired intangible assets. The determination of related estimated useful lives and whether these assets are impaired involves significant judgments. Our ability to accurately predict future cash flows related to these intangible assets might be hindered by events over which we have no control. Due to the highly competitive nature of the medical device industry, new technologies could impair the value of our intangible assets if they create market conditions that adversely affect the competitiveness of our products. Any future determination that these assets are carried at greater than their fair value could result in additional charges, which could significantly impact our operating results.

Table of Contents

Our acquisitions have included in-process research and development assets (IPR&D assets) for which we hope to generate future cash flows; our results of operations could be adversely affected if we are unable to bring these assets to market

Through our acquisitions of other businesses, we have acquired IPR&D assets from which we hope to generate future cash flows. There is inherent risk in bringing these IPR&D assets to market and we may be unable to realize the full value we have assigned to them. We may be unable to complete the development of these IPR&D assets within a timely manner, or we may encounter technological difficulties that prevent us from completing their development. If we are unable to derive future revenue from our IPR&D assets, our results of operations could be adversely impacted.

We may not be able to preserve the value of our intellectual property because we may not be able to protect access to it or we may lose our intellectual property rights due to expiration of our licenses or patents

If we fail to protect our intellectual property rights or if our intellectual property rights do not adequately cover the technology we employ, other medical device companies could sell products with features similar to ours, and this could reduce demand for our products. We protect our intellectual property through a combination of patent, copyright, trade secret and trademark laws. Despite our efforts to protect our proprietary rights, others may attempt to copy or otherwise improperly obtain and use our products or technology. Policing unauthorized use of our technology is difficult and expensive, and we cannot be certain that the steps we have taken will prevent misappropriation. Our means of protecting our proprietary rights may be inadequate. Enforcing our intellectual property rights could be costly and time consuming and may divert our management's attention and resources. Failing to enforce our intellectual property rights could also result in the loss of those rights.

In the past, we have relied on sales of our newborn screening products for the majority of our revenue, and these products will continue to contribute to a substantial portion of our revenue; a decline in sales of these products could cause our revenue to fall

We expect that the revenue from our newborn hearing screening products will continue to account for a substantial portion of our revenue for at least the next year. Any factors adversely affecting the pricing of our newborn hearing screening devices and related supplies, or demand for our newborn hearing screening products, including physician acceptance or the selection of competing products, could cause our revenue to decline and our business to suffer.

If health care providers are not adequately reimbursed for procedures conducted with our devices or supplies, or if reimbursement policies change adversely, we may not be successful marketing and selling new products or technologies

Clinicians, hospitals, and government agencies are unlikely to purchase our products if clinicians are not adequately reimbursed for the procedures conducted with our devices or supplies. Unless a sufficient amount of conclusive, peer-reviewed clinical data about our products has been published, third-party payors, including insurance companies and government agencies, may refuse to provide reimbursement. Furthermore, even if reimbursement is provided, it may not be adequate to fully compensate the clinicians or hospitals. Some third-party payors may refuse adequate reimbursement unless the patient has demonstrable risk factors. If health care providers cannot obtain sufficient reimbursement from third-party payors for our products or the screenings conducted with our products, we may not achieve significant market acceptance of our products. Acceptance of our products in international markets will depend upon the availability of adequate reimbursement or funding within prevailing health care payment systems. Reimbursement, funding, and health care payment systems vary significantly by country. We may not obtain approvals for reimbursement in a timely manner or at all.

Adverse changes in reimbursement policies in general could harm our business. We are unable to predict changes in the reimbursement methods used by third-party health care payors, particularly those in countries and regions outside the U.S. For example, some payors are moving toward a managed care system in which providers contract to provide comprehensive health care for a fixed cost per person. In a managed care system the cost of our products may not be incorporated into the overall payment for patient care or there may not be adequate reimbursement for our products separate from reimbursement for other procedures.

If we fail in our efforts to educate clinicians, government agency personnel, and third-party payors on the effectiveness of our products, we will not achieve future sales growth

It is critical to the success of our sales efforts that we educate a sufficient number of clinicians, hospital administrators, and government agencies about our products and the costs and benefits of their use. The commercial success of our products depends upon clinician, government agency and other third-party payor confidence in the economic and clinical benefits of our products as well as their comfort with the efficacy, reliability, sensitivity and

Table of Contents

specificity of our products. We believe that clinicians will not use our products unless they determine, based on published peer-reviewed journal articles and experience, that our products provide an accurate and cost-effective alternative to other means of testing or treatment. Our customers may choose to use competitive products, which may be less expensive or may provide faster results than our devices. Clinicians are traditionally slow to adopt new products, testing practices and clinical treatments, partly because of perceived liability risks and the uncertainty of third-party reimbursement. If more clinicians, government agencies and hospital administrators do not adopt our products, we may not maintain profitability. Factors that may adversely affect the medical community's acceptance of our products include:

Publication of clinical study results that demonstrate a lack of efficacy or cost-effectiveness of our products;

Changing governmental and physician group guidelines;

Performance, quality, price, and total cost of ownership of our products relative to other competitive products;

Our ability to maintain and enhance our existing relationships and to form new relationships with leading physicians, physician organizations, hospitals, state laboratory personnel, and third-party payors;

Changes in state and third-party payor reimbursement policies for our products; and

Repeal of laws requiring universal newborn hearing screening and metabolic screening.

Increased sales through group purchasing organizations and sales to high volume purchasers may reduce our average selling prices, which would reduce our revenue and gross profits

We have entered, and may in the future enter, into agreements with customers who purchase high volumes of our products. Our agreements with these customers may contain discounts from our normal selling prices and other special pricing considerations, which could cause our revenue and profits to decline. In addition, we have entered into agreements to sell our products to members of group purchasing organizations, or GPOs, which negotiate volume purchase prices for medical devices and supplies for member hospitals, group practices and other clinics. While we make sales directly to GPO members, the GPO members receive volume discounts from our normal selling price and may receive other special pricing considerations from us. Sales to members of all GPOs accounted for approximately 31%, 28%, and 46% of our total revenue during 2006, 2005, and 2004, respectively, and sales to members of one GPO, Novation LLC, accounted for approximately 12%, 15%, and 20% of our total revenue in 2006, 2005, and 2004, respectively. Other of our existing customers may be members of GPOs with which we do not have agreements. Our sales efforts through GPOs may conflict with our direct sales efforts to our existing customers. If we enter into agreements with new GPOs and some of our existing customers begin purchasing our products through those GPOs, our revenue and profits could decline.

Demand for some of our products depends on the capital spending policies of our customers, and changes in these policies could harm our business

A majority of customers for our products are hospitals, physician offices, and clinics. Many factors, including public policy spending provisions, available resources, and economic cycles have a significant effect on the capital spending policies of these entities and therefore the amount that they can spend on our equipment products. If budget resources limit the capital spending of our customers, they will be unlikely to either purchase any new equipment from us or upgrade to any of our newer equipment products. These factors can have a significant adverse effect on the demand for our products.

Our markets are very competitive and in the United States we sell certain of our products in a mature market

We face competition from other companies in all of our product lines. Our competitors range from small, privately-held companies to multinational corporations and their product offerings vary in scope and breadth. We do not believe that any single competitor is dominant in any of our product lines.

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

The markets for certain of our products in the U.S., including the newborn hearing screening and EEG monitoring markets, are mature and we are unlikely to see significant growth for such products in the U.S. In the U.S. we derive a

-26-

Table of Contents

significant portion of our revenue from the sale of disposable supplies that are used with our hearing screening devices. Because these disposable supply products can generate high margins, we expect that our products, particularly our hearing screening disposable supply products, could face increasing competition, including competitors offering lower prices, which could have an adverse affect on our revenue and margins.

We believe that our primary competitive strengths relate to the functionality and reliability of our products, our recognized brands, and our developed sales channels. Our competitors may have certain competitive advantages, which include the ability to devote greater resources to the development, promotion, and sale of their products. Consequently, we may need to increase our efforts, and related expenses for research and development, marketing, and selling to maintain or improve our position.

We expect recurring sales to our existing customers to generate a majority of our revenue in the future, and if our existing customers do not continue to purchase products from us, our revenue may decline.

Our operating results may decline if we do not succeed in developing, acquiring and marketing additional products or improving our existing products

We intend to develop and acquire additional products and technologies for the screening, detection, treatment, monitoring and tracking of common medical ailments. Developing and acquiring new products, and improving our existing products, to meet the needs of current and future customers require significant investments in research and development. If we fail to successfully sell new products, update our existing products, or timely react to changes in technology, our operating results may decline as our existing products reach the end of their commercial life cycles.

Our business could be harmed if our competitors establish cooperative relationships with large medical device vendors or rapidly acquire market share through industry consolidation

Large medical device vendors may acquire or establish cooperative relationships with our current competitors. We expect that the medical device industry will continue to consolidate. New competitors or alliances among competitors may emerge and rapidly acquire significant market share, which would harm our business and financial prospects.

Our plan to expand our international operations will result in increased costs and is subject to numerous risks; if our efforts are not successful, this could harm our business

We plan to expand our international sales and marketing efforts to increase sales of our products in foreign countries. During the past five years we significantly expanded our distributor network outside the U.S. We may not realize corresponding growth in revenue from growth in international unit sales, due to the lower average selling prices we receive on sales outside of the U.S. Even if we are able to successfully expand our international selling efforts, we cannot be certain that we will be able to create or increase demand for our products outside of the U.S. Our international operations are subject to other risks, which include:

Impact of possible recessions in economies outside the U.S.;

Political and economic instability, including instability related to war and terrorist attacks in the U.S. and abroad;

Contractual provisions governed by foreign law, such as local law rights to sales commissions by terminated distributors;

Decreased health care spending by foreign governments that would reduce international demand for our produces;

A strengthening of the U.S. dollar relative to foreign currencies that could make our products less competitive because most of our international sales are denominated in the U.S. dollar;

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

Greater difficulty in accounts receivable collection and longer collection periods;

Difficulties of staffing and managing foreign operations;

Reduced protection for intellectual property rights in some countries and potentially conflicting intellectual property rights of third parties under the laws of various foreign jurisdictions;

-27-

Table of Contents

Difficulty in obtaining and maintaining foreign regulatory approval; and

Attitudes by clinicians, and cost reimbursement policies, towards use of disposable supplies that are potentially unfavorable to our business.

If guidelines mandating universal newborn hearing screening do not continue to develop in foreign countries and governments do not mandate testing of all newborns as we anticipate, or if those guidelines have a long phase-in period, our revenue may be adversely impacted

We estimate that approximately 95% of the children born in the U.S. are currently being tested for hearing impairment prior to discharge from the hospital. To date, there has been only limited adoption of newborn hearing screening prior to hospital discharge by foreign governments, and the phase-in period generally spans several years. The widespread adoption of guidelines depends, in part, on our ability to educate foreign government agencies, neonatologists, pediatricians, third-party payors, and hospital administrators about the benefits of universal newborn hearing screening as well as the use of our products to perform the screening and monitoring. Our revenue from our newborn hearing screening product lines may not grow if governments do not require universal newborn hearing screening prior to hospital discharge, or if physicians or hospitals are slow to comply with those guidelines, or if governments provide for a lengthy phase-in period for compliance.

Because we rely on distributors or sub-distributors to sell our products in most of our markets outside of the U.S., our revenue could decline if our existing distributors reduce the volume of purchases from us, or if our relationship with any of these distributors is terminated

We currently rely on our distributors or sub-distributors for a majority of our sales outside the U.S. Our reliance on international distributors has increased because of our decisions in 2004 and 2005 to close our Japanese and U.K. sales subsidiaries and sell through distributors in those countries, and because of our acquisition of Fischer-Zoth, which sells its products through distributors in Europe and Asia. We may also sell Deltamed products through distributors in countries outside of France and Germany. Some distributors also assist us with regulatory approvals and education of clinicians and government agencies. We intend to continue our efforts to increase our sales in Europe, Japan, and other developed countries. If we fail to sell our products through our international distributors, we would experience a decline in revenues unless we begin to sell our products directly in those markets. We cannot be certain that we will be able to attract new international distributors to market our products effectively or provide timely and cost-effective customer support and service. Even if we are successful in selling our products through new distributors, the rate of growth of our revenue could be harmed if our existing distributors do not continue to sell a large dollar volume of our products. None of our existing distributors are obligated to continue selling our products.

We may be subject to foreign laws governing our relationships with our international distributors. These laws may require us to make payments to our distributors if we terminate our relationship for any reason, including for cause. Some countries require termination payments under local law or legislation that may supersede our contractual relationship with the distributor. These payments could be equal to a year or more of gross profit on sales of our products that the distributor would have earned. Any required payments would adversely affect our operating results.

Our operating results may suffer because of our exposure to foreign currency exchange rate fluctuations and may require us to engage in foreign currency hedging

Substantially all of our sales contracts to our U.S. based customers provide for payment in U.S. dollars. In addition, sales to most of our international distributors provide for payment in U.S. dollars. However, substantially all of the revenue and expenses of our foreign subsidiaries are denominated in the applicable foreign currency. To date we have not undertaken any foreign currency hedging transactions and, as a result, our future revenue and expenses may be subject to volatility due to exchange rate fluctuations that could result in foreign exchange gains and losses associated with the translation of assets denominated in foreign currencies.

If we lose our relationship with any supplier of key product components or our relationship with a supplier deteriorates or key components are not available in sufficient quantities, our manufacturing could be delayed and our business could suffer

We contract with third parties for the supply of some of the components used in our products and the production of our disposable products. Some of our suppliers are not obligated to continue to supply us. We have relatively few

Table of Contents

sources of supply for some of the components used in our products and in some cases we rely entirely on sole-source suppliers. In addition, the lead-time involved in the manufacturing of some of these components can be lengthy and unpredictable. For example, during 2002, we experienced delays on the part of a supplier to provide us with volume production of our Flexicoupler supplies, and in 2005, we relied on a single supplier of cables used in our ALGO hearing screening devices to help us complete a field replacement program of those cables. If these or other suppliers become unwilling or unable to supply us with components meeting our requirements, it might be difficult to establish additional or replacement suppliers in a timely manner, or at all. This would cause our product sales to be disrupted and our revenue and operating results to suffer.

Replacement or alternative sources might not be readily obtainable due to regulatory requirements and other factors applicable to our manufacturing operations. Incorporation of components from a new supplier into our products may require a new or supplemental filing with applicable regulatory authorities and clearance or approval of the filing before we could resume product sales. This process may take a substantial period of time, and we may not be able to obtain the necessary regulatory clearance or approval. This could create supply disruptions that would harm our product sales and operating results.

We depend upon key employees in a competitive market for skilled personnel, and, without additional employees, we cannot grow or maintain profitability

Our products and technologies are complex, and we depend substantially on the continued service of our senior management team. The loss of any of our key employees could adversely affect our business and slow our product development process. Our future success also will depend, in part, on the continued service of our key management personnel, software engineers, and other research and development employees and our ability to identify, hire, and retain additional personnel, including customer service, marketing, and sales staff. Hiring research and development, engineering, sales, marketing and customer service personnel in our industry is very competitive due to the limited number of people available with the necessary technical skills and understanding of our product technologies. We may be unable to attract and retain personnel necessary for the development of our business.

Our ability to market and sell products depends upon receipt of domestic and foreign regulatory approval of our products and manufacturing operations. Our failure to obtain or maintain regulatory approvals and compliance could negatively affect our business

Our products and manufacturing operations are subject to extensive regulation in the United States by the Food and Drug Administration, or the FDA, and by similar regulatory agencies in many other countries in which we do business. Unless an exemption applies, each medical device that we propose to market in the U.S. must first receive one of the following types of FDA premarket review authorizations:

Clearance via Section 510(k) of the Food, Drug, and Cosmetics Act of 1938, as amended; or

Premarket approval via Section 515 of the Food, Drug, and Cosmetics Act if the FDA has determined that the medical device in question poses a greater risk of injury.

The FDA's Section 510(k) clearance process usually takes from three to 12 months, but can take longer. The process of obtaining premarket approval via Section 515 is much more costly, lengthy and uncertain. Premarket approval generally takes from one to three years, but can take even longer. The FDA may not grant either Section 510(k) clearance or premarket approval for any product we propose to market. Furthermore, if the FDA concludes that future products using our technology do not meet the requirements to obtain Section 510(k) clearance, we would have to seek premarket approval via Section 515. The FDA may impose the more burdensome premarket approval requirement on modifications to our existing products or future products, which in either case could be costly and cause us to divert our attention and resources from the development of new products or the enhancement of existing products.

Domestic regulation of our products and manufacturing operations, other than that which is administered by the FDA, includes the Environmental Protection Act, the Occupational Safety and Health Act, and state and local counterparts to these acts.

Table of Contents

Our business could be harmed if the FDA determines that we have failed to substantially comply with applicable regulations or we do not pass an inspection

We are subject to market surveillance by the FDA concerning compliance with pertinent regulatory requirements. If the FDA finds that we have failed to comply with these requirements, the Agency can institute a wide variety of enforcement actions, ranging from a public warning letter to more severe sanctions such as:

Fines, injunctions and civil penalties;

Recall or seizure of our products;

Issuance of public notices or warnings;

Imposition of operating restrictions, partial suspension, or total shutdown of production;

Refusal of our requests for Section 510(k) clearance or premarket approval of new products;

Withdrawal of Section 510(k) clearance or premarket approvals already granted; or

Criminal prosecution.

Our facilities are subject to inspection by the FDA. Upon completing these inspections, the FDA may take a variety of actions, including issuing observations on Form FDA-483 or issuing a warning letter. The issuance of a warning letter by the FDA could result in regulatory action being initiated by the FDA without further notice, and these actions could include seizure, injunction, and/or civil money penalties. In the past, we have cooperated fully with the FDA in their inspections and have responded to their observations on Form 483 in the normal course of business. To date, these inspections and observations have not resulted in an adverse impact on the operations of the Company; however, we cannot be assured of this outcome in the future.

We have received clearance from the FDA to market a new product that will potentially expose us to greater products liability exposure and FDA regulation

In December 2006 we received clearance from the FDA to market the Olympic Cool-Cap, a product designed to lower the cerebral temperature of term newborns born with a particular medical condition. However, in transitioning production of the Olympic Cool-Cap from clinical units to commercial units, we updated several of its components and are seeking FDA approval to adopt these changes. This product is a Class III minimally invasive medical device, and as such, we may be subject to an increased product liability risk relative to our other, Class I and Class II non-invasive products. In addition, this type of product is subject to greater FDA oversight than our other products and there is greater risk that sales of the product could be interrupted, due to the premarket approval processes of the FDA and other regulatory bodies.

Our business may suffer if we are required to revise our labeling or promotional materials, or the FDA takes an enforcement action against us for off-label uses

We are prohibited by the FDA from promoting or advertising our medical device products for uses not within the scope of our clearances or approvals, or from making unsupported promotional claims about the benefits of our products. If the FDA determines that our claims are outside the scope of our clearances, or are unsupported, it could require us to revise our promotional claims or take enforcement action against us. If we were subject to such an action by the FDA, our sales could be delayed, our revenue could decline, and our reputation among clinicians could be harmed.

If we, or our suppliers, fail to comply with applicable regulations, sales of our products could be delayed and our revenue could be harmed

Every manufacturer of a finished medical device, including Natus and some of our contract manufacturers and suppliers, is required to demonstrate and maintain compliance with the FDA's quality system regulation and comparable regulations of states and other countries. The FDA enforces the quality system regulation through periodic inspections. We, or our contract manufacturers, may fail to pass future quality system regulation inspections. If we, or our contract manufacturers, fail one of these inspections in the future, our operations could be disrupted and our manufacturing and sales delayed significantly until we demonstrate adequate compliance. If we or our contract manufacturers fail to take adequate corrective action in a timely fashion in response to a quality system regulation inspection, the FDA could shut down our or our contract manufacturers' manufacturing operations or require us, among other things, to recall our products, either of which would harm our business.

Table of Contents

Our operating results would suffer if we were subject to a protracted infringement claim

The medical technology industry has, in the past, been characterized by a substantial amount of litigation and related administrative proceedings regarding patents and intellectual property rights. We expect that medical screening and diagnostic products may become increasingly subject to third-party infringement claims as the number of competitors in our industry segment grows and the functionality of products in different industry segments overlap. Third parties such as individuals, educational institutions or other medical device companies may claim that we infringe their intellectual property rights. Any claims, with or without merit, could have any of the following negative consequences:

Result in costly litigation and damage awards;

Divert our management's attention and resources;

Cause product shipment delays or suspensions; or

Require us to seek to enter into royalty or licensing agreements.

A successful claim of infringement against us could result in a substantial damage award and materially harm our financial condition. Our failure or inability to license the infringed or similar technology, or design and build non-infringing products, could prevent us from selling our products and adversely affect our business and financial results.

We license intellectual property rights from third parties and would be adversely affected if our licensors do not appropriately defend their proprietary rights or if we breach any of the agreements under which we license commercialization rights to products or technology from others

We license rights from third parties for products and technology that are important to our business. If our licensors are unsuccessful in asserting and defending their proprietary rights, including patent rights and trade secrets, we may lose the competitive advantages we have through selling products that we license from third parties. Additionally, if it is found that our licensors infringe on the proprietary rights of others, we may be prohibited from marketing our existing products that incorporate those proprietary rights. Under our licenses, we are subject to commercialization and development, sublicensing, royalty, insurance and other obligations. If we fail to comply with any of these requirements, or otherwise breach a license agreement, the licensor may have the right to terminate the license in whole or to terminate the exclusive nature of the license.

Product liability suits against us could result in expensive and time consuming litigation, payment of substantial damages, and an increase in our insurance rates

The sale and use of our products could lead to the filing of a product liability claim by someone claiming to have been injured using one of our products or claiming that one of our products failed to perform properly. A product liability claim could result in substantial damages and be costly and time consuming to defend, either of which could materially harm our business reputation or financial condition. Our product liability insurance may not protect our assets from the financial impact of defending a product liability claim. Any product liability claim brought against us, with or without merit, could increase our product liability insurance rates or prevent us from securing any coverage in the future.

We have a history of losses, variable quarterly results, and seasonality in the sale of our products, and may not maintain profitability in the future

Since our inception, we have incurred significant net losses, including net losses for the years 2004 and 2003, and we may incur net losses in the future. As of December 31, 2006, we had an accumulated deficit of approximately \$31.7 million. Additionally, our revenue and operating results have varied significantly from quarter to quarter in the past and may continue to fluctuate in the future. The following are among the factors that could cause our revenue, operating results and margins to fluctuate significantly from quarter to quarter:

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

Budgeting cycle of our customers, particularly government entities;

Size and timing of specific sales, such as large purchases of our devices and systems or our supplies and services by government agencies or hospital systems;

-31-

Table of Contents

Trade-in allowances or other concessions in connection with the introduction of new products or improvements to existing products;

Length and unpredictability of our sales cycle; and

Market changes caused by rapidly evolving technology.

In addition, we experience seasonality in our revenue. For example, our sales typically decline from our fourth fiscal quarter to our first fiscal quarter, due to patterns in the capital budgeting and purchasing cycles of our current and prospective customers, many of which are government agencies. We may also experience declining sales in the third fiscal quarter due to summer holiday and vacation schedules. We anticipate that we will continue to experience these seasonal fluctuations, which may lead to fluctuations in our quarterly operating results. We believe that you should not rely on our results of operations for interim periods as an indication of our expected results in any future period.

We anticipate that it will become increasingly difficult for us to manage our expenses as we:

Continue to invest in research and development to enhance our product lines, including products and technologies we have gained through our acquisitions;

Develop additional applications for our current technology;

Increase our marketing and selling activities, particularly outside the U.S.; and

Develop additional infrastructure and hire required management and other employees to keep pace with our growth.

As a result of these factors, we may need to generate proportionately higher revenue to maintain profitability. We cannot be certain that we will be able to sustain profitability in the future.

We could lose the ability to use net operating loss and credit carryforwards, which may adversely affect our financial results

As of December 31, 2006, we had total federal net operating loss carryforwards of approximately \$11.2 million and credit carryforwards of approximately \$1.2 million available to reduce future taxable income. These net operating loss and credit carryforwards, if not utilized to offset taxable income in future periods, will expire in various amounts beginning in 2012. In addition, the net operating loss and credit carryforwards are subject to examination by the Internal Revenue Service (IRS), and are thus subject to adjustment or disallowance resulting from any such IRS examination. If we are unable to fully utilize our net operating loss carryforwards, our future tax payments could be higher and our financial condition may suffer.

ITEM 6. Exhibits

(a) Exhibits

| Exhibit | | Incorporated By Reference | | | |
|---------|--|---------------------------|-------------|----------|-----------|
| No. | Exhibit | Filing | Exhibit No. | File No. | File Date |
| 31.1 | Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 | | | | |

Edgar Filing: NATUS MEDICAL INC - Form 10-Q

- 31.2 Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification of Principal Executive Officer and Principal Financial Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

-32-

Table of Contents

SIGNATURES

Pursuant to the requirements 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.

NATUS MEDICAL INCORPORATED

Dated: November 8, 2007

By: **/s/ James B. Hawkins
James B. Hawkins
President and Chief Executive Officer

(Principal Executive Officer)**

Dated: November 8, 2007

By: **/s/ Steven J. Murphy
Steven J. Murphy,
Vice President Finance and

Chief Financial Officer

(Principal Financial and

Accounting Officer)**

Table of Contents

NATUS MEDICAL INCORPORATED

INDEX TO EXHIBITS

| Exhibit | | Incorporated By Reference | | | |
|----------------|--|----------------------------------|--------------------|-----------------|------------------|
| No. | Exhibit | Filing | Exhibit No. | File No. | File Date |
| 31.1 | Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 | | | | |
| 31.2 | Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 | | | | |
| 32.1 | Certification of Principal Executive Officer and Principal Financial Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | | | | |