

REALNETWORKS INC  
Form 10-Q  
May 07, 2015

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

FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended March 31, 2015

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_  
Commission file number 0-23137

RealNetworks, Inc.  
(Exact name of registrant as specified in its charter)

Washington 91-1628146  
(State of incorporation) (I.R.S. Employer Identification Number)

1501 First Avenue South, Suite 600 98134  
Seattle, Washington  
(Address of principal executive offices) (Zip Code)

(206) 674-2700  
(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 such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

Large accelerated filer  Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company

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

The number of shares of the registrant's Common Stock outstanding as of April 30, 2015 was 36,106,018.

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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## REALNETWORKS, INC. AND SUBSIDIARIES

## UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except per share data)

	March 31, 2015	December 31, 2014
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 102,994	\$ 103,253
Short-term investments	31,394	58,453
Trade accounts receivable, net of allowances	15,510	15,257
Deferred costs, current portion	314	702
Deferred tax assets, net, current portion	651	652
Prepaid expenses and other current assets	8,278	8,980
Total current assets	159,141	187,297
Equipment, software, and leasehold improvements, at cost:		
Equipment and software	71,840	74,100
Leasehold improvements	3,395	3,590
Total equipment, software, and leasehold improvements, at cost	75,235	77,690
Less accumulated depreciation and amortization	60,610	61,442
Net equipment, software, and leasehold improvements	14,625	16,248
Restricted cash equivalents and investments	3,000	3,000
Investment in and advances to Rhapsody	10,743	10,000
Available for sale securities	2,648	2,676
Other assets	3,761	2,299
Deferred costs, non-current portion	263	316
Deferred tax assets, net, non-current portion	899	999
Other intangible assets, net	9,700	10,109
Goodwill	16,839	17,355
Total assets	\$ 221,619	\$ 250,299
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 18,315	\$ 18,653
Accrued and other current liabilities	22,052	25,286
Deferred tax liabilities, net, current portion	1,576	1,628
Deferred revenue, current portion	3,857	5,301
Total current liabilities	45,800	50,868
Deferred revenue, non-current portion	173	235
Deferred rent	1,207	1,215
Deferred tax liabilities, net, non-current portion	690	702
Other long-term liabilities	448	81
Total liabilities	48,318	53,101
Commitments and contingencies		
Shareholders' equity:		
Preferred stock, \$0.001 par value, no shares issued and outstanding:		
Series A: authorized 200 shares	—	—
Undesignated series: authorized 59,800 shares	—	—

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Common stock, \$0.001 par value authorized 250,000 shares; issued and outstanding 36,106 shares in 2015 and 36,099 shares in 2014	36	36
Additional paid-in capital	621,007	617,756
Accumulated other comprehensive loss	(57,931	) (55,252 )
Retained deficit	(389,811	) (365,342 )
Total shareholders' equity	173,301	197,198
Total liabilities and shareholders' equity	\$221,619	\$250,299

See accompanying notes to unaudited condensed consolidated financial statements.

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REALNETWORKS, INC. AND SUBSIDIARIES  
 UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
 AND COMPREHENSIVE INCOME (LOSS)

(In thousands, except per share data)

	Quarters Ended	
	March 31,	
	2015	2014
Net revenue (A)	\$30,597	\$45,724
Cost of revenue (B)	16,547	18,786
Extinguishment of liability (See Note 9)	—	(10,580 )
Gross profit	14,050	37,518
Operating expenses:		
Research and development	12,379	14,059
Sales and marketing	12,837	21,723
General and administrative	7,283	9,317
Restructuring and other charges	485	1,216
Lease exit and related charges	78	79
Total operating expenses	33,062	46,394
Operating income (loss)	(19,012 )	(8,876 )
Other income (expenses):		
Interest income, net	200	136
Gain (loss) on sale of available for sale securities, net	299	2,371
Equity in net loss of Rhapsody	(6,180 )	(838 )
Other income (expense), net	443	(77 )
Total other income (expenses), net	(5,238 )	1,592
Income (loss) before income taxes	(24,250 )	(7,284 )
Income tax expense (benefit)	219	486
Net income (loss)	\$(24,469 )	\$(7,770 )
Basic net income (loss) per share	\$(0.68 )	\$(0.22 )
Diluted net income (loss) per share	\$(0.68 )	\$(0.22 )
Shares used to compute basic net income (loss) per share	36,104	35,840
Shares used to compute diluted net income (loss) per share	36,104	35,840
Comprehensive income (loss):		
Unrealized investment holding gains (losses), net of reclassification adjustments	\$(94 )	\$(3,575 )
Foreign currency translation adjustments, net of reclassification adjustments	(2,585 )	(25 )
Total other comprehensive income (loss)	(2,679 )	(3,600 )
Net income (loss)	(24,469 )	(7,770 )
Comprehensive income (loss)	\$(27,148 )	\$(11,370 )
(A) Components of net revenue:		
License fees	\$7,289	\$8,579
Service revenue	23,308	37,145
	\$30,597	\$45,724
(B) Components of cost of revenue:		
License fees	\$1,743	\$2,212
Service revenue	14,804	16,574
	\$16,547	\$18,786

See accompanying notes to unaudited condensed consolidated financial statements.



REALNETWORKS, INC. AND SUBSIDIARIES  
 UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
 (In thousands)

	Quarters Ended March 31,	
	2015	2014
Cash flows from operating activities:		
Net income (loss)	\$(24,469	) \$(7,770
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	2,503	2,983
Stock-based compensation	1,329	1,337
Equity in net loss of Rhapsody	6,180	838
Deferred income taxes, net	(77	) 10
Gain on sale of available for sale securities	(299	) (2,371
Realized translation gain	—	(48
Extinguishment of liability	—	(10,580
Fair value of warrants received	(1,155	) —
Net change in certain operating assets and liabilities:		
Trade accounts receivable	(654	) (818
Prepaid expenses and other assets	621	(1,426
Accounts payable	(62	) 1,435
Accrued and other liabilities	(4,011	) (2,100
Net cash provided by (used in) operating activities	(20,094	) (18,510
Cash flows from investing activities:		
Purchases of equipment, software, and leasehold improvements	(306	) (998
Proceeds from sale of available for sale securities	352	2,754
Purchases of short-term investments	(6,018	) (29,030
Proceeds from sales and maturities of short-term investments	33,077	25,589
Advance to Rhapsody	(5,000	) —
Net cash provided by (used in) investing activities	22,105	(1,685
Cash flows from financing activities:		
Proceeds from issuance of common stock (stock options and stock purchase plan)	6	210
Tax payments from shares withheld upon vesting of restricted stock	(7	) (60
Net cash provided by (used in) financing activities	(1	) 150
Effect of exchange rate changes on cash and cash equivalents	(2,269	) 86
Net increase (decrease) in cash and cash equivalents	(259	) (19,959
Cash and cash equivalents, beginning of period	103,253	151,235
Cash and cash equivalents, end of period	\$ 102,994	\$ 131,276
Supplemental disclosure of cash flow information:		
Cash received from income tax refunds	\$ 229	\$ 86
Cash paid for income taxes	\$ 229	\$ 621
Non-cash investing activities:		
Increase (decrease) in accrued purchases of equipment, software, and leasehold improvements	\$ 49	\$ 3
Acquisition of intangible assets	\$ 473	\$ —
See accompanying notes to unaudited condensed consolidated financial statements.		



REALNETWORKS, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Quarters Ended March 31, 2015 and 2014

Note 1 Description of Business and Summary of Significant Accounting Policies

Description of Business. RealNetworks, Inc. and subsidiaries is a leading global provider of network-delivered digital media applications and services that make it easy to manage, play and share digital media. The Company also develops and markets software products and services that enable the creation, distribution and consumption of digital media, including audio and video.

Inherent in our business are various risks and uncertainties, including a limited history of certain of our product and service offerings. RealNetworks' success will depend on the acceptance of our technology, products and services and the ability to generate related revenue.

In this Quarterly Report on Form 10-Q (10-Q or Report), RealNetworks, Inc. and Subsidiaries is referred to as "RealNetworks", the "Company", "we", "us", or "our". "RealPlayer," and other trademarks of ours appearing in this report are our property.

Basis of Presentation. The unaudited condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. Intercompany balances and transactions have been eliminated in consolidation.

The unaudited condensed consolidated financial statements reflect all adjustments, consisting only of normal, recurring adjustments that, in the opinion of management, are necessary for a fair presentation of the results of operations for the periods presented. Operating results for the quarter ended March 31, 2015 are not necessarily indicative of the results that may be expected for any subsequent period or for the year ending December 31, 2015.

Certain information and disclosures normally included in financial statements prepared in conformity with accounting principles generally accepted in the United States of America (GAAP) have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission (SEC).

These unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended December 31, 2014 (the 10-K).

Use of Estimates. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Note 2 Recent Accounting Pronouncements

In August 2014, the Financial Accounting Standards Board (FASB) issued a new standard, "Disclosure of Uncertainties About an Entity's Ability to Continue as a Going Concern". This standard provides guidance around management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosures in certain circumstances. The new guidance is effective for all annual and interim periods ending after December 15, 2016. We are currently evaluating the impact, if any, the adoption of this standard will have on our consolidated financial statements.

In May 2014, the FASB issued new revenue recognition guidance. The guidance will require an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The new guidance will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective. The new guidance is effective for us on January 1, 2017; however, the FASB is in the process of reconsidering and potentially deferring the effective date by one year. The guidance permits the use of either the retrospective or cumulative effect transition method. We are evaluating the effect that the guidance will have on our consolidated financial statements and related disclosures. We have not yet selected a transition method nor determined the effect of the standard on our ongoing financial reporting.

There have been no other recent accounting pronouncements or changes in accounting pronouncements to be implemented that are of significance or potential significance to RealNetworks.



Note 3 Stock-Based Compensation

Total stock-based compensation expense recognized in our unaudited condensed consolidated statements of operations and comprehensive income (loss) includes amounts related to stock options, restricted stock units, and employee stock purchase plans and was as follows (in thousands):

	Quarters Ended	
	March 31,	
	2015	2014
Total stock-based compensation expense	\$1,329	\$1,337

The fair value of options granted determined using the Black-Scholes model used the following weighted-average assumptions:

	Quarters Ended		
	March 31,		
	2015	2014	
Expected dividend yield	0	% 0	%
Risk-free interest rate	1.20	% 1.10	%
Expected life (years)	4.2	3.8	
Volatility	37	% 40	%

The total stock-based compensation amounts for 2015 and 2014 disclosed above are recorded in their respective line items within operating expenses in the unaudited condensed consolidated statements of operations and comprehensive income (loss). As of March 31, 2015, \$13.5 million of total unrecognized compensation cost, net of estimated forfeitures, related to stock awards. The unrecognized compensation cost is expected to be recognized over a weighted-average period of approximately 3 years.

Note 4 Rhapsody Joint Venture

As of March 31, 2015 we owned approximately 43% of the issued and outstanding stock of Rhapsody and account for our investment using the equity method of accounting.

Rhapsody was initially formed in 2007 as a joint venture between RealNetworks and MTV Networks, a division of Viacom International Inc. (MTVN), to own and operate a business-to-consumer digital audio music service known as Rhapsody.

Following certain restructuring transactions effective March 31, 2010, we began accounting for our investment in Rhapsody using the equity method of accounting. As part of the 2010 restructuring transactions, RealNetworks contributed \$18.0 million in cash, the Rhapsody brand and certain other assets, including content licenses, in exchange for shares of convertible preferred stock of Rhapsody, carrying a \$10.0 million preference upon certain liquidation events.

We recorded our share of losses of Rhapsody of \$6.2 million and \$0.8 million for the quarters ended March 31, 2015 and 2014, respectively. Because of the \$10.0 million liquidation preference on the preferred stock we hold in Rhapsody, under the equity method of accounting we do not record any share of Rhapsody losses that would reduce our carrying value of Rhapsody, which is impacted by Rhapsody equity transactions, below \$10.0 million, unless Rhapsody's book value is reduced below \$10.0 million. Because Rhapsody's book value declined below \$10.0 million in the first quarter of 2015, we reduced our investment in Rhapsody below the \$10.0 million liquidation preference and recorded \$6.2 million of our share of losses of Rhapsody. On the unaudited condensed consolidated balance sheet, Investment in and advances to Rhapsody of \$10.7 million includes the \$5.7 million carrying value of our Rhapsody equity investment.

In March 2015, RealNetworks extended a \$5.0 million loan to Rhapsody, as did the other 43% owner of Rhapsody. The loans have maturity dates of June 2018 or earlier if Rhapsody's certain loan to an external strategic partner is repaid on its due date of June 2015. The loans bear interest at the greater of prime plus 5.25% or 9% per annum, and interest accrues and is paid upon final maturity. In April 2015 RealNetworks and the other 43% owner of Rhapsody

each provided a \$5.0 million guaranty to Rhapsody's senior secured lender, related to the senior lender's loans to Rhapsody, which mature in April 2018. The guaranties will be released by the senior secured lender upon the June 2015 maturity of Rhapsody's loan to the external strategic partner, or no later than April 2018 if Rhapsody's loan to the external strategic partner is not repaid upon its due date.

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Summarized financial information for Rhapsody, which represents 100% of their financial information, is as follows (in thousands):

	Quarters Ended	
	March 31, 2015	2014
Net revenue	\$46,324	\$42,003
Gross profit	8,090	9,121
Net loss	(8,924	) (1,630

Note 5 Fair Value Measurements

Items Measured at Fair Value on a Recurring Basis

The following table presents information about our financial assets that have been measured at fair value on a recurring basis as of March 31, 2015 and December 31, 2014, and indicates the fair value hierarchy of the valuation inputs utilized to determine such fair value (in thousands).

	Fair Value Measurements as of				Amortized Cost as of March 31, 2015
	March 31, 2015				
	Level 1	Level 2	Level 3	Total	
Cash and cash equivalents:					
Cash	\$26,642	\$—	\$—	\$26,642	\$26,642
Money market funds	9,370	—	—	9,370	9,370
Corporate notes and bonds	—	66,982	—	66,982	66,982
Total cash and cash equivalents	36,012	66,982	—	102,994	102,994
Short-term investments:					
Corporate notes and bonds	—	24,394	—	24,394	24,383
U.S. government agency securities	7,000	—	—	7,000	7,000
Total short-term investments	7,000	24,394	—	31,394	31,383
Restricted cash equivalents and investments	—	3,000	—	3,000	3,000
Equity investment in publicly traded securities	2,648	—	—	2,648	376
Warrant issued by Rhapsody (included in Other assets)	—	—	1,155	1,155	—
Total	\$45,660	\$94,376	\$1,155	\$141,191	\$137,753

	Fair Value Measurements as of				Amortized Cost as of December 31, 2014
	December 31, 2014				
	Level 1	Level 2	Level 3	Total	
Cash and cash equivalents:					
Cash	\$30,105	\$—	\$—	\$30,105	\$30,105
Money market funds	11,629	—	—	11,629	11,630
Corporate notes and bonds	—	61,519	—	61,519	61,520
Total cash and cash equivalents	41,734	61,519	—	103,253	103,255
Short-term investments:					
Corporate notes and bonds	—	51,453	—	51,453	51,438
U.S. government agency securities	7,000	—	—	7,000	7,000
Total short-term investments	7,000	51,453	—	58,453	58,438
Restricted cash equivalents and investments	—	3,000	—	3,000	3,000

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Equity investment in publicly traded securities	2,676	—	—	2,676	428
Total	\$51,410	\$115,972	\$—	\$167,382	\$165,121

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Restricted cash equivalents and investments amounts as of March 31, 2015, and December 31, 2014 relate to cash pledged as collateral against a letter of credit in connection with a lease agreement.

Realized gains or losses on sales of short-term investment securities for the quarters ended March 31, 2015 and 2014 were not significant. Gross unrealized gains and gross unrealized losses on short-term investment securities as of March 31, 2015 and December 31, 2014 were also not significant.

Investments with remaining contractual maturities of five years or less are classified as short-term because the investments are marketable and highly liquid, and we have the ability to utilize them for current operations.

Contractual maturities of short-term investments as of March 31, 2015 (in thousands):

	Estimated Fair Value
Within one year	\$27,809
Between one year and five years	3,585
Total short-term investments	\$31,394

Our equity investment in a publicly traded company as of March 31, 2015 and December 31, 2014 consisted of J-Stream Inc., a Japanese media services company. This equity investment is accounted for as available for sale. In March 2015 and 2014 we sold a portion of the J-Stream shares we held, resulting in cash proceeds of \$0.4 million and \$2.8 million, respectively, and a pre-tax gain of \$0.3 million and \$2.4 million respectively, reported in Other income (expense), net, in the unaudited condensed consolidated statements of operations and comprehensive income (loss). In February 2015, Rhapsody issued warrants to purchase Rhapsody common shares to each of RealNetworks and Rhapsody's one other 43% stockholder. The warrants were issued as compensation for past services provided by RealNetworks and the other 43% stockholder, and both warrants covered the same number of underlying shares. The exercise price of the warrants was equal to the fair value of the underlying shares on the issuance date, and we used the Black-Scholes option-pricing model to calculate the fair value of the warrant, using an expected term of 5 years and expected volatility of 55%. We recognized and recorded the \$1.2 million fair value of the warrant issued to RealNetworks within Other assets in the unaudited condensed consolidated balance sheets, and as an expense reduction within General and administrative expense in the unaudited condensed consolidated statements of operations and comprehensive income (loss).

#### Items Measured at Fair Value on a Non-recurring Basis

Certain of our assets and liabilities are measured at estimated fair value on a non-recurring basis, using Level 3 inputs. These instruments are subject to fair value adjustments only in certain circumstances (for example, when there is evidence of impairment). During the three months ended March 31, 2015 and 2014, we did not record any impairments on those assets required to be measured at fair value on a non-recurring basis.

#### Note 6 Allowance for Doubtful Accounts Receivable and Sales Returns

Activity in the allowance for doubtful accounts receivable and sales returns (in thousands):

	Allowance For Doubtful Accounts Receivable	Sales Returns
Balances, December 31, 2014	\$1,288	\$354
Addition (reduction) to allowance	65	15
Amounts written off	(34	) —
Foreign currency translation	(98	) (1
Balances, March 31, 2015	\$1,221	\$368

One customer accounted for 35% of trade accounts receivable as of March 31, 2015. One customer accounted for 21% and one other customer accounted for 15% of trade accounts receivable as of December 31, 2014.



One customer accounted for 17% of consolidated revenue, or \$5.3 million during the quarter ended March 31, 2015, and is reflected in our Mobile Entertainment segment.

Two customers each accounted for 17% of consolidated revenue during the quarter ended March 31, 2014. The revenue from one of these customers, which totaled \$7.6 million, is reflected in our RealPlayer Group and Games segments. The other customer, which accounted for \$7.8 million of consolidated revenue during the quarter ended March 31, 2014, is reflected in our Mobile Entertainment segment.

Note 7 Other Intangible Assets

Other intangible assets (in thousands):

	March 31, 2015			December 31, 2014		
	Gross Amount	Accumulated Amortization	Net	Gross Amount	Accumulated Amortization	Net
Amortizing intangible assets:						
Customer relationships	\$33,047					