

ENTROPIC COMMUNICATIONS INC

Form 10-Q

July 29, 2010

Table of Contents

**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 June 30, 2010

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: 001-33844

**ENTROPIC COMMUNICATIONS, INC.**

(Exact Name of Registrant as Specified in Its Charter)

**Delaware**  
(State or Other Jurisdiction  
of Incorporation or Organization)

**33-0947630**  
(I.R.S. Employer  
Identification No.)

**6290 Sequence Drive**

**San Diego, CA 92121**

(Address of Principal Executive Offices, Including Zip Code)

**Registrant's telephone number, including area code: (858) 768-3600**

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.

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company   
(Do not check if a 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

There were 72,567,672 shares of the registrant's common stock, par value \$0.001 per share, issued and outstanding as of July 26, 2010.

**Table of Contents**

**ENTROPIC COMMUNICATIONS, INC.**  
**QUARTERLY REPORT ON FORM 10-Q**  
**FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2010**

**TABLE OF CONTENTS**

<b><u>PART I FINANCIAL INFORMATION</u></b>	1
Item 1. <u>Financial Statements</u>	1
<u>Unaudited Condensed Consolidated Balance Sheets as of June 30, 2010 and December 31, 2009</u>	1
<u>Unaudited Condensed Consolidated Statements of Operations for the three and six months ended June 30, 2010 and 2009</u>	2
<u>Unaudited Condensed Consolidated Statements of Cash Flows for the six months ended June 30, 2010 and 2009</u>	3
<u>Notes to Unaudited Condensed Consolidated Financial Statements</u>	4
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	15
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	22
Item 4. <u>Controls and Procedures</u>	23
<b><u>PART II OTHER INFORMATION</u></b>	24
Item 1A. <u>Risk Factors</u>	24
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	46
Item 6. <u>Exhibits</u>	46
<b><u>SIGNATURES</u></b>	47

**Table of Contents****PART I FINANCIAL INFORMATION****Item 1. Financial Statements****Entropic Communications, Inc.****Unaudited Condensed Consolidated Balance Sheets***(in thousands)*

	June 30, 2010	December 31, 2009 <sup>(1)</sup>
<b>Assets</b>		
<b>Current assets:</b>		
Cash and cash equivalents	\$ 41,329	\$ 35,252
Accounts receivable, net	19,917	15,468
Inventory	23,077	16,353
Prepaid expenses and other current assets	2,772	3,302
Total current assets	87,095	70,375
Property and equipment, net	11,706	11,581
Intangible assets, net	811	1,623
Other long-term assets	213	235
Total assets	\$ 99,825	\$ 83,814
<b>Liabilities and stockholders' equity</b>		
<b>Current liabilities:</b>		
Accounts payable	\$ 9,979	\$ 5,726
Accrued payroll and benefits	3,730	3,396
Accrued expenses and other current liabilities	2,538	2,217
Deferred revenues	161	174
Total current liabilities	16,408	11,513
Stock repurchase liability	211	345
Other long-term liabilities	2,751	3,043
<b>Stockholders' equity:</b>		
Common stock	73	71
Additional paid-in capital	317,495	310,796
Accumulated deficit	(237,057)	(241,907)
Accumulated other comprehensive loss	(56)	(47)
Total stockholders' equity	80,455	68,913
Total liabilities and stockholders' equity	\$ 99,825	\$ 83,814

- (1) The condensed consolidated balance sheet at December 31, 2009 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements.

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



**Table of Contents****Entropic Communications, Inc.****Unaudited Condensed Consolidated Statements of Operations***(in thousands, except per share data)*

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Net revenues	\$ 40,680	\$ 26,146	\$ 78,131	\$ 50,269
Cost of net revenues	18,831	13,201	36,532	25,105
Gross profit	21,849	12,945	41,599	25,164
Operating expenses:				
Research and development	11,746	10,102	23,284	23,425
Sales and marketing	3,991	3,395	7,769	7,032
General and administrative	3,012	2,712	5,712	5,401
Amortization of intangibles				16
Restructuring charges		979		2,103
Impairment of goodwill and intangible assets				208
Total operating expenses	18,749	17,188	36,765	38,185
Income (loss) from operations	3,100	(4,243)	4,834	(13,021)
Other income, net	20	30	45	89
Income (loss) before income taxes	3,120	(4,213)	4,879	(12,932)
Income tax provision	28	74	29	91
Net income (loss)	\$ 3,092	\$ (4,287)	\$ 4,850	\$ (13,023)
Net income (loss) per share basic	\$ 0.04	\$ (0.06)	\$ 0.07	\$ (0.19)
Net income (loss) per share diluted	\$ 0.04	\$ (0.06)	\$ 0.06	\$ (0.19)
Weighted average number of shares used to compute net income (loss) per share basic	71,972	69,424	71,621	69,113
Weighted average number of shares used to compute net income (loss) per share diluted	75,616	69,424	74,777	69,113

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

**Table of Contents****Entropic Communications, Inc.****Unaudited Condensed Consolidated Statements of Cash Flows***(in thousands)*

	<b>Six Months Ended June 30,</b>	
	<b>2010</b>	<b>2009</b>
<b>Operating activities:</b>		
Net income (loss)	\$ 4,850	\$ (13,023)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	1,769	1,718
Amortization of intangible assets	811	827
Impairment of goodwill and intangible assets		208
Stock-based compensation to consultants	132	9
Stock-based compensation to employees	4,617	5,019
Impairment of assets related to restructuring charge		145
Loss on disposal of assets	7	
Changes in operating assets and liabilities:		
Accounts receivable	(4,449)	(1,016)
Inventory	(6,723)	5,231
Prepaid expenses and other current assets	526	(368)
Other long-term assets	20	6
Accounts payable	4,257	184
Accrued payroll and benefits	346	(435)
Accrued expenses and other current liabilities	323	254
Deferred revenues	(13)	(282)
Other long-term liabilities	(292)	(173)
Net cash provided by (used in) operating activities	6,181	(1,696)
<b>Investing activities:</b>		
Purchases of property and equipment	(1,901)	(971)
Sales/maturities of marketable securities		3,489
Net cash (used in) provided by investing activities	(1,901)	2,518
<b>Financing activities:</b>		
Net proceeds from the issuance of common stock, net of issuance costs	1,817	510
Net cash provided by financing activities	1,817	510
Net effect of exchange rates on cash	(20)	
Net increase in cash and cash equivalents	6,077	1,332
Cash and cash equivalents at beginning of period	35,252	30,071
Cash and cash equivalents at end of period	\$ 41,329	\$ 31,403

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

**Table of Contents**

**ENTROPIC COMMUNICATIONS, INC.**

**Notes to Unaudited Condensed Consolidated Financial Statements**

**June 30, 2010**

**1. Organization and Summary of Significant Accounting Policies**

**Business**

Entropic Communications, Inc. was organized under the laws of the state of Delaware on January 31, 2001. We are a leading fabless semiconductor company that designs, develops and markets systems solutions to enable connected home entertainment. Our technologies significantly change the way high-definition and standard-definition television-quality video, or HD video and SD video, respectively, and other multimedia content, such as movies, music, games and photos, are brought into and delivered throughout the home.

**Basis of Presentation**

The accompanying interim unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States, or GAAP, for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X promulgated by the Securities and Exchange Commission, or SEC. They do not include all of the information and footnotes required by GAAP for complete financial statements. These financial statements should be read in conjunction with our audited consolidated financial statements and notes for the year ended December 31, 2009 which are included in our Annual Report on Form 10-K filed on February 4, 2010 with the SEC, or the Annual Report.

The interim condensed consolidated financial statements included herein are unaudited; however, they contain all normal recurring accruals and adjustments that, in the opinion of management, are necessary to present fairly our consolidated financial position, results of operations and cash flows as of and for the interim periods presented. Interim results are not necessarily indicative of the results to be expected for future quarters or the full year.

The accompanying unaudited condensed consolidated financial statements include our accounts and those of our wholly-owned subsidiaries. All inter-company accounts and transactions have been eliminated in consolidation.

**Use of Estimates**

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the condensed consolidated financial statements and these accompanying notes. Among the significant estimates affecting the condensed consolidated financial statements are those related to business combinations, revenue recognition, allowance for doubtful accounts, inventory reserves, long-lived assets (including intangible assets), warranty reserves, accrued bonuses, income taxes, valuation of equity securities and stock-based compensation. On an ongoing basis, management reviews its estimates based upon currently available information. Actual results could differ materially from those estimates.

**Foreign Currency Translation**

The functional currency for our foreign subsidiaries is the local currency. Assets and liabilities denominated in foreign currencies are translated using the exchange rates on the balance sheet dates. Net revenues and expenses are translated using the average exchange rates prevailing during the year. Any translation adjustments resulting from this process are shown separately as a component of accumulated other comprehensive loss within stockholders' equity in the condensed consolidated balance sheets. Foreign currency transaction gains and losses are reported in operating expenses, net in the condensed consolidated statements of operations.

**Revenue Recognition**

Our net revenues are generated principally by sales of our semiconductor products. During the three and six months ended June 30, 2010 and 2009, product net revenues represented more than 99% of our total net revenues.



## Edgar Filing: ENTROPIC COMMUNICATIONS INC - Form 10-Q

Our sales primarily occur through the efforts of our direct sales force. The remainder of our sales occurs through sales representatives and distributors. During the three and six months ended June 30, 2010 and 2009, more than 99% of our sales occurred through the efforts of our direct sales force.

## **Table of Contents**

We recognize product revenues when the following fundamental criteria are met: (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred or services have been rendered, (iii) the price to the customer is fixed or determinable and (iv) collection of the resulting receivable is reasonably assured. These criteria are usually met at the time of product shipment; however, we do not recognize revenue until all customer acceptance requirements have been met, when applicable.

A portion of our sales is made through distributors, agents or customers acting as agents under agreements allowing for pricing credits and/or rights of return. Product net revenues on sales made through these distributors are not recognized until the distributors ship the product to their customers.

Revenues derived from billing customers for shipping and handling costs are classified as a component of net revenues. Costs of shipping and handling charged by suppliers are classified as a component of cost of net revenues.

We record reductions to net revenues for estimated product returns and pricing adjustments, such as competitive pricing programs, in the same period that the related revenue is recorded. The amount of these reductions is based on historical sales returns and other factors known at the time. If actual returns differ significantly from our estimates, such differences would be recorded in our results of operations for the period in which the actual returns become known. To date, changes in estimated returns have not been material to net revenues in any related period.

We are party to an inventory hubbing agreement with a key customer. Pursuant to this agreement, we deliver products to the designated third-party warehouse based upon the customer's projected needs, but do not recognize product revenue unless and until the customer removes our products from the third-party warehouse to incorporate into its own products.

We receive royalties in exchange for an exclusive right to manufacture and sell certain products. We have determined that we are not able to reliably estimate the royalties earned in the period the sales occur and, as a result, we record net revenues based on cash receipts. The royalty revenues recorded during the three months ended June 30, 2010 and 2009 and the six months ended June 30, 2010 and 2009 were \$0.5 million, \$0.6 million, \$0.8 million and \$1.2 million, respectively, and are included in net revenues on the accompanying condensed consolidated statements of operations.

We have entered into agreements to license our hardware and software, also referred to as the nodes, to certain members of the Multimedia over Coax Alliance, or MoCA, for a period of three years and to provide upgrades when and if they become available. The agreements limit the rights to use the nodes to test compliance of the members' own products to the MoCA specification. For any agreements entered into on or prior to December 31, 2009, we deferred all of the license revenues when the nodes are delivered and recognized the revenues on a straight-line basis over the term of the agreement. For agreements entered into after December 31, 2009 we will consider the accounting for any new node agreements under the new multiple deliverable guidance, as applicable.

We provide rebates on our products to certain customers. At the time of the sale, we accrue 100% of the potential rebate as a reduction to net revenue and do not apply a breakage factor. The amount of these reductions is based upon the terms included in various rebate agreements. We reverse the accrual for unclaimed rebate amounts as specific rebate programs contractually end or when we believe unclaimed rebates are no longer subject to payment and will not be paid. For the three months ended June 30, 2010 and 2009 and the six months ended June 30, 2010 and 2009, we reduced net revenue by \$14,000, \$2,000, \$36,000 and \$0.2 million, respectively, in connection with our rebate programs.

We occasionally enter into agreements where revenue is derived from multiple deliverables including any mix of products and/or services. These products and/or services are generally delivered from approximately three months to two years after the execution date. Revenue recognition for agreements with multiple deliverables is based on the individual units of accounting determined to exist in the agreement. A delivered item is considered a separate unit of accounting when the delivered item has value to the customer on a stand-alone basis. Items are considered to have stand-alone value when they are sold separately by any vendor or when the customer could resell the item on a stand-alone basis.

For multiple deliverable agreements entered into after December 31, 2009, consideration is allocated at the inception of the agreement to all deliverables based on their relative selling price. The relative selling price for each deliverable is determined using vendor specific objective evidence, or VSOE, of selling price or third-party evidence of selling price if VSOE does not exist. If neither VSOE nor third-party evidence of selling price exists, we use our best estimate of the selling price for the deliverable. To date, multiple deliverable contracts have not been material to net revenues in any related period and our adoption of the new accounting guidance for determining multiple element arrangements effective January 1, 2010 did not have an impact on our operating results.

For multiple deliverable agreements entered into on or prior to December 31, 2009, consideration was generally allocated to each unit of accounting based upon its relative fair value when objective and reliable evidence of fair value existed for all units of accounting in the agreement. The fair value of an item was generally the price charged for the product, if the item was regularly sold on a stand-alone basis.



## **Table of Contents**

In order to establish VSOE of selling price, we must regularly sell the product and/or service on a standalone basis with a substantial majority priced within a relatively narrow range. VSOE of selling price is usually the midpoint of that range. If there is not a sufficient number of standalone sales and VSOE of selling price cannot be determined, then we consider whether third-party evidence can be used to establish the selling price. If neither VSOE nor third-party evidence of selling price exists, effective January 1, 2010 we determine our best estimate of selling price using average selling prices over a rolling 12-month period as well as market conditions. If the product or service has no history of sales, we rely upon sales prices set by our pricing committee, adjusted for applicable discounts.

We recognize revenue for delivered elements only when we determine there are no uncertainties regarding customer acceptance. Changes in the allocation of the sales price between delivered and undelivered elements can impact the revenue recognition but do not change the total revenue recognized on any agreement.

## **Concentration of Credit Risk**

Financial instruments that potentially subject us to concentration of credit risk consist primarily of cash and cash equivalents, accounts receivable, leases payable and lines of credit. Our policy is to place our cash and cash equivalents with high quality financial institutions in order to limit our credit exposure. We extend credit to our customers based on an evaluation of the customer's financial condition and a cash deposit is generally not required. We estimate potential losses on trade receivables on an ongoing basis.

## **Inventories**

Inventories are stated at the lower of cost (first-in, first-out) or market. Lower of cost or market adjustments reduce the carrying value of the related inventory and take into consideration reductions in sales prices, excess inventory levels and obsolete inventory. These adjustments are done on a part-by-part basis and, in general, represent excess inventory value on hand compared to our 12-month demand projections. Once established, these adjustments are considered permanent and are not reversed until the related inventory is sold or disposed.

## **Intangible Assets**

We record intangible assets based on the fair value of the assets acquired. In determining the fair value of the assets acquired, we utilize extensive accounting estimates and judgments to allocate the purchase price to the fair value of the net tangible and intangible assets acquired. We use the discounted cash flow method to estimate the value of intangible assets acquired. The estimates used to value and amortize intangible assets are consistent with the plans and estimates that we use to manage our business and are based on available historical information and industry estimates and averages.

We assess intangible assets for impairment using fair value measurement techniques on an annual basis or more frequently if indicators of impairment exist. In March 2009, we implemented a restructuring plan (see Note 2). As part of the restructuring plan, we closed our Kfar Saba, Israel office and terminated all of the employees at that location. As a result of this location closure, we reassessed the intangible assets associated with our Kfar Saba, Israel office and recorded an impairment charge for the remaining \$0.2 million of core technology intangible assets associated with our 2007 acquisition of Arabella Software, Ltd., or Arabella.

## **Guarantees and Indemnifications**

In the ordinary course of business, we have entered into agreements with customers that include indemnity provisions. To date, there have been no known events or circumstances that have resulted in any significant costs related to these indemnification provisions and, as a result, no liabilities have been recorded in the accompanying financial statements.

## **Warranty Accrual**

We generally provide a warranty on our products for a period of one year; however, it may be longer for certain customers. Accordingly, we establish provisions for estimated product warranty costs at the time revenue is recognized based upon our historical activity and, additionally, for any known product warranty issues. Warranty provisions are recorded as a cost of net revenues. The determination of such provisions requires us to make estimates of product return rates and expected costs to replace or rework the products under warranty. When the actual product failure rates, cost of replacements and rework costs differ from our estimates, revisions to the estimated warranty accrual are made. Actual claims are charged against the warranty reserve.



## **Table of Contents**

### **Research and Development Costs**

Research and development costs are expensed as incurred and primarily include costs related to personnel, outside services, which consist primarily of contract labor services, fabrication masks, architecture licenses, engineering design development software and hardware tools, allocated support expenses and depreciation of equipment used in research and development.

### **Software Development Costs**

Software development costs are capitalized beginning when technological feasibility has been established and ending when a product is available for sale to customers. To date, the period between achieving technological feasibility and when the software is made available for sale to customers has been relatively short and software development costs qualifying for capitalization have not been significant. As such, all software development costs have been expensed as incurred in research and development expense.

### **Income Taxes**

We estimate income taxes based on the various jurisdictions where we conduct business. Significant judgment is required in determining our worldwide income tax provision. We estimate the current tax liability and assess temporary differences that result from differing treatments of certain items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are reflected in our balance sheets. We then assess the likelihood that deferred tax assets will be realized. A valuation allowance is recorded when it is more likely than not that some of the deferred tax assets will not be realized. When a valuation allowance is established or increased, we record a corresponding tax expense in our statements of operations. We review the need for a valuation allowance each interim period to reflect uncertainties about whether we will be able to utilize deferred tax assets before they expire. The valuation allowance analysis is based on estimates of taxable income for the jurisdictions in which we operate and the periods over which our deferred tax assets will be realizable.

We recognize and measure benefits for uncertain tax positions using a two-step approach. The first step is to evaluate the tax position taken or expected to be taken in a tax return by determining if the weight of available evidence indicates that it is more likely than not that the tax position will be sustained upon audit, including resolution of any related appeals or litigation processes. For tax positions that are more likely than not of being sustained upon audit, the second step is to measure the tax benefit as the largest amount that has more than a 50% chance of being realized upon settlement. Significant judgment is required to evaluate uncertain tax positions. We evaluate uncertain tax positions on a quarterly basis. The evaluations are based upon a number of factors, including changes in facts or circumstances, changes in tax law, correspondence with tax authorities during the course of audits and effective settlement of audit issues.

### **Stock-Based Compensation**

We have equity incentive plans under which incentive stock options have been granted to employees and restricted stock units and non-qualified stock options have been granted to employees and non-employees. We also have an employee stock purchase plan for all eligible employees.

Our stock-based compensation cost is measured at the grant date, based on the estimated fair value of the award, and is recognized as an expense over the employee's requisite service period. We have no stock-based compensation awards with market or performance conditions. The stock-based compensation expense attributable to awards under our 2007 Employee Stock Purchase Plan, or ESPP, was determined using the Black-Scholes option pricing model.

We also grant awards to non-employees and determine the fair value of such stock-based compensation awards granted as either the fair value of the consideration received or the fair value of the equity instruments issued, whichever is more reliably measurable. If the fair value of the equity instruments issued is used, it is measured using the stock price and other measurement assumptions as of the earlier of (i) the date at which a commitment for performance by the counterparty to earn the equity instruments is reached, or (ii) the date at which the counterparty's performance is completed.

We recognize excess tax benefits associated with stock-based compensation to stockholders' equity only when realized. When assessing whether excess tax benefits relating to stock-based compensation have been realized, we follow the with and without approach excluding any indirect effects to be realized until after the utilization of all other tax benefits available to us.

**Table of Contents****Segment Reporting**

We are organized as, and operate in, one reportable segment: the design, development and sale of silicon integrated circuits. Products within this segment are embedded in electronic devices used to enable the delivery of multiple streams of high definition video and other multimedia content for entertainment purposes into and throughout the home. Our chief operating decision maker is our chief executive officer, or CEO. Our CEO reviews financial information presented on a consolidated basis evaluating financial performance and allocating resources. There are no segment managers who are held accountable for operations below the consolidated financial statement level. Our assets are primarily located in the United States and not allocated to any specific region. Therefore, geographic information is presented only for total revenue.

**Recently Issued Accounting Standards**

On March 31, 2010, the Financial Accounting Standards Board (FASB) ratified the milestone method of revenue recognition. Under this new standard, an entity can recognize contingent consideration earned from the achievement of a substantive milestone in its entirety in the period in which the milestone is achieved. A milestone is defined as an event (i) that can only be achieved based in whole or in part on either the entity's performance or on the occurrence of a specific outcome resulting from the entity's performance (ii) for which there is substantive uncertainty at the date the arrangement is entered into that the event will be achieved and (iii) that would result in additional payments being due to the entity. The milestone method of revenue recognition is effective for fiscal years beginning on or after June 15, 2010 and may be applied prospectively after the adoption date or retrospectively for all periods presented. We are currently in the process of evaluating whether to adopt this new standard early. The impact of adoption on our consolidated financial statements will ultimately depend on the terms of any future business transactions.

There have been no other recent accounting pronouncements or changes in accounting pronouncements during the six months ended June 30, 2010, as compared to the recent accounting pronouncements described in the Annual Report that are of material significance, or have potential material significance, to us.

**2. Supplemental Financial Information****Fair Value Measurements**

We hold certain financial assets and liabilities, including cash equivalents, marketable securities and deferred compensation liability that are required to be measured at fair value on a recurring basis. Cash equivalents generally include U.S. Treasury money market funds. Marketable securities, to the extent that we hold any, are carried at amortized cost which approximates fair value.

We use a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value. These tiers include: Level 1, defined as observable inputs such as quoted prices in active markets; Level 2, defined as inputs other than quoted prices in active markets that are either directly or indirectly observable; and Level 3, defined as unobservable inputs in which little or no market data exists, therefore requiring an entity to develop its own assumptions.

The following table summarizes our assets and liabilities that require fair value measurements on a recurring basis.

	Fair Value Measurements as of June 30, 2010			
	Total	Level 1	Level 2	Level 3
<b>Assets:</b>				
Cash equivalents	\$ 8,143	\$ 8,143	\$	\$
<b>Liabilities:</b>				
Deferred compensation	\$ 564	\$	\$	\$ 564
<b>Fair Value Measurements as of December 31, 2009</b>				
	Total	Level 1	Level 2	Level 3
<b>Assets:</b>				
Cash equivalents	\$ 8,143	\$ 8,143	\$	\$

Edgar Filing: ENTROPIC COMMUNICATIONS INC - Form 10-Q

Liabilities:

Deferred compensation	\$ 561	\$	\$	\$ 561
-----------------------	--------	----	----	--------



**Table of Contents**

Our deferred compensation liability represents bonus compensation to be paid out in the event that our stock price does not reach a guaranteed level in connection with certain stock options granted. The fair value of this liability is remeasured quarterly using the Black Scholes option pricing model which considers the potential payout, the remaining time until payout, volatility of the underlying shares, and the risk-free interest rate to calculate the liability that may be due under the arrangement.

The change in liability for the six months ended June 30, 2010 is included in earnings in compensation expense as follows:

	<b>Fair Value Measurement Using Significant Unobservable Inputs (Level 3)</b>	
Liability as of December 31, 2009	\$	561
Increase in compensation expense		3
<b>Liability as of June 30, 2010</b>	<b>\$</b>	<b>564</b>

**Inventory**

The components of inventory were as follows (in thousands):

	<b>As of June 30, 2010</b>	<b>As of December 31, 2009</b>
Work in process	\$ 9,395	\$ 4,177
Finished goods	13,682	12,176
<b>Total inventory</b>	<b>\$ 23,077</b>	<b>\$ 16,353</b>

**Property and Equipment**

Property and equipment consisted of the following (in thousands, except for years):

	<b>Useful Lives (in years)</b>	<b>As of June 30, 2010</b>	<b>As of December 31, 2009</b>
Office and laboratory equipment	5	\$ 10,513	\$ 9,325
Computer equipment	3 - 5	2,845	2,496
Furniture and fixtures	6 - 7	1,767	1,570
Leasehold improvements	Lease term	5,209	5,122
Licensed software	1 - 3	1,291	1,195
Construction in progress		151	217
		21,776	19,925
Accumulated depreciation		(10,070)	(8,344)
<b>Property and equipment, net</b>		<b>\$ 11,706</b>	<b>\$ 11,581</b>

Depreciation and amortization expense for the three months ended June 30, 2010 and 2009 and the six months ended June 30, 2010 and 2009 was \$0.9 million, \$0.9 million, \$1.8 million and \$1.7 million, respectively.

**Intangible Assets**

Intangible assets consisted of the following (in thousands):

	<b>As of June 30, 2010</b>			
	<b>Gross</b>	<b>Accumulated Amortization</b>	<b>Impairment</b>	<b>Net</b>
Developed technology	\$ 24,800	\$ (9,874)	\$ (14,115)	\$ 811

As of June 30, 2010, the estimated future amortization expense of intangible assets expected to be charged to cost of net revenues for the remainder of the year ending December 31, 2010 is \$0.8 million.

**Table of Contents****Accrued Warranty**

The following table presents a rollforward of our product warranty liability, which is included within accrued expenses and other current liabilities in the unaudited condensed consolidated balance sheets (in thousands):

	As of June 30, 2010
Liability as of December 31, 2009	\$ 147
Expirations	(115)
Accruals for warranties issued during the six months ended June 30, 2010	150
Settlements made during the six months ended June 30, 2010	(6)
<b>Liability as of June 30, 2010</b>	<b>\$ 176</b>

**Accrued Management Bonuses**

In April 2010, the compensation committee of our board of directors adopted and approved a management bonus plan, or MBP, to reward officers and specified individuals for their performance, generally on an annual basis. A portion of the bonuses payable under the MBP is dependent on the extent to which specified performance goals for a specified performance period are achieved. We refer to these bonuses as performance-based bonuses. The MBP also allows for the payment of discretionary bonuses for which no specific award criteria need to be established. The amount of 2010 performance-based bonuses payable under the MBP is based on the extent to which specified financial goals are met. As of June 30, 2010, we believe the achievement of certain of these financial goals is probable and, accordingly, have estimated and accrued \$0.9 million in management bonuses under the MBP. Any actual bonus amounts awarded will be at the discretion of our compensation committee and in accordance with the terms of the MBP.

In 2009, we maintained a management bonus plan to reward the performance of officers and specified individuals for their 2009 performance. The actual bonus payments paid under the 2009 management bonus plan were determined based on the achievement of operational, financial and business development objectives for 2009. For the six months ended June 30, 2009, we accrued \$0.3 million in management bonuses under the 2009 management bonus plan.

**Other Long-Term Liabilities**

The components of other long-term liabilities are as follows (in thousands):

	As of June 30, 2010	As of December 31, 2009
Deferred Rent	\$ 2,126	\$ 2,280
Other	625	763
	<b>\$ 2,751</b>	<b>\$ 3,043</b>

**Impairment of Intangible Assets**

During the six months ended June 30, 2009, we recorded an impairment charge on intangible assets of \$0.2 million. We determined that the intangible assets associated with our 2007 acquisition of Arabella were fully impaired as the core technology acquired would no longer be used in our ongoing business operations.

**Restructuring Activity**

## Edgar Filing: ENTROPIC COMMUNICATIONS INC - Form 10-Q

We incurred restructuring charges totaling \$1.0 million and \$2.1 million during the three months and six months ended June 30, 2009, respectively, resulting from a restructuring plan we implemented in March 2009 that resulted in a worldwide reduction-in-force of 55 employees and the closure of our Nice, France and Kfar Saba, Israel offices. All of the terminated employees received severance payments upon their effective termination. In addition, the affected French and Israeli employees continued to receive salaries until their termination became effective upon the expiration of applicable contractual or statutory notice periods.

The continued payment of salaries to the terminated Nice and Kfar Saba employees during their respective notice periods represented a one-time termination benefit since we were required by contract or law to make these payments whether or not these employees continued to work for us through their actual termination dates.

In subsequent periods during 2009, we recorded additional restructuring charges of \$0.1 million in connection with this restructuring plan.

**Table of Contents**

**Debt**

As of June 30, 2010, we had access to a \$5.0 million revolving credit line under the terms of our Loan and Security Agreement, as amended, with Silicon Valley Bank, or SVB. We amended the provisions of our credit line in April 2010 upon the payment of a \$12,500 amendment fee and extended the term of the credit line through April 8, 2011. The maximum credit available under the credit line was reduced from \$10.0 million to \$5.0 million. As amended, interest on the credit line is payable at an annual interest rate equal to the prime rate plus 0.5% if we maintain a liquidity ratio of at least 1.75 to 1, or the prime rate plus 2.0% if we maintain a liquidity ratio of less than 1.75 to 1. If any portion of the credit line remains unused at any time, we are required to pay a fee equal to 0.125% per annum of the average unused portion of the credit line so long as we maintain a liquidity ratio of at least 1.75 to 1, or 0.5% per annum of the average unused portion of the credit line when our liquidity ratio falls below 1.75 to 1. The credit line, as amended, also limits the aggregate amount of assets and collateral that we are allowed to transfer to, and the amount of investments that we are allowed to make in, certain of our subsidiaries to \$600,000 per month. The amount available under the credit line cannot exceed 80% of the value of our eligible accounts receivable and may be decreased by certain commitments, such as the \$1.2 million and \$35,000 standby letters of credit that secure our performance under our San Diego, California, and San Jose, California, facility leases, respectively.

As of June 30, 2010, \$3.8 million was available under the credit line. The availability was reduced by the two standby letters of credit for our facility leases.

**Deferred Rent**

We recognize rent expense on a straight-line basis over the lease term and record landlord allowances for tenant improvements as deferred rent. The deferred rent is amortized over the lease term as a reduction of rent expense. As of June 30, 2010 and December 31, 2009, there was \$2.1 million and \$2.3 million, respectively, of unamortized deferred rent recorded as a component of other long-term liabilities.

**Purchase Commitments**

We had firm purchase order commitments for the acquisition of inventory as of June 30, 2010 and December 31, 2009 of \$32.4 million and \$20.2 million, respectively.

**Stock-Based Compensation**

We have in effect equity incentive plans under which incentive stock options, non-qualified stock options and restricted stock units have been granted to employees, directors and consultants to purchase shares of our common stock at a price not less than the fair market value of the stock at the date of grant, except for certain options assumed in connection with a business combination. These equity plans include the 2007 Non-Employee Directors Stock Option Plan, under which we continue to grant non-qualified stock options, and the 2007 Equity Incentive Plan, or 2007 Plan, under which we continue to grant non-qualified stock options and restricted stock units. These plans are further described in the Annual Report.

We also grant stock awards under our ESPP. Under the terms of the ESPP, eligible employees may purchase shares of our common stock at 85% of the fair market value of our common stock on the offering date or the purchase date, whichever is less. Purchase dates occur twice each year, with a look-back period of up to 12 months to determine the lowest common stock valuation date, either the offering date or the purchase date.

Stock-based compensation expense recognized in our condensed consolidated statements of operations for the three and six months ended June 30, 2010 and 2009 included compensation expense for stock-based options and awards granted subsequent to December 31, 2005, based on the grant date fair value. For options and awards granted, expenses are amortized under the straight-line method. Stock-based compensation expense recognized in the condensed consolidated statements of operations has been reduced for estimated forfeitures of options that are subject to vesting. Forfeitures are estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

We allocated stock-based compensation expense as follows (in thousands):

Three Months Ended June 30,	Six Months Ended June 30,
--------------------------------	------------------------------

Edgar Filing: ENTROPIC COMMUNICATIONS INC - Form 10-Q

	2010	2009	2010	2009
Cost of net revenues	\$ 89	\$ 45	\$ 152	\$ 61
Research and development	1,211	996	2,290	2,518
Sales and marketing	382	326	694	694
General and administrative	875	853	1,613	1,755
Total stock-based compensation expense	\$ 2,557	\$ 2,220	\$ 4,749	\$ 5,028

**Table of Contents***2007 Equity Incentive Plans*

We reviewed and updated our forfeiture rate, expected term and volatility assumptions during the three months ended June 30, 2010. The risk-free interest rate is based on zero coupon U.S. Treasury instruments with maturities similar to those of the expected term of the award being valued. The expected life is based on the average life of certain guideline companies, adjusted for differences in vesting schedule and contractual terms. Prior to the three months ended June 30, 2010, the expected life was based on the average of the contractual term of the options and the weighted-average vesting period for all option tranches. The change in the expected life assumption does not have a material impact in the current period. The estimated volatility incorporates historical volatility of similar entities whose share prices are publicly available. The expected dividend yield was based on our expectation of not paying dividends on common stock for the foreseeable future.

We granted options and other stock awards to consultants in connection with their service agreements. For the three months ended June 30, 2010 and 2009 and the six months ended June 30, 2010 and 2009, we recorded compensation expense related to these awards of \$0.1 million, \$7,000, \$0.1 million and \$9,000, respectively. The fair value of the awards was estimated using a Black-Scholes option-pricing model.

The fair value of stock options granted to employees, directors and consultants was estimated at the grant date using the following assumptions:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Expected life (years) for employee and director options	5.0	6.1	5.0 - 6.1	6.1
Contractual term (years) for consultant options	10.0	10.0	10.0	10.0
Risk-free interest rate	2.54%	3.18%	2.54% - 3.07%	2.20 - 3.18%
Expected volatility	84%	99%	80% - 84%	69% - 99%
Expected dividend yield				

As of June 30, 2010, we estimated there were \$16.6 million in total unrecognized compensation costs related to employee stock option agreements, which are expected to be recognized over a weighted-average period of 1.4 years.

*2007 Employee Stock Purchase Plan*

For the three months ended June 30, 2010 and 2009 and the six months ended June 30, 2010 and 2009, the fair value of stock-based awards granted under the ESPP was estimated using the following assumptions:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Expected life (years)	0.5 - 1.0	0.5 - 1.0	0.5 - 1.0	0.5 - 1.0
Risk-free interest rate	0.17% to 0.43%	0.16% - 0.92%	0.17% to 0.43%	0.16% - 0.92%
Expected volatility	63% to 139%	151% - 180%	63% to 139%	151% - 180%
Expected dividend yield				

For the three months ended June 30, 2010 and 2009 and the six months ended June 30, 2010 and 2009, we recorded stock-based compensation expense for the ESPP totaling \$0.2 million, \$0.1 million, \$0.5 million and \$0.3 million, respectively. As of June 30, 2010, we estimate there were \$0.3 million of unrecognized compensation costs related to the shares expected to be purchased through the ESPP, which are expected to be recognized over a remaining weighted-average period of 0.4 years.

**Table of Contents****3. Income Taxes**

Our effective tax rates for the three and six months ended June 30, 2010 were 0.57% and 0.42%, respectively, compared to (1.8)% and (0.7)% for the three and six months ended June 30, 2009, respectively. The effective tax rates for the three and six months ended June 30, 2009, are expressed as a negative rate because the Company recorded tax expense while in a loss position for the period. The tax expense related to foreign taxes during the three months ended June 30, 2010 and 2009 and six months ended June 30, 2010 and 2009, was \$9,000, \$73,000, \$13,000 and \$89,000, respectively.

On January 1, 2007, we adopted guidance that prescribes a recognition threshold and measurement process for recording in the financial statements uncertain tax positions taken or expected to be taken in a tax return. Additionally, the guidance provides clarity on de-recognition, classification, accounting in interim periods and disclosure requirements for uncertain tax positions. The unrecognized tax benefit was \$9.5 million as of December 31, 2009.

No adjustments have been made during the three and six months ended June 30, 2010 for any uncertain tax positions and we do not expect our unrecognized tax benefits to change significantly over the next 12 months. There were no accrued interest and penalties associated with uncertain tax positions as of June 30, 2010 or December 31, 2009.

We file federal and state income tax returns in the United States and various other income tax returns in foreign jurisdictions.

**4. Net Income (Loss) Per Share of Common Stock**

We compute basic income (loss) per share of common stock by dividing net income (loss) by the weighted average number of shares of common stock outstanding for the period. Diluted income (loss) per share is computed using the weighted average number of shares of common stock and dilutive common equivalent shares outstanding during the period. Common equivalent shares from stock options and other common stock equivalents are excluded from the computation when their effect is antidilutive.

The following table presents the computation of basic and diluted net income (loss) per share for the periods indicated (in thousands, except per share data):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
<b>Numerator:</b>				
Net income (loss) basic and diluted	\$ 3,092	\$ (4,287)	\$ 4,850	\$ (13,023)
<b>Denominator:</b>				
Weighted average number of shares of common stock outstanding	72,137	69,985	71,841	69,733
Less: Restricted stock	(165)	(561)	(220)	(620)
Weighted average number of shares used in computing net income (loss) per common share basic	71,972	69,424	71,621	69,113
<b>Effect of dilutive securities:</b>				
Restricted stock	165		193	
ESPP shares	7		22	
Stock award common share equivalents	3,472		2,941	
Weighted average number of shares used in computing net income (loss) per common share diluted	75,616	69,424	74,777	69,113
Net income (loss) per share basic	\$ 0.04	\$ (0.06)	\$ 0.07	\$ (0.19)
Net income (loss) per share diluted	\$ 0.04	\$ (0.06)	\$ 0.06	\$ (0.19)





## Edgar Filing: ENTROPIC COMMUNICATIONS INC - Form 10-Q

Potentially dilutive securities that were not included in the diluted net income (loss) per share calculations because they would be antidilutive, for any reason, are as follows (in thousands):

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2010	2009	2010	2009
Stock options outstanding	3,802	9,169	3,504	9,540
Stock reserved for issuance under put and call option agreements		147		147
Restricted stock		587		678
Total	3,802	9,903	3,504	10,365

**Table of Contents****5. Supplemental Disclosure of Cash Flow and Non-Cash Activity****Cash Flow**

There was no cash paid for interest or taxes in the six months ended June 30, 2010 and 2009.

**Non-Cash Activity**

The following table sets forth supplemental disclosure of non-cash activity (in thousands):

	Six Months Ended June 30,	
	2010	2009
Decrease in repurchase liability for early exercise of stock options	\$ 134	\$ 165
Currency translation adjustment	9	25

**6. Significant Customer and Geographic Information****Customers**

Based on direct shipments, customers that represented 10% or more of our total net revenues were as follows:

	Net Revenues Three Months Ended June 30,		Net Revenues Six Months Ended June 30,	
	2010	2009	2010	2009
Actiontec Electronics, Inc.	14%	19%	*	19%
Motorola, Inc.	15%	37%	18%	23%
Wistron NeWeb Corporation	17%	17%	14%	13%
Zinwell Corporation	10%	*	12%	*

\* Customer accounted for less than 10% of our total net revenues for the period indicated.

As of June 30, 2010 and December 31, 2009, customers that individually represented 10% or more of our accounts receivable balances represented a total of 59% and 44% of our accounts receivable, respectively.

**Geographic Information**

Net revenues are allocated to the geographic region based on the shipping destination of customer orders. Net revenues as a percentage of total net revenues by geographic region were as follows:

	Six Months Ended June 30,	
	2010	2009
Asia	90%	93%
Europe	3	3
North America	7	4
	100%	100%

**7. Subsequent Events**

On July 28, 2010 we filed a shelf registration statement covering the offer and sale of up to \$100 million of securities which may include our common stock, preferred stock, debt securities, warrants or any combination of the foregoing with the SEC. We have no immediate plans or current commitments to sell these securities. The terms of any offering under our shelf registration statement will be determined at the time of the offering and disclosed in a prospectus supplement filed with the SEC.

**Table of Contents****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

*The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our unaudited condensed consolidated financial statements and the related notes thereto contained in Part I, Item 1 of this Quarterly Report on Form 10-Q, or Quarterly Report, and our consolidated financial statements and related notes as of and for the year ended December 31, 2009 and the related Management's Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report.*

**Forward-Looking Statements**

*The following discussion contains forward-looking statements, which involve risks and uncertainties. These forward-looking statements include, but are not limited to, statements concerning our strategy, future operations, competitors, future financial position, future revenues, projected costs, prospects and plans and objectives of management. These forward-looking statements are based on our current expectations, estimates, approximations and projections about our industry and business, management's beliefs, and certain assumptions made by us, all of which are subject to change. Forward-looking statements can often be identified by words such as anticipates, expects, intends, plans, predicts, believes, seeks, estimates, may, will, should, would, could, potential, continue, ongoing and similar expressions, and variations or negatives of these words. Forward-looking statements are not guarantees of future performance and are subject to risks, uncertainties and assumptions that are difficult to predict. Therefore, our actual results could differ materially and adversely from those expressed in any forward-looking statements as a result of various factors, some of which are listed under Part II, Item 1A, Risk Factors and elsewhere in this Quarterly Report, and in our other filings with the SEC. We operate in a very competitive and rapidly changing environment. New risks emerge from time to time. It is not possible for our management to predict all risks, nor can we assess the impact of all factors on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements in this Quarterly Report or in our other filings with the SEC. Forward-looking statements herein speak only as of the date of this Quarterly Report. Except as required by law, we assume no obligation to update or revise any forward-looking statements publicly, or to update the reasons actual results could differ materially from those anticipated in these forward-looking statements, even if new information becomes available in the future. Thus, you should not assume that our silence over time means that actual events are bearing out as expressed or implied in such forward-looking statements.*

*In this Quarterly Report, Entropic Communications, Inc., Entropic Communications, Entropic, the Company, we, us and our refer to Entropic Communications, Inc. and its subsidiaries, taken as a whole, unless otherwise noted.*

**Overview**

Entropic Communications is a leading fabless semiconductor company that designs, develops and markets systems solutions to enable connected home entertainment. Our technologies significantly change the way HD and SD video and other multimedia content such as movies, music, games and photos are brought into and delivered throughout the home. Our products include home networking chipsets based on the MoCA standard, high-speed broadband access chipsets, integrated circuits that simplify and enhance digital broadcast satellite, or DBS, services and silicon tuner integrated circuits. We use our considerable experience with service provider-based deployments to create solutions that address the complex requirements associated with delivering multiple streams of HD video into and throughout the home, while seamlessly coexisting with video, voice and data services that are using the same coaxial cable infrastructure.

In December 2004, we introduced and commenced commercial shipments of our home networking products. In the first quarter of 2006, we began commercially shipping our broadband access solutions. In May 2007, we acquired Arabella, a developer of embedded software. In June 2007, we acquired RF Magic, Inc., or RF Magic, a provider of digital broadcast satellite outdoor unit and silicon tuner solutions. In 2008, we acquired certain specified assets of Vativ Technologies, Inc., or Vativ, a provider of high-bandwidth, advanced digital processing solutions for digital television and 10 gigabit Ethernet markets. Since inception, we have invested heavily in product development and have not yet achieved profitability on an annual basis, although we had net income of \$4.9 million for the six months ended June 30, 2010 and \$3.1 million for the three months ended June 30, 2010. Our net revenues grew from \$122.5 million in 2007 to \$146.0 million in 2008 driven primarily by increased demand for our home networking products. Our net revenues decreased to \$116.3 million in 2009 driven primarily by softness in demand for our home networking products and, to a lesser extent, by lower demand for our DBS products. As of June 30, 2010, we had an accumulated deficit of \$237.1 million.

We generate net revenues principally by sales of our semiconductor products. We principally sell our products directly to either original design manufacturers, or ODMs, or original equipment manufacturers, or OEMs. We price our products based on market and competitive conditions and reduce the price of our products over time, as market and competitive conditions change, and as manufacturing costs are reduced. Our markets are generally characterized by declining average selling prices over the life of a product and, accordingly, we must reduce costs and successfully introduce new products and enhancements to maintain our gross margins.



**Table of Contents**

We rely on a limited number of customers for a significant portion of our net revenues. Sales to these customers are in turn driven by service providers that purchase our customers' products which incorporate our products. A substantial percentage of our net revenues are dependent upon four major service providers, DIRECTV, Verizon, DISH Network and Comcast. In addition, we are dependent on sales outside of the United States for almost all of our net revenues and expect that to continue in the future.

We use third-party foundries and assembly and test contractors to manufacture, assemble and test our products. This outsourced manufacturing approach allows us to focus our resources on the design, sales and marketing of our products and avoid the cost associated with owning and operating our own manufacturing facility. A significant portion of our cost of net revenues consists of payments for the purchase of wafers and for manufacturing, assembly and test services.

We expect research and development expenses in future years to continue to increase in total dollars as we develop additional products and expand our business, and to fluctuate over the course of the year based on the timing of our development tools and supply costs, which include outside services, masks costs and licenses. We also anticipate that our sales and marketing expenses will increase as we expand our domestic and international sales and marketing organization and activities and build brand awareness. Due to the lengthy sales cycles that we face, we may experience significant delays from the time we incur research and development and sales and marketing expenses until the time, if ever, that we generate sales from the related products.

Since our inception, we have funded our operations using a combination of preferred stock issuances, cash collections from customers, bank credit facilities, cash received from the exercise of stock options and proceeds from our initial public offering. We intend to continue spending substantial amounts in connection with the growth of our business and we may need to obtain additional financing to pursue our business strategy, develop new products, respond to competition and market opportunities and acquire complementary businesses or technologies.

**Results of Operations**

The following table sets forth selected items from our unaudited condensed consolidated statements of operations data as a percentage of total net revenues for each of the periods indicated:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
<b>Consolidated Statements of Operations Data:</b>				
Total net revenues	100%	100%	100%	100%
Total cost of net revenues	46	50	47	50
Gross profit	54	50	53	50
Operating expenses:				
Research and development	29	39	30	47
Sales and marketing	10	13	10	14
General and administrative	7	10	7	11
Restructuring charges		4		4
Total operating expenses	46	66	47	76
Income (loss) from operations	8	(16)	6	(26)
Income taxes				
Net income (loss) attributable to common stockholders	8%	(16)%	6%	(26)%

**Table of Contents****Comparison of Three and Six Months Ended June 30, 2010 and 2009***(Tables presented in thousands, except percentage amounts)**Net Revenues*

	Three Months Ended June 30,			Six Months Ended June 30,		
	2010	2009	% Change	2010	2009	% Change
Net revenues	\$ 40,680	\$ 26,146	56%	\$ 78,131	\$ 50,269	55%

Net revenues increased during the three and six months ended June 30, 2010 compared to the same periods in 2009 driven primarily by higher demand for our home networking products, including new deployments by additional service providers and by higher demand for our DBS outdoor unit products.

*Gross Profit/Gross Margin*

	Three Months Ended June 30,			Six Months Ended June 30,		
	2010	2009	% Change	2010	2009	% Change
Gross profit	\$ 21,849	\$ 12,945	69%	\$ 41,599	\$ 25,164	65%
% of net revenues	54%	50%		53%	50%	

Gross profit increased during the three and six months ended June 30, 2010 compared to the same periods in 2009 driven primarily by higher net revenues from sales of our home networking products and our DBS outdoor unit products.

Gross margin increased during the three and six months ended June 30, 2010 compared to the same periods in 2009 driven primarily by higher sales of our DBS outdoor unit products. Cost of net revenues also included amortization of developed technology in the amounts of \$0.4 million and \$0.8 million, or approximately 1% and 2% of net revenues, during each of the three and six month periods ended June 30, 2010 and 2009, respectively.

*Research and Development Expenses*

	Three Months Ended June 30,			Six Months Ended June 30,		
	2010	2009	% Change	2010	2009	% Change
Research and development	\$ 11,746	\$ 10,102	16%	\$ 23,284	\$ 23,425	(1)%
% of net revenues	29%	39%		30%	47%	

The \$1.6 million increase in research and development expenses during the three months ended June 30, 2010, compared to the three months ended June 30, 2009, was partially due to increased personnel costs of \$0.7 million (of which \$0.2 million was due to stock-based compensation). The increase in personnel costs was principally caused by a 9% increase in employees engaged in research and development activities during the three months ended June 30, 2010 compared to the same period in 2009. Other factors contributing to the increase in research and development expense include a \$0.9 million increase in development tools and supply costs, which include outside services, masks costs and licenses that fluctuate in timing and amount from period to period, all of which resulted from a general increase in research and development activities.



## Edgar Filing: ENTROPIC COMMUNICATIONS INC - Form 10-Q

The \$0.1 million decrease in research and development expenses during the six months ended June 30, 2010, compared to the six months ended June 30, 2009, was partially due to decreased personnel costs of \$0.8 million (of which \$0.3 million was due to stock-based compensation). Although there was a 9% increase in the number of employees engaged in research and development activities at the end of the six months ended June 30, 2010, compared to the same period in 2009, the personnel costs decrease was primarily as a result of the termination benefits incurred during the six months ended June 30, 2009, due to the implementation, in late March 2009, of our restructuring plan. Other factors contributing to the decrease in research and development expense include a \$0.1 million reduction in overhead allocations and depreciation, offset by an \$0.8 million increase in development tools and supply costs, which include outside services, masks costs and licenses that fluctuate in timing and amount from period to period, all of which resulted from a general increase in research and development activities.

**Table of Contents***Sales and Marketing Expenses*

	Three Months Ended June 30,			Six Months Ended June 30,		
	2010	2009	% Change	2010	2009	% Change
Sales and marketing	\$ 3,991	\$ 3,395	18%	\$ 7,769	\$ 7,032	10%
% of net revenues	10%	13%		10%	14%	

The increase of \$0.6 million in sales and marketing expenses for the three months ended June 30, 2010, compared to the three months ended June 30, 2009, was primarily due to increased personnel costs (of which \$0.1 million was due to stock-based compensation), attributable to an 8% increase in the number of employees engaged in sales and marketing activities to support our growth.

The increase of \$0.7 million in sales and marketing expenses for the six months ended June 30, 2010, compared to the six months ended June 30, 2009, was primarily due to increased personnel costs, attributable to an 8% increase in the number of employees engaged in sales and marketing activities to support our growth.

*General and Administrative Expenses*

	Three Months Ended June 30,			Six Months Ended June 30,		
	2010	2009	% Change	2010	2009	% Change
General and administrative	\$ 3,012	\$ 2,712	11%	\$ 5,712	\$ 5,401	6%
% of net revenues	7%	10%		7%	11%	

The \$0.3 million increase in general and administrative expenses for the three months ended June 30, 2010, compared to the three months ended June 30, 2009, was primarily due to increased personnel costs, attributable to a 3% increase in the number of employees engaged in general and administrative activities to support our growth.

The \$0.3 million increase in general and administrative expenses for the six months ended June 30, 2010, compared to the six months ended June 30, 2009, was primarily due to increased personnel costs, attributable to a 3% increase in the number of employees engaged in general and administrative activities to support our growth.

*Amortization of Intangibles*

	Three Months Ended June 30,			Six Months Ended June 30,		
	2010	2009	% Change	2010	2009	% Change
Amortization of intangible assets	\$	\$	%	\$	\$ 16	(100)%
% of net revenues	%	%		%	%	

During the six months ended June 30, 2009, we determined that the intangible assets associated with our 2007 acquisition of Arabella were fully impaired as the core technology acquired would no longer be used in our ongoing business operation and, as such, no further amortization was recognized related to this intangible.

*Impairment of Intangible Assets*

	Three Months Ended June 30,			Six Months Ended June 30,		
	2010	2009	% Change	2010	2009	% Change
Impairment of intangible assets	\$	\$	%	\$	\$ 208	(100)%
% of net revenues	%	%		%	%	

During the six months ended June 30, 2009, we recorded an impairment charge on intangible assets of \$0.2 million. We determined that the intangible assets associated with our 2007 acquisition of Arabella were fully impaired as the core technology acquired would no longer be used in our ongoing business operations.

**Table of Contents***Restructuring Charges*

We incurred restructuring charges of \$1.0 million and \$2.1 million during the three and six months ended June 30, 2009, respectively, resulting from a restructuring plan we implemented in March 2009 that resulted in a worldwide reduction-in-force of 55 employees and the closure of our Nice, France and Kfar Saba, Israel offices. All of the terminated employees received severance payments upon their effective termination. In addition, the affected French and Israeli employees continued to receive salaries until their termination became effective upon the expiration of applicable contractual or statutory notice periods.

The continued payment of salaries to the terminated Nice and Kfar Saba employees during their respective notice periods represented a one-time termination benefit since we were required by contract or law to make these payments whether or not these employees continued to work for us through their actual termination dates.

**Liquidity and Capital Resources**

As of June 30, 2010 and December 31, 2009, we had cash and cash equivalents of \$41.3 million and \$35.3 million, respectively, and no marketable securities for either period.

As of June 30, 2010, we had access to a \$5.0 million revolving credit line under the terms of our Loan and Security Agreement, as amended, with SVB. We amended the provisions of our credit line in April 2010 upon the payment of a \$12,500 amendment fee and extended the term of the credit line through April 8, 2011. The maximum credit available under the credit line was reduced from \$10.0 million to \$5.0 million. As amended, interest on the credit line is payable at an annual interest rate equal to the prime rate plus 0.5% if we maintain a liquidity ratio of at least 1.75 to 1, or the prime rate plus 2.0% if we maintain a liquidity ratio of less than 1.75 to 1. If any portion of the credit line remains unused at any time, we are required to pay a fee equal to 0.125% per annum of the average unused portion of the credit line so long as we maintain a liquidity ratio of at least 1.75 to 1, or 0.5% per annum of the average unused portion of the credit line when our liquidity ratio falls below 1.75 to 1. The credit line, as amended, also limits the aggregate amount of assets and collateral that we are allowed to transfer to, and the amount of investments that we are allowed to make in, certain of our subsidiaries, to \$600,000 per month. The amount available under the credit line cannot exceed 80% of the value of our eligible accounts receivable and may be decreased by certain commitments, such as the \$1.2 million and \$35,000 standby letters of credit that secure our performance under our San Diego, California, and San Jose, California, facility leases, respectively. As of June 30, 2010, the availability was reduced by the two standby letters of credit for our facility leases, and \$3.8 million was available under the credit line.

The following table shows our cash flows from operating activities, investing activities and financing activities for the six months ended June 30, 2010 and 2009 (in thousands):

	Six Months Ended June 30,	
	2010	2009
Net cash provided by (used in) operating activities	\$ 6,181	\$ (1,696)
Net cash (used in) provided by investing activities	(1,901)	2,518
Net cash provided by financing activities	1,817	510
Net effect of exchange rates on cash	(20)	
<b>Total increase in cash and cash equivalents</b>	<b>\$ 6,077</b>	<b>\$ 1,332</b>

**Cash Flows from Operating Activities**

Net cash provided by operating activities was \$6.2 million for the six months ended June 30, 2010, primarily resulting from net income of \$4.9 million, \$4.7 million in stock compensation expenses, depreciation and amortization of \$2.6 million, a \$4.6 million increase in accounts payable and other liabilities, driven primarily by an increase in inventory, and a \$0.5 million decrease in prepaid expenses. The increase in net cash was offset by a \$6.7 million increase in inventory primarily related to new deployments of our home networking products and an increase in accounts receivable of \$4.4 million due to an increase in sales during the six months ended June 30, 2010.

## Edgar Filing: ENTROPIC COMMUNICATIONS INC - Form 10-Q

Net cash used in operating activities was \$1.7 million for the six months ended June 30, 2009, primarily resulting from a net loss of \$13.0 million and an increase in accounts receivable of \$1.0 million due to a majority of sales occurring later in the second quarter of 2009, offset by \$5.0 million in stock compensation expenses, a \$5.2 million decrease in inventory primarily due to lower than anticipated future revenues at June 30, 2009, and \$2.5 million in depreciation and amortization expenses including \$0.8 million attributable to amortization of developed technology.

## **Table of Contents**

### ***Cash Flows from Investing Activities***

Net cash used in investing activities was \$1.9 million for the six months ended June 30, 2010 due to purchases of property and equipment primarily consisting of research and development equipment.

Net cash provided by investing activities was \$2.5 million for the six months ended June 30, 2009, primarily due to \$3.5 million sales of marketable securities offset by \$1.0 million in purchases of property and equipment primarily consisting of operations equipment and research and development equipment.

### ***Cash Flows from Financing Activities***

Net cash provided by financing activities was \$1.8 million for the six months ended June 30, 2010, due to proceeds from the issuance of common stock in connection with stock option exercises.

Net cash provided by financing activities was \$0.5 million for the six months ended June 30, 2009, due to proceeds from the issuance of common stock in connection with stock option exercises and stock purchases made under our ESPP.

We expect to experience an increase in our operating expenses in absolute dollars, particularly in research and development expenses, but also in sales and marketing and general and administrative expenses, for the foreseeable future in order to execute our business strategy and to support our growth. As a result, we anticipate that operating expenses, as well as planned capital expenditures, will constitute a material use of our cash resources.

We believe that our cash and cash equivalents of \$41.3 million as of June 30, 2010, together with the \$3.8 million available to us under our existing credit line as of June 30, 2010, will be sufficient to fund our projected operating requirements for at least the next 12 months. We intend to continue spending substantial amounts in connection with the growth of our business and we may need to obtain additional financing to pursue our business strategy, develop new products, respond to competition and market opportunities, and acquire complementary businesses or technologies. We may not be able to obtain such financing on favorable terms or at all. If we were to raise additional capital through further sales of our equity securities, our stockholders would suffer dilution of their equity ownership. If we engage in debt financing, we may be required to accept terms that restrict our ability to incur additional indebtedness, prohibit us from paying dividends, repurchasing our stock or making investments and force us to maintain specified liquidity or other ratios, any of which could harm our business, operating results and financial condition.

### **Indemnities**

In the ordinary course of business, we have entered into agreements with customers that include indemnity provisions. Based on historical experience and information known as of June 30, 2010, we have not recorded any indemnity obligations.

### **Off-Balance Sheet Arrangements**

During the periods presented, we did not have, nor do we currently have, any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

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

Our discussion and analysis of our financial condition and the results of operations are based on our financial statements which have been prepared in accordance with GAAP. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. Our critical accounting policies are discussed in our Annual Report and there have been no material changes to such policies with the exception of new revenue recognition guidance which we adopted effective January 1, 2010. The guidance allows companies to allocate arrangement consideration in multiple deliverable agreements in a manner that is intended to better reflect the transaction's economics. The guidance also removes non-software components of tangible products and certain software components of tangible products from the scope of existing software revenue guidance. The application of this guidance did not have a material impact on our consolidated financial statements.



**Table of Contents**

**Recent Accounting Pronouncements**

On March 31, 2010, the Financial Accounting Standards Board (FASB) ratified the milestone method of revenue recognition. Under this new standard, an entity can recognize contingent consideration earned from the achievement of a substantive milestone in its entirety in the period in which the milestone is achieved. A milestone is defined as an event (i) that can only be achieved based in whole or in part on either the entity's performance or on the occurrence of a specific outcome resulting from the entity's performance (ii) for which there is substantive uncertainty at the date the arrangement is entered into that the event will be achieved and (iii) that would result in additional payments being due to the entity. The milestone method of revenue recognition is effective for fiscal years beginning on or after June 15, 2010 and may be applied prospectively after the adoption date or retrospectively for all periods presented. We are currently in the process of evaluating whether to adopt this new standard early. The impact of adoption of our consolidated financial statements will ultimately depend on the terms of any future business transactions.

There have been no other recent accounting pronouncements or changes in accounting pronouncements during the three and six months ended June 30, 2010, as compared to the recent accounting pronouncements described in the Annual Report that are of material significance, or have potential material significance, to us.



## **Table of Contents**

### **Item 3. *Quantitative and Qualitative Disclosures About Market Risk.***

#### **Foreign Currency Risk**

Our sales have been historically denominated in U.S. dollars and an increase in the value of the U.S. dollar relative to the currencies of the countries in which our customers operate could materially affect the demand of our non-U.S. customers for our products, leading to a reduction in orders placed by these customers, which would adversely affect our business. Our international sales and marketing operations incur expenses that are denominated in foreign currencies. These expenses could be materially affected by currency fluctuations; however, we do not consider this currency risk to be material as the related costs do not constitute a significant portion of our total spending. We outsource our wafer manufacturing, assembly, testing, warehousing and shipping operations; however all expenses related thereto are denominated in U.S. dollars. If the value of the U.S. dollar decreases relative to the currencies of the countries in which such contractors operate, the prices we are charged for their services may increase, which would adversely affect our business. Currently, we have not implemented any hedging strategies to mitigate risks related to the impact of fluctuations in currency exchange rates.

#### **Interest Rate Risk**

We typically maintain an investment portfolio of various holdings, types and maturities. We do not use derivative financial instruments. We place our cash investments in deposits and money market funds with major financial institutions, U.S. government obligations and debt securities of corporations with strong credit ratings in a variety of industries that meet high credit quality standards, as specified in our investment policy guidelines. These guidelines also limit the amount of credit exposure to any one issue, issuer or type of instrument.

Our cash and cash equivalents are not subject to significant interest rate risk due to the short maturities of these instruments. As of June 30, 2010, the carrying value of our cash and cash equivalents approximated fair value. A change in market interest rates of 1.0% annualized would have impacted our net income from these investments by \$0.2 million for the six months ended June 30, 2010.

#### **Marketable Securities Risk**

Our cash equivalents and marketable securities, to the extent we hold any, consist of U.S. Treasury and agency obligations, commercial paper, corporate notes and bonds, time deposits, foreign notes and certificates of deposit, and are generally classified as held-to-maturity and are stated at cost, adjusted for amortization of premiums and discounts to maturity. In the past, certain of our short-term marketable securities were classified as available-for-sale and were stated at fair value, which was equal to cost due to the short-term maturity of these securities. In the event that there were to be a difference between fair value and cost in any of our available-for-sale securities, unrealized gains and losses on these investments would be reported as a separate component of accumulated other comprehensive income (loss).

Our investment policy for marketable securities requires that all securities mature in two years or less, with a weighted average maturity of no longer than 12 months. As of June 30, 2010, we did not carry any of these securities, but we may do so in the future. The fair value of marketable securities we may purchase will fluctuate based on changes in market conditions and interest rates and is affected by the credit condition of the U.S. financial sector. Absent the unprecedented turmoil and upheaval in the U.S. financial sector, given the short-term maturities of marketable securities we may purchase, we do not believe these instruments will be subject to significant market or interest rate risk. Although there have been recent signs of improvement within the U.S. financial sector, the sector remains fragile and conditions may deteriorate rapidly, which could adversely affect the value, realized or unrealized, of our investments and cause us to record significant impairment losses.

Investments in fixed rate interest earning instruments carry a degree of interest rate risk. Fixed rate securities may have their market value adversely impacted due to rising interest rates. Due in part to these factors, our future investment income may fall short of expectations due to changes in interest rates.

**Table of Contents**

**Item 4. *Controls and Procedures.***

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our periodic reports filed with the SEC are recorded, processed, summarized and reported within the time periods specified in the rules and forms of the SEC and that such information is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and no evaluation of controls and procedures can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected. Management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As required by Rule 13a-15(b) of the Securities Exchange Act of 1934, as amended, or the Exchange Act, prior to filing this Quarterly Report, we carried out an evaluation, under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Exchange Act) as of the end of the period covered by this Quarterly Report. Based on their evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this Quarterly Report.

An evaluation was also performed under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, of any change in our internal control over financial reporting that occurred during our fiscal quarter ended June 30, 2010 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting. That evaluation did not identify any change in our internal control over financial reporting that occurred during our fiscal quarter ended June 30, 2010 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

---

**Table of Contents**

**PART II: OTHER INFORMATION**

**Item 1A. Risk Factors**

*Investing in our common stock involves a high degree of risk. Before deciding to purchase, hold or sell our common stock, you should carefully consider the risks described below in addition to the other cautionary statements and risks described, and the other information contained, elsewhere in this Quarterly Report, in our Annual Report and in our other filings with the SEC. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also affect our business. If any of these known or unknown risks or uncertainties actually occurs, our business, financial condition, results of operations and/or liquidity could be seriously harmed. In that event, the trading price of our common stock could decline, and you could lose some or all of your investment.*

*The risk factors set forth below with an asterisk (\*) next to the title are new risk factors or risk factors containing changes from the risk factors previously disclosed in our Annual Report.*

**Risks Related to Our Business**

***We have had net operating losses for several years, had an accumulated deficit of \$237.1 million as of June 30, 2010 and only recently became profitable on a quarterly basis, and we are unable to predict whether we will remain profitable.\****

We were incorporated in 2001, did not commence shipping production quantities of our home networking products until December 2004 and only became profitable in the fourth quarter of 2009. Consequently, any predictions about future performance may not be as accurate as they could be if we had a longer history of successfully commercializing our home networking solutions. You should not rely on our operating results for any prior quarterly or annual periods as an indication of our future operating performance.

We have incurred substantial net operating losses during our limited operating history. For the years ended December 31, 2009, 2008 and 2007, we incurred net losses attributable to common stockholders of \$13.2 million, \$136.4 million and \$32.1 million, respectively, and for the six months ended June 30, 2010, we had net income of \$4.9 million. Although we became profitable in the fourth quarter of 2009 and continued to maintain quarterly profitability in the first and second quarters of 2010, we have incurred significant net losses since our inception and have never been profitable on an annual basis. As of June 30, 2010, we had an accumulated deficit of \$237.1 million. We may incur operating losses in the future as we continue to make significant expenditures related to the development of our products and the expansion of our business, and increase our general and administrative expenses to comply with public company reporting requirements. Our ability to sustain profitability depends on the extent to which we can maintain revenue and control or improve upon our cost control in order to counter any unforeseen difficulties, complications, product delays or other unknown factors that may require additional expenditures, or unforeseen difficulties or costs associated with the integration of acquired assets or businesses. Because of the numerous risks and uncertainties associated with our growth prospects, product development, sales and marketing and other efforts and factors, we are unable to predict the extent of our profitability or future losses. If we are unable to achieve adequate growth, we may not sustain profitability and our stock price could decline.

***We face intense competition and expect competition to increase in the future, with many of our competitors being larger, more established and better capitalized than we are.\****

The markets for our products are extremely competitive and have been characterized by rapid technological change, evolving industry standards, rapid changes in customer requirements, short product life cycles and frequent introduction of next generation and new products, as well as competing technologies. This competition could make it more difficult for us to sell our products and result in increased pricing pressure, reduced gross profit as a percentage of revenues or gross margins, increased sales and marketing expenses and failure to increase or the loss of market share or expected market share. Semiconductor products in particular have a history of declining prices driven by customer insistence on lower prices as the cost of production is reduced and as demand falls when competitive products or newer, more advanced products are introduced. If market prices decrease faster than product costs, our gross margins and operating margins would be adversely affected. Moreover, we expect increased competition from other established and emerging companies both domestically and internationally. In particular, we currently face, or in the future expect to face, competition from companies such as Broadcom Corporation, or Broadcom, STMicroelectronics N.V., Trident Microsystems, Inc., Sigma Designs, Inc. and Cisco Systems, Inc. in the sale of MoCA-compliant chipsets and technology. For example, Broadcom has announced the availability of several multi-format video decoder system-on-a-chip solutions with integrated MoCA functionality. Broadcom's MoCA home networking reference design platform, which is based on Broadcom's MoCA-enabled system-on-a-chip product, has achieved MoCA 1.0 and MoCA 1.1 certification from the MoCA certification board.



## **Table of Contents**

In addition, current and potential competitors may establish cooperative relationships among themselves or with third parties. If so, competitors or alliances that include our competitors may emerge and could acquire significant market share. Further, our current and potential competitors may also enter into licensing arrangements with third parties with respect to MoCA chipsets or technology on licensing terms that are more favorable than the licensing terms that we would be able to offer through the direct licensing of our MoCA chipsets and technology to such third parties. We expect these trends to continue as companies attempt to strengthen or maintain their market positions in an evolving industry. In addition, our competitors could develop products or technologies that cause our products and technologies to become non-competitive or obsolete, or cause us to substantially reduce our prices.

Currently, we face competition from a number of established companies that offer products based on competing technologies, such as Data over Cable Service Interface Specifications, versions of Digital Subscriber Line, Ethernet, HomePNA, HomePlug AV, Broadband over Power Line, High Performance Network Over Coax, or HiNOC, Wi-Fi and WiMAX, also known as Worldwide Interoperability for Microwave Access. Although some of these competing technologies were not originally designed to operate over coaxial cables, our competitors have modified certain technologies, including HomePNA, HomePlug AV, Broadband over Power Line and Wi-Fi, to work on the same in-home coaxial cables that our MoCA-based products use. We also expect to face competition from companies that offer products based on G.hn technology once the G.hn standard has been set by the International Telecommunication Union, or ITU. Many of our competitors and potential competitors are substantially larger and have longer operating histories, larger customer bases and significantly greater financial, technical, sales, marketing and other resources than we. Given their capital resources, many of these larger organizations are in a better position to withstand any significant reduction in customer purchases or market downturns in the markets in which we compete. Many of our competitors also have broader product lines and market focus, allowing them to bundle their products and services and effectively use other products to subsidize lower prices for those products that compete with ours or to provide integrated product solutions that offer cost advantages to customers. In addition, many of our competitors have been in operation much longer than we and therefore have better name recognition and more long-standing and established relationships with service providers, ODMs and OEMs.

Our ability to compete depends on a number of factors, including:

the adoption of our products and technologies by service providers, ODMs and OEMs;

the performance and cost effectiveness of our products relative to our competitors' products;

our ability to deliver high quality and reliable products in large volumes and on a timely basis;

our ability to build close relationships with service providers, ODMs and OEMs;

our success in developing and utilizing new technologies to offer products and features previously not available in the marketplace that are technologically superior to those offered by our competitors;

our ability to identify new and emerging markets and market trends;

our ability to reduce our product costs and receive favorable pricing from our suppliers;

our ability to recruit design and application engineers and other technical personnel;

our ability to protect our intellectual property and obtain licenses to the intellectual property of others on commercially reasonable terms; and

availability of substitute goods offered at a lower price than ours.

Our inability to address any of these factors effectively, alone or in combination with others, could seriously harm our business, operating results and financial condition.

In addition, consolidation by industry participants could result in competitors with increased market share, larger customer bases, greater diversified product offerings and greater technological and marketing expertise, which would allow them to compete more effectively against us. Current and potential competitors may also gain such competitive advantages by establishing financial or strategic relationships with existing or potential customers, suppliers or other third-parties. These new competitors or alliances among competitors could emerge rapidly and acquire significant market share. In addition, some of our suppliers and customers offer or may offer products that compete with our products. Depending on the participants, industry consolidation or the formation of strategic relationships could have a material adverse effect on our business and results of operations by reducing our ability to compete successfully in our current markets and the markets we are seeking to serve.

---

## **Table of Contents**

***We depend on a limited number of customers, and ultimately service providers, for a substantial portion of our revenues, and the loss of, or a significant shortfall in, orders from any of these parties could significantly impair our financial condition and results of operations.\****

We derive a substantial portion of our revenues from a limited number of customers. For example, during the six months ended June 30, 2010, three customers accounted for approximately 44% of our net revenues. Our inability to generate anticipated revenues from our key existing or targeted customers, or a significant shortfall in sales to certain of these customers would significantly reduce our revenues and adversely affect our operating results. Our operating results in the foreseeable future will continue to depend on our ability to effect sales to existing and other large customers.

In addition, we depend on a limited number of service providers that purchase products from our customers that incorporate our products. To date, we primarily rely on two major service providers, Verizon and DIRECTV, to deploy products using our home networking solutions. We also primarily rely on two major service providers, DISH Network and DIRECTV, to deploy products using our digital broadcast satellite outdoor unit solutions. During the six months ended June 30, 2010, products sold to our customers that were incorporated into products purchased by DIRECTV, Verizon, DISH Network and Comcast accounted for approximately 90% of our net revenues with one of them accounting for approximately 50% of our net revenue. If these service providers, or other service providers that elect to use our products, reduce or eliminate purchases of our customers' products which incorporate our products, this would significantly reduce our revenues and adversely affect our operating results. In addition, any sudden or unexpected slowdown in deployments by service providers that incorporate our products may lead to an inventory buildup by our customers who may, in turn, postpone taking delivery of our products or wait to clear their existing inventory before ordering more products from us, which, in turn, may adversely affect our results. Our operating results in the foreseeable future will continue to depend on a limited number of service providers' demand for products which incorporate our products.

We may have conflicts with our customers or the service providers that purchase products from our customers that incorporate our products. Any such conflict could result in events that have a negative impact on our business, including:

reduced purchases of our products or our customers' products that incorporate them;

uncertainty regarding ownership of intellectual property rights;

litigation or the threat of litigation; or

settlements or other business arrangements imposing obligations on us or restrictions on our business, including obligations to license intellectual property rights or make cash payments.

***If we fail to develop and introduce new or enhanced products on a timely basis, our ability to attract and retain customers could be impaired, and our competitive position may be harmed.\****

To compete successfully, we must design, develop, market and sell new or enhanced products that provide increasingly higher levels of performance and reliability and meet the cost expectations of our customers. The introduction of new products by our competitors, the market acceptance of products based on new or alternative technologies, or the emergence of new industry standards could render our existing or future products obsolete. Our failure to anticipate or timely develop new or enhanced products or technologies in response to technological shifts could result in decreased revenues and an increase in design wins by our competitors. In particular, we may experience difficulties with product design, manufacturing, marketing or certification that could delay or prevent our development, introduction or marketing of new or enhanced products. If we fail to introduce new or enhanced products that meet the needs of our customers or penetrate new markets in a timely fashion, we may lose market share and our operating results will be adversely affected.

***Our results could be adversely affected if our customers or the service providers who purchase their products are unable to successfully compete in their respective markets.\****

Our customers and the service providers that purchase products from our customers face significant competition from their competitors. We rely on these customers' and service providers' ability to develop products and/or services that meet the needs of their customers in terms of functionality, performance, availability and price. If these customers and service providers do not successfully compete, they may lose market

## Edgar Filing: ENTROPIC COMMUNICATIONS INC - Form 10-Q

share, which would negatively impact the demand for our products. For example, for our home networking products, there is intense competition among service providers to deliver video and other multimedia content into and throughout the home. For the sale of our home networking products,



**Table of Contents**

we are currently dependent on Verizon's and DIRECTV's ability to compete in the market for the delivery of HD video and other multimedia content. Therefore, factors influencing Verizon's or DIRECTV's ability to compete in this market, such as laws and regulations regarding local cable franchising or satellite broadcasting rights, could have an adverse effect on our current ability to sell home networking products. In addition, our digital broadcast satellite outdoor unit products are primarily supplied to digital broadcast satellite service providers by our ODM and OEM customers. Digital broadcast satellite service providers are facing significant competition from telecommunications carriers and cable multiple service operators as they compete for customers in terms of video, voice and data services. Moreover, ODMs and OEMs who market satellite set-top boxes using our silicon tuners are competing with a variety of internet protocol-based video delivery solutions, including versions of Digital Subscriber Line technology and certain fiber optic-based solutions. Many of these technologies compete effectively with satellite set-top boxes and do not require tuners such as the ones we sell. If our customers and the service providers who purchase products from our customers that incorporate our products do not successfully compete, they may lose market share, which would reduce their demand for our products.

***If the market for HD video and other multimedia content delivery solutions based on the MoCA standard does not develop as we anticipate, our revenues may decline or fail to grow, which would adversely affect our operating results.\****

We derive, and expect to continue to derive for the foreseeable future, a significant portion of our revenues from sales of our home networking products based on the MoCA standard. The market for multimedia content delivery solutions based on the MoCA standard is relatively new, still evolving and difficult to predict. Currently, the growth of the MoCA-based multimedia content delivery market and the success of our business are largely driven by the adoption and deployment of the existing and future generations of the technology by service providers, ODMs and OEMs and, to a lesser extent, by consumer adoption of such technology which is dependent on the availability of over-the-top, or OTT, services that directly deliver internet video content into the home. It is uncertain whether the MoCA standard will achieve and sustain high levels of demand and market acceptance by service providers or consumers, whether the availability of OTT services will continue to grow or whether consumers beyond the early technology adopters will embrace OTT services in increasing numbers, if at all. Some service providers, ODMs and OEMs have adopted, and others may adopt, multimedia content delivery solutions that rely on technologies other than the MoCA standard or may choose to wait for the introduction of products and technologies that serve as a replacement or substitute for, or represent an improvement over, MoCA-based solutions. The alternative technology solutions, which compete with MoCA-based solutions, currently include Ethernet, HomePNA, Home Plug AV, Wi-Fi and WiMedia. It is critical to our success that additional service providers, including telecommunications carriers, digital broadcast satellite service providers and cable operators, adopt the MoCA standard for home networking.

If the market for MoCA-based solutions does not continue to develop or develops more slowly than we expect, or if we make errors in predicting adoption and deployment rates for these solutions, our revenues may be significantly adversely affected. Our operating results may also be adversely affected by any delays in consumer adoption of OTT services, or if the market for OTT services develops more slowly than we expect.

***Even if service providers, ODMs and OEMs adopt multimedia content delivery solutions based on the MoCA standard, we may not compete successfully in the market for MoCA-compliant chipsets.***

As a member of MoCA, we are required to license any of our patent claims that are essential to implement the MoCA specifications to other MoCA members on reasonable and non-discriminatory terms. As a result, we are required to license some of our important intellectual property to other MoCA members, including other semiconductor manufacturers that may compete with us in the sale of MoCA-compliant chipsets. If we are unable to differentiate our MoCA-compliant chipsets from other MoCA-compliant chipsets by offering superior pricing and features outside MoCA specifications, we may not be able to compete effectively in the market for such chipsets. Moreover, although we are currently and actively involved in the ongoing development of the MoCA standard, we cannot guarantee that future MoCA specifications will incorporate technologies or product features we are developing or that our products will be compatible with future MoCA specifications. As additional members, including our competitors, continue to join MoCA, they and existing members may exert greater influence on MoCA and the development of the MoCA standard in a manner that is adverse to our interests. If our home networking products fail to comply with future MoCA specifications, the demand for these products could be severely reduced.

---

**Table of Contents**

*The semiconductor and communications industries are highly cyclical and subject to rapid change and evolving industry standards and, from time to time, have experienced significant downturns in customer demand as well as unexpected increases in demand resulting in production capacity constraints. These factors could impact our operating results, financial condition and cash flows and may increase the volatility of the price of our stock.\**

The semiconductor and communications industries are highly cyclical and subject to rapid change and evolving industry standards and, from time to time, have experienced significant downturns in customer demand, most recently in late 2008 through 2009 as a result of the deterioration in global macroeconomic conditions. These downturns are characterized by decreases in product demand, excess customer inventories and accelerated erosion of prices; factors which have caused, and could continue to cause, substantial fluctuations in our net revenue and in our operating results. Any downturns in the semiconductor and communications industries may be severe and prolonged, and any failure of these industries to fully recover from downturns could harm our business. For example, because a significant portion of our expense is fixed in the near term or is incurred in advance of anticipated sales, during these downturns we may not be able to decrease our expenses rapidly enough to offset any unanticipated shortfall in revenues during industry downturns, which could adversely affect our operating results. Even as the industry recovers from the most recent downturn, some OEMs and ODMs may slow down their research and development activities, cancel or delay new product development, reduce their inventories and/or take a cautious approach to acquiring products, which may negatively impact our business.

The semiconductor and communications industries also periodically experience increased demand and production capacity constraints, which may affect the ability of companies such as ours to ship products to customers. Any factor adversely affecting either the semiconductor or communications industries in general, or the particular segments of any of these industries that our products target, may adversely affect our ability to generate revenue and could negatively impact our operating results, cash flow and financial condition. During 2010, the semiconductor and communications industries began experiencing supply shortages due to sudden increases in demand beyond foundry capacity. In addition to capacity issues, during periods of increased demand these industries may also experience difficulty obtaining sufficient manufacturing, assembly and test resources from manufacturers. If, as a result of these industry issues, we are unable to meet our customers increased demand for our products, we would miss opportunities for additional revenue and could experience a negative impact on our relationships with affected customers. Further, in response to the cyclical and rapidly changing nature of the semiconductor and communications industries, our operating results may fluctuate from period to period as we adjust our inventory and production requirements to meet the changing demands of our customers, which could impact our financial condition and cash flows and may increase the volatility of the price of our stock.

*Our operating results have fluctuated significantly in the past and we expect them to continue to fluctuate in the future, which could lead to volatility in the price of our common stock.*

Our operating results have fluctuated in the past and are likely to continue to fluctuate, on an annual and a quarterly basis, as a result of a number of factors, many of which are outside of our control. These fluctuations in our operating results may cause our stock price to fluctuate as well. The primary factors that are likely to affect our quarterly and annual operating results include:

changes in demand for our products or those offered by service providers and our customers;

the timing and amount of orders, especially from significant service providers and customers;

the seasonal nature of the sales of products that incorporate our products by certain service providers which may affect the timing of orders for our products;

the level and timing of capital spending of service providers, both in the United States and in international markets;

competitive market conditions, including pricing actions by us or our competitors;

adverse market perception of MoCA-compliant products;

our unpredictable and lengthy sales cycles;

the mix of products and product configurations sold;

our ability to successfully define, design and release new products on a timely basis that meet customers or service providers needs;

**Table of Contents**

costs related to acquisitions of complementary products, technologies or businesses;

new product introductions and enhancements, or the market anticipation of new products and enhancements, by us or our competitors;

the timing of revenue recognition on sales arrangements, which may include multiple deliverables and the effect of our use of inventory hubbing arrangements;

unexpected changes in our operating expenses;

general economic conditions (including the current industry and economic downturn) and political conditions in the countries where we operate or our products are sold or used;

our ability to attain and maintain production volumes and quality levels for our products, including adequate allocation of wafer, assembly and test capacity for our products by our subcontractors;

our customers' ability to obtain other components needed to manufacture their products;

the cost and availability of components and raw materials used in our products, including, without limitation, increases in the price of gold;

changes in manufacturing costs, including wafer, test and assembly costs, manufacturing yields and product quality and reliability;

productivity of our sales and marketing force;

our inability to reduce operating expenses in a particular quarter if revenues for that quarter fall below expectations;

future accounting pronouncements and changes in accounting policies;

costs associated with litigation; and

changes in domestic and international regulatory environments.

Unfavorable changes in any of the above factors, many of which are beyond our control, could significantly harm our business and results of operations. You should not rely on the results of prior periods as an indication of our future performance.

***Adverse U.S. and international economic conditions have affected and may continue to adversely affect our revenues, margins and profitability.***

## Edgar Filing: ENTROPIC COMMUNICATIONS INC - Form 10-Q

Since September 2008, the credit markets and the financial services industry have been experiencing a period of unprecedented turmoil and upheaval characterized by the bankruptcy, failure, collapse or sale of various financial institutions and an unprecedented level of intervention from the U.S. federal government. These events, together with the current adverse economic conditions facing the broader economy and, in particular, the semiconductor and communications industries, have adversely affected, and may continue to adversely affect, our business as service providers cut back or delay deployments that include our products and to the extent that consumers decrease their discretionary spending for enhanced video offerings from service providers, which may in turn lead to cautious or reduced spending by service providers and, in turn, may lead to a decrease in orders for our products, thereby adversely affecting our operating results. Our operating results may also be adversely affected if the State of California adopts laws to suspend net operating loss deductions as it has done in the past in response to the sharp decrease in tax revenue collections caused by the current adverse economic conditions.

We may also experience adverse conditions in our cost base due to changes in foreign currency exchange rates that reduce the purchasing power of the U.S. dollar, increase research and development expenses and other factors. These conditions may harm our margins and prevent us from achieving or sustaining profitability if we are unable to increase the selling prices of our products or reduce our costs sufficiently to offset the effects of effective increases in our costs. Our attempts to offset the effects of cost increase through controlling our expenses, passing cost increases on to our customers or any other method may not succeed.

## **Table of Contents**

***The success of our digital broadcast satellite outdoor unit products depends on the demand for our products within the satellite digital television market and the growth of this overall market.***

In addition to our MoCA home networking products, we also derive a significant portion of our revenues from sales of our digital broadcast satellite outdoor unit products into markets served by digital broadcast satellite providers and their ODM and OEM partners. The digital broadcast satellite market may not grow in the future as anticipated or a significant market slowdown may occur, which would in turn reduce the demand for applications or devices, such as set-top boxes and low-noise block converters that rely on our digital broadcast satellite outdoor unit products. Because of the intense competition in the satellite, terrestrial and cable digital television markets, the unproven technology of many products addressing these markets and the short product life cycles of many consumer applications or devices, it is difficult to predict the potential size and future growth rate of the markets for our digital broadcast satellite outdoor unit products. If the demand for our digital broadcast satellite outdoor unit products is not as great as we expect, or if we are unable to produce competitive products to meet that demand, our revenues could be adversely affected.

***Market-specific risks affecting the digital television, digital television set-top boxes and digital television peripheral markets could impair our ability to successfully sell our silicon tuners.***

The market for digital television applications in digital televisions, digital television set-top boxes and digital television peripherals is characterized by certain market-specific risks, any of which may adversely affect our ability to sell our silicon tuners. For example, sellers of module tuners that offer similar or better functionality than our silicon tuner solutions may dramatically lower their prices and become more competitive than we in the tuner market. In addition, our silicon tuners may not meet the specifications or have the feature sets desired by our customers or may not be architecturally compatible with other components in the customers' designs. Our efforts to penetrate the digital television market, in particular, will depend on our ability to overcome these and other challenges. To the extent our efforts are adversely affected by any of these risks or are otherwise unsuccessful, the demand for our silicon tuner products may not develop as anticipated or decline which would adversely affect our revenues, financial condition and results of operations.

***The success of our silicon tuners is highly dependent on our relationships with demodulator manufacturers.***

Our silicon tuners are designed to be interoperable with various specific demodulator integrated circuit products that are designed and manufactured by other companies. Historically, we have relied on strategic relationships with various demodulator manufacturers to enable both parties to offer an interoperable tuner/demodulator solution to mutual end customers. Although we work in concert with third-party demodulator manufacturers to complete highly functional reference designs, we have no control over their future product plans and product roadmaps and could be effectively designed out of future customer applications by the refusal of such a demodulator manufacturer to continue to support our products. Likewise, our ability to acquire new customers is dependent on the cooperation of third-party demodulator manufacturers. If such third-party manufacturers decide to partner with one of our competitors or to provide their own tuner solutions, we would effectively be prevented from selling our products to potential new customers. Furthermore, our dependence on these third-party demodulator manufacturers often limits our strategic direction. If we were to design products that were competitive with any of such demodulator manufacturers, they may choose to stop working with us.

If any of the current or prospective demodulator manufacturers with whom we have or intend to have relationships were to stop working with us in favor of other tuner manufacturers or in favor of deploying their own tuner products, we would be effectively designed out of current and potential customers' products and the demand for our silicon tuners would be substantially reduced.

***The market for our broadband access products is limited and these products may not be widely adopted.***

Our broadband access products are designed to meet broadband access requirements in areas characterized by fiber optic network deployments that terminate within one kilometer of customer premises. We believe the primary geographic markets for our broadband access products are currently in certain Asian countries such as China, Japan and Korea, and parts of Europe where there are many multi-dwelling units and fiber optic networks that extend to or near a customer premises. We do not expect to generate significant revenues from sales of our broadband access products in North America, which is generally characterized by low-density housing, or in developing nations which do not generally have extensive fiber optic networks. To the extent our efforts to sell our broadband access products into currently targeted markets are unsuccessful, the demand for these products may not develop as anticipated or may decline, either of which could adversely affect our future revenues. Moreover, these markets have a large number of service providers and varying regulatory standards, both of which may delay any widespread adoption of our products and increase the time during which competing technologies could be introduced and displace our products.

In addition, if areas characterized by fiber optic networks that terminate within one kilometer of customer premises do not continue to grow, or we are unable to develop broadband access products that are competitive outside of these



## **Table of Contents**

areas, the demand for our broadband access products may not grow and our revenues may be limited. Even if the markets in which our broadband access products are targeted continue to grow or we are able to serve additional markets, customers and service providers may not adopt our technology. There are a growing number of competing technologies for delivering high-speed broadband access from the service provider's network to the customer's premises. For example, our broadband access products face competition from products using DOCSIS, versions of DSL, Ethernet and WiMAX-based solutions. Moreover, there are many other access technologies that are currently in development including some low cost proprietary solutions. If service providers adopt competing products or technologies, the demand for our broadband access products will decline and we may not be able to generate significant revenues from these products.

***We intend to expand our operations and increase our expenditures in an effort to grow our business. If we are not able to manage this expansion and growth, or if our business does not grow as we expect, we may not be able to realize a return on the resources we devote to expansion.\****

We anticipate that we will continue to expand our infrastructure and grow our headcount to accommodate changes in our research and development strategy and achieve planned expansion of our product offerings, projected increases in our customer base and anticipated growth in the number of our product deployments. Overgrowth may place a strain on our administrative and operational infrastructure. Our success in managing our growth will be dependent upon our ability to:

enhance our operational, financial and management controls, reporting systems and procedures;

expand our facilities and equipment and develop new sources of supply for the manufacture, assembly and testing of our semiconductor products;

successfully hire, train, motivate and productively deploy employees, including technical personnel; and

expand our international resources.

Our inability to address effectively any of these factors, alone or in combination with others, could harm our ability to execute our business strategy.

Further, we intend to continue to grow our business by entering new markets, developing new product offerings and pursuing new customers. If we fail to timely or efficiently expand operational and financial systems in connection with such growth or if we fail to implement or maintain effective internal controls and procedures, resulting operating inefficiencies could increase costs and expenses more than we planned and might cause us to lose the ability to take advantage of market opportunities, enhance existing products, develop new products, satisfy customer requirements, respond to competitive pressures, control our inventory or otherwise execute our business plan. Failure to implement or maintain such controls and procedures could also impact our ability to produce timely and accurate financial statements. Additionally, if we increase our operating expenses in anticipation of the growth of our business and such growth does not meet our expectations, our financial results likely would be negatively impacted.

***Any acquisition, strategic relationship, joint venture or investment could disrupt our business and harm our financial condition.***

We actively pursue acquisitions, strategic relationships, joint ventures, collaborations or investments that we believe may allow us to complement our growth strategy, increase market share in our current markets or expand into adjacent markets, or broaden our technology and intellectual property. Such transactions may be complex, time consuming and expensive, and may present numerous challenges and risks including:

difficulties in assimilating any acquired workforce and merging operations;



## Edgar Filing: ENTROPIC COMMUNICATIONS INC - Form 10-Q

attrition and the loss of key personnel;

an acquired company, asset or technology, or a strategic collaboration or licensed asset or technology not furthering our business strategy as anticipated;

our overpayment for a company, asset or technology or changes in the economic or market conditions or assumptions underlying our decision to make an acquisition;

difficulties entering and competing in new product or geographic markets and increased competition, including price competition;

**Table of Contents**

significant problems or liabilities, including increased intellectual property and employment related litigation exposure, associated with acquired businesses, assets or technologies;

in connection with any such transaction, the need to use a significant portion of our available cash, issue additional equity securities that would dilute the then-current stockholders' percentage ownership or incur substantial debt or contingent liabilities;

requirements to devote substantial managerial and engineering resources to any strategic relationship, joint venture or collaboration, which could detract from our other efforts or significantly increase our costs;

lack of control over the actions of our business partners in any strategic relationship, joint venture or collaboration, which could significantly delay the introduction of planned products or otherwise make it difficult or impossible to realize the expected benefits of such relationship; and

requirements to record substantial charges and amortization expense related to certain intangible assets, deferred stock compensation and other items.

Any one of these challenges or risks could impair our ability to realize any benefit from our acquisitions, strategic relationships, joint ventures or investments after we have expended resources on them.

In addition, from time to time we may enter into negotiations for acquisitions, relationships, joint ventures or investments that are not ultimately consummated. These negotiations could result in significant diversion of management time, as well as substantial out-of-pocket costs.

We cannot forecast the number, timing or size of future acquisitions, strategic relationships, joint ventures or investments, or the effect that any such transactions might have on our operating or financial results. Any such transaction could disrupt our business and harm our operating results and financial condition.

***We may not realize the anticipated financial and strategic benefits from the businesses we have acquired or be able to successfully integrate such businesses with ours.\****

We will need to overcome significant challenges in order to realize the benefits or synergies from the acquisitions we have completed to date. These challenges include the following:

integrating businesses, operations and technologies;

retaining and assimilating key personnel;

retaining existing customers and attracting additional customers;

creating uniform standards, controls, procedures, policies and information systems;

meeting the challenges inherent in efficiently managing an increased number of employees, including some at geographic locations distant from our headquarters and senior management; and

## Edgar Filing: ENTROPIC COMMUNICATIONS INC - Form 10-Q

implementing appropriate systems, policies, benefits and compliance programs.

Integration in particular may involve considerable risks and may not be successful. These risks include the following:

the potential disruption of our ongoing business and distraction of our management;

the potential strain on our financial and managerial controls and reporting systems and procedures;

unanticipated expenses and potential delays related to integration of the operations, technology and other resources of the acquired companies;

the impairment of relationships with employees, suppliers and customers; and

potential unknown or contingent liabilities.

The inability to integrate successfully any businesses we acquire, or any significant delay in achieving integration, could delay introduction of new products and require expenditure of additional resources to achieve integration. For example, although we recorded significant amounts of goodwill and other intangible assets in connection with the

---

## **Table of Contents**

acquisitions we completed in 2007 and 2008, as a result of the recent industry and economic turmoil and its effects on our market value and business outlook, we had to reduce the carrying amount of all of these long-lived assets and, as of June 30, 2010, we have recorded an aggregate impairment charge of \$113.4 million against our goodwill and intangible assets carrying value related to these acquisitions.

Investors should not rely on attempts to combine our historical financial results with those of any of our acquired businesses as separate operating entities to predict our future results of operations as a combined entity.

***The average selling prices of our products have historically decreased over time and will likely do so in the future, which may reduce our revenues and gross margin.***

Our products and products sold by other companies in our industry have historically experienced a decrease in average selling prices over time. We anticipate that the average selling prices of our products will continue to decrease in the future in response to competitive pricing pressures, increased sales discounts and new product introductions by our competitors. For example, we expect that other chipset manufacturers who are members of MoCA will produce competing chipsets and create pricing pressure for such products and Broadcom has announced the availability of competing chipsets for certain applications. Our future operating results may be harmed due to the decrease of our average selling prices. To maintain our current gross margins or increase our gross margins in the future, we must develop and introduce on a timely basis new products and product enhancements, continually reduce our product costs and manage product transitions in a timely and cost-effective manner. Our failure to do so would likely cause our revenues and gross margins to decline, which could have a material adverse effect on our operating results and cause the value of our common stock to decline.

***Our product development efforts are time-consuming, require substantial research and development expenditures and may not generate an acceptable return.\****

Our product development efforts require substantial research and development expense. Our research and development expense was \$23.2 million and \$23.4 million for the six months ended June 30, 2010 and 2009, respectively. There can be no assurance that we will achieve an acceptable return on our research and development efforts.

The development of our products is also highly complex. Due to the relatively small size of our product design teams, our research and development efforts in our core technologies may lag behind those of our competitors, some of whom have substantially greater financial and technical resources. We occasionally have experienced delays in completing the development and introduction of new products and product enhancements, and we could experience delays in the future. Unanticipated problems in developing products could also divert substantial engineering resources, which may impair our ability to develop new products and enhancements and could substantially increase our costs. Furthermore, we may expend significant amounts on a research and development program that may not ultimately result in a commercially successful product, and we have in the past terminated ongoing research and development programs before they could be brought to successful conclusions. As a result of these and other factors, we may be unable to develop and introduce new products successfully and in a cost-effective and timely manner, and any new products we develop and offer may never achieve market acceptance. Any failure to develop future products that are commercially successful would have a material adverse effect on our business, financial condition and results of operations.

***Our products typically have lengthy sales cycles, which may cause our operating results to fluctuate, and a service provider, ODM or OEM customer may decide to cancel or change its service or product plans, which could cause us to lose anticipated sales.***

Our products typically have lengthy sales cycles. A service provider must first evaluate our products. This initial evaluation period can vary considerably based on the service provider and product being evaluated, and could take a significant amount of time to complete. Products incorporating new technologies generally require longer periods for evaluation. After this initial evaluation period, if a service provider decides to adopt our products, that service provider and the applicable ODM or OEM customers will need to further test and evaluate our products prior to completing the design of the equipment that will incorporate our products. Additional time is needed to begin volume production of equipment that incorporates our products. Due to these lengthy sales cycles, we may experience significant delays from the time we incur research and development and sales expenses until the time, if ever, that we generate sales from these products. The delays inherent in these lengthy sales cycles increase the risk that a customer will decide to cancel or change its product plans. From time to time, we have experienced changes, delays and cancellations in the purchase plans of our customers. A cancellation or change in plans by a service provider, ODM or OEM customer could prevent us from realizing anticipated sales. In addition, our anticipated sales could be lost or substantially reduced if a significant service provider, ODM or OEM customer reduces or delays orders during our sales cycle or chooses not to release equipment that contains our products. We may invest significant time and effort in marketing to a particular customer that does not



---

## **Table of Contents**

ultimately result in a sale to that customer. As a result of these lengthy and uncertain sales cycles for our products, it is difficult for us to predict if or when our customers may purchase products in volume from us, and our operating results may vary significantly from quarter to quarter, which may negatively affect our operating results for any given quarter.

***Fluctuations in the mix of products we sell may adversely affect our financial results.***

Because of differences in selling prices and manufacturing costs among our products, the mix and types of products sold affect the average selling price of our products and have a substantial impact on our revenues and profit margins. To the extent our sales mix shifts toward increased sales of our lower-margin products, our overall gross margins will be negatively affected. Fluctuations in the mix and types of our products sold may also affect the extent to which we are able to recover our costs and expenditures that are associated with a particular product, and as a result can negatively impact our financial results.

***If we do not complete our design-in activities before a customer's design window closes, we will lose the design opportunity, which could adversely affect our future sales and revenues and harm our customer relationships.***

The timing of our design-in activities with key customers and prospective customers may not align with their open design windows, which may or may not be known to us, making design win predictions more difficult. If we miss a particular customer's design window, we may be forced to wait an entire year or even longer for the next opportunity to compete for the customer's next design. The loss of a particular design opportunity could eliminate or substantially delay revenues from certain target customers and markets, which could have a material adverse effect on our results of operations and future prospects as well as our customer relationships.

***Our products must interoperate with many software applications and hardware found in service providers' networks and other devices in the home, and if they do not interoperate properly, our business would be harmed.***

Our products must interoperate with service providers' networks and other devices in the home, which often have varied and complex specifications, utilize multiple protocol standards, software applications and products from multiple vendors, and contain multiple generations of products that have been added over time. As a result, we must continually ensure that our products interoperate properly with existing and planned future networks. To meet these requirements, we must undertake development efforts that involve significant expense and the dedication of substantial employee resources. We may not accomplish these development efforts quickly or cost-effectively, if at all. If we fail to maintain or anticipate compatibility with products, software or equipment found in our customers' networks, we may face substantially reduced demand for our products, which would adversely affect our business, operating results and financial condition.

From time to time, we may enter into collaborations or interoperability arrangements with equipment and software vendors providing for the use, integration or interoperability of their technology with our products. These arrangements would give us access to and enable interoperability with various products or technologies in the connected home entertainment market. If these relationships fail to achieve their goals, we would have to devote substantially more resources to the development of alternative products and the support of our existing products, or the addressable market for our products may become limited. In many cases, these parties are either companies that we compete with directly in other areas or companies that have extensive relationships with our existing and potential customers and may have influence over the purchasing decisions of these customers. A number of our competitors have stronger relationships than we do with some of our existing and potential customers and, as a result, our ability to have successful arrangements with these companies may be harmed. Our failure to establish or maintain key relationships with third-party equipment and software vendors may harm our ability to successfully sell and market our products. We are currently devoting significant resources to the development of these relationships. Our operating results could be adversely affected if these efforts do not result in the revenues necessary to offset these investments.

In addition, if we find errors in the software or hardware used in service providers' networks or problematic network configurations or settings we may have to modify our products so that they will interoperate with service providers' networks. This could cause longer installation times for our products and order cancellations, either of which would adversely affect our business, operating results and financial condition.

***Our customers may cancel their orders, change production quantities or delay production, and if we fail to forecast demand for our products accurately, we may incur product shortages, delays in product shipments or excess or insufficient product inventory.\****

We sell our products to customers who integrate them into their products. We do not obtain firm, long-term purchase commitments from our customers. We have limited visibility as to the volume of our products that our customers are selling or carrying in their inventory. In addition, certain service providers are affected by seasonality in their deployment of products that incorporate our products, which may in turn impact the timing of our sales. Because production lead times



---

**Table of Contents**

often exceed the amount of time required to fulfill orders, we often must build inventory in advance of orders, relying on an imperfect demand forecast to project volumes and product mix. Our demand forecast accuracy, and our ability to manage our inventory carrying levels accurately, can be adversely affected by a number of factors, including inaccurate forecasting by our customers, changes in market conditions, adverse changes in our product order mix and demand for our customers' products. We have in the past had customers dramatically decrease and increase their requested production quantities with little or no advance notice. Even after an order is received, our customers may cancel these orders, postpone taking delivery or request a decrease in production quantities. Any such cancellation, postponement of delivery or decrease in production quantity subjects us to a number of risks, most notably that our projected sales will not materialize on schedule or at all, leading to unanticipated revenue shortfalls, reduced profit margins and excess or obsolete inventory which we may be unable to sell to other customers or which we must sell at reduced prices, or that any resulting disputes with our customers may adversely impact our future relationships with those customers. Alternatively, if we are unable to project customer requirements accurately, we may not build enough products, which could lead to delays in product shipments and lost sales opportunities in the near term, as well as force our customers to identify alternative sources of supply, which could affect our ongoing relationships with these customers and potentially reduce our market share. If we do not timely fulfill customer demands, our customers may cancel their orders and we may be subject to customer claims for cost of replacement.

***Our ability to accurately predict revenues and inventory needs, and to effectively manage inventory levels, may be adversely impacted due to our use of inventory hubbing arrangements.***

We are party to an inventory hubbing arrangement with Motorola and we may enter into similar arrangements with other customers in the future. Pursuant to these arrangements, we ship our products to a designated third-party warehouse, or hub, rather than shipping them directly to the customer. The products generally remain in the hub until the customer removes them for incorporation into its own products. In the absence of any hubbing arrangement, we generally recognize revenues on sales of our products upon shipment of those products to the buyer. Under our hubbing arrangement with Motorola, however, we maintain ownership of our products in the hub, and therefore do not recognize the related revenue, until the date Motorola removes them from the hub. As a result, our ability to accurately predict future revenues recognized from sales to Motorola or any other customers with which we implement hubbing arrangements may be impaired, and we may experience significant fluctuations in our quarterly operating results depending on when Motorola or any such other customers remove our products from the hub, which they may do with little or no lead time. In the short term, we may experience an increase in operating expenses as we build and ship inventory to the hub and may not recognize revenues from sales of this inventory, if at all, until Motorola or any such other customers remove it from the hub at a later time. Furthermore, because we continue to own but do not maintain control over our products after they are shipped to the hub, our ability to effectively manage inventory levels may be impaired as our shipments under the hubbing arrangement increase and we may be exposed to additional risk that the inventory in the hub becomes obsolete before sales are recognized.

***We extend credit to our customers, sometimes in large amounts, but there is no guarantee every customer will be able to pay our invoices when they become due.***

As part of our routine business, we extend credit to customers purchasing our products. While our customers may have the ability to pay on the date of shipment or on the date credit is granted, their financial condition could change and there is no guarantee that customers will ever pay the invoices. Rapid changes in our customers' financial conditions and risks associated with extending credit to our customers can subject us to a higher financial risk and could have a material adverse effect on our business, financial condition and results of operations.

***We depend on a limited number of third parties to manufacture, assemble and test our products which reduces our control over key aspects of our products and their availability. \****

We do not own or operate a manufacturing, assembly or test facility for our products. Rather, we outsource the manufacture, assembly and testing of our products to third-party subcontractors including Taiwan Semiconductor Manufacturing Company, TowerJazz, Amkor Technologies, Inc. and Giga Solution Tech. Co., Ltd. Accordingly, we are greatly dependent on a limited number of suppliers to deliver quality products on time. Our reliance on sole or limited suppliers involves several risks, including susceptibility to increased manufacturing costs if competition for foundry capacity intensifies and reduced control over the following:

supply of our products available for sale;

pricing, quality and timely delivery of our products;



prices and availability of components for our products; and

## **Table of Contents**

production capacity for our products, including shortages due to the difficulties by suppliers to meet production capacities because of unexpected increases in demand.

Because we rely on a limited number of third-party manufacturers, if we were required to change contract manufacturers or one of our contract manufacturers became unable or unwilling to continue manufacturing our products, we may sustain lost revenues, increased costs and damage to our customer relationships. In addition, we would need to expend significant time and effort to locate and qualify new third-party manufacturers, if available.

Manufacturing defects may not be detected by the testing process performed by our subcontractors. If defects are discovered after we have shipped our products, we may be exposed to warranty and consequential damages claims from our customers. Such claims may have a significant adverse impact on our revenues and operating results. Furthermore, if we are unable to deliver quality products, our reputation would be harmed, which could result in the loss of future orders and business with our customers.

***When demand for manufacturing capacity is high, we may take various actions to try to secure sufficient capacity, which may be costly and negatively impact our operating results.***

The ability of each of our subcontractors' manufacturing facilities to provide us with chipsets is limited by their available capacity and existing obligations. Although we have purchase order commitments to supply specified levels of products to our customers, we do not have a guaranteed level of production capacity from any of our subcontractors' facilities to produce our products. Facility capacity may not be available when we need it or at reasonable prices. In addition, our subcontractors may allocate capacity to the production of other companies' products and thereby reduce deliveries to us on short notice.

In order to secure sufficient manufacturing facility capacity when demand is high and mitigate the risks associated with an inability to meet our customers' demands for our products, we may enter into various arrangements with subcontractors that could be costly and harm our operating results, including:

option payments or other prepayments to a subcontractor;

nonrefundable deposits with or loans to subcontractors in exchange for capacity commitments;

contracts that commit us to purchase specified quantities of components over extended periods; and

purchase of testing equipment for specific use at the facilities of our subcontractors.

We may not be able to make any such arrangements in a timely fashion or at all, and any arrangements may be costly, reduce our financial flexibility and not be on terms favorable to us. Moreover, if we are able to secure capacity, we may be obligated to use all of that capacity or incur penalties. These penalties and obligations may be expensive and require significant capital and could harm our business.

***We believe that transitioning certain of our silicon products to newer or better manufacturing process technologies will be important to our future competitive position. If we fail to make this transition efficiently, our competitive position could be seriously harmed.***

We continually evaluate the benefits, on a product-by-product basis, of migrating to higher performance or lower cost process technologies in order to produce higher performance, more efficient or better integrated circuits because we believe this migration is required to remain competitive. Other companies in our industry have experienced difficulty in migrating to new process technologies and, consequently, have suffered reduced yields, delays in product deliveries and increased expense levels. We may experience similar difficulties. Moreover, we are dependent on our relationships with subcontractors to successfully migrate to newer or better process technologies. Our third-party manufacturers may not make newer or better process technologies available to us on a timely or cost-effective basis, if at all. If our third-party manufacturers do not make newer or better manufacturing process technologies available to us on a timely or cost-effective basis, or if we experience difficulties in migrating to these processes, it could have a material adverse effect on our competitive position and business prospects.

***We rely on sales representatives to assist in selling our products, and the failure of these representatives to perform as expected could reduce our future sales.***

## Edgar Filing: ENTROPIC COMMUNICATIONS INC - Form 10-Q

We sell our products to some of our customers through third-party sales representatives and distributors. Our relationships with some of these third-party sales representatives and distributors are relatively new and we are unable to predict the extent to which our third-party sales representatives and distributors will be successful in marketing and selling

## **Table of Contents**

our products. Moreover, many of our third-party sales representatives and distributors also market and sell competing products. Our third-party sales representatives and distributors may terminate their relationships with us at any time, or with short notice, and may give greater attention to the products sold by our competitors. Our future performance will also depend, in part, on our ability to attract additional third-party sales representatives and distributors that will be able to market our products effectively, especially in markets in which we have not previously distributed our products. If we cannot retain our current third-party sales representatives and distributors and recruit additional or replacement third-party sales representatives and distributors, our revenues and operating results could be harmed.

***Our products may contain defects or errors which may adversely affect their market acceptance and our reputation and expose us to product liability claims.***

Our products are very complex and may contain defects or errors, especially when first introduced or when new versions are released. Despite testing, errors may occur. Product errors could affect the performance of our products, delay the development or release of new products or new versions of products, adversely affect our reputation and our customers' willingness to buy products from us, and adversely affect market acceptance or perception of our products. Any such errors or delays in releasing new products or new versions of products or allegations of unsatisfactory performance could cause us to lose revenue or market share, increase our service costs, cause us to incur substantial costs in redesigning our products, subject us to liability for damages and divert our resources from other tasks. Our products must successfully interoperate with products from other vendors. As a result, when problems occur in a device or application in which our product is used, it may be difficult to identify the sources of these problems. The occurrence of hardware and software errors, whether or not caused by our products, could result in the delay or loss of market acceptance of our products, and therefore delay our ability to recognize revenue from sales, and any necessary revisions may cause us to incur significant expenses. Moreover, since one of the key benefits of our home networking products is reduction of the need for service providers to dispatch service vehicles to customer premises, often referred to as truck rolls, problems with our products would likely result in a greater number of truck rolls and this in turn could adversely affect our sales. The occurrence of any such problems could harm our business, operating results and financial condition.

Any limitation of liability provisions in our standard terms and conditions of sale may not fully or effectively protect us from claims as a result of federal, state or local laws or ordinances or unfavorable judicial decisions in the United States or other countries. The use of our products also entails the risk of product liability claims. We maintain insurance to protect against certain claims associated with the use of our products, but our insurance coverage may not adequately cover any claim asserted against us. In addition, even claims that ultimately are unsuccessful could result in our expenditure of funds in litigation and divert management's time and other resources.

***We depend on key personnel to operate our business, and if we are unable to retain our current personnel and hire additional qualified personnel, our ability to develop and successfully market our products could be harmed.***

We believe our future success will depend in large part upon our ability to attract and retain highly skilled managerial, engineering and sales and marketing personnel. Even during the recent economic downturn, there continues to be competition for qualified personnel in the markets in which we compete. In addition, the cost of living in the San Diego, California area, where our corporate headquarters is located, has proved to be an obstacle to attracting new employees in the past, and we expect that this will continue to impact, to some extent, our ability to attract and retain employees in the future. We do not have employment agreements with most of our executive or key employees and the unexpected loss of any key employees, including Patrick Henry, our president and chief executive officer, other members of our senior management or our senior engineering personnel, or an inability to attract additional qualified personnel, including engineers and sales and marketing personnel, could delay the development, introduction and sale of our products and our ability to execute our business strategy may suffer. In addition, in the event that there is a loss of key personnel, there is a potential for loss of important knowledge that may delay or negatively impact development or sale of our products and our ability to execute on our business strategy. We do not currently have any key person life insurance covering any executive officer or employee.

***If we fail to comply with environmental regulatory requirements, our operating results could be adversely affected.***

We face increasing complexity in our product design and procurement operations as we adjust to requirements relating to the materials composition of many of our products. The European Union has adopted certain directives to facilitate the recycling of electrical and electronic equipment sold in the European Union, including the Restriction on the Use of Certain Hazardous Substances in Electrical and Electronic Equipment, or RoHS, directive that restricts the use of lead, mercury and certain other substances in electrical and electronic products placed on the market in the European Union after July 1, 2006, and many other countries, including China, Taiwan and Korea, where the majority of our products are manufactured and packaged and sold, have also adopted similar directives banning or limiting the use of

---

## **Table of Contents**

specified substances in products introduced into their domestic markets. We have incurred costs in connection with our compliance with these environmental laws and regulations, such as costs related to eliminating lead from our semiconductor product packaging. Other environmental regulations may be enacted in the future, including in the United States, that require us to reengineer our products to utilize components that are compatible with these regulations, and this reengineering and component substitution may result in additional costs to us or disrupt our operations or logistics. If we or the third-party manufacturers of our products are unable to meet future environmental regulations in a timely manner, it could have a material adverse effect on our business, results of operations and financial condition.

### ***Certain of our customers' products and service providers' services are subject to governmental regulation.\****

Governmental regulation could place constraints on our customers and service providers' services and consequently reduce our customers demand for our products. For example, the Federal Communications Commission has broad jurisdiction over products that emit radio frequency signals in the United States. Similar governmental agencies regulate these products in other countries. Moreover, laws and regulations regarding local cable franchising or satellite broadcasting rights could have an adverse effect on Verizon's, DIRECTV's and other service providers' ability to compete in the HD video and multimedia content delivery market. Although most of our products are not directly subject to current regulations of the Federal Communications Commission or any other federal or state communications regulatory agency, much of the equipment into which these products are incorporated is subject to direct governmental regulation. Accordingly, the effects of regulation on our customers or the industries in which they operate may, in turn, impede sales of our products. For example, demand for these products will decrease if equipment into which they are incorporated fails to comply with the specifications of the Federal Communications Commission.

### ***Our failure to raise additional capital or generate the significant capital necessary to expand our operations and invest in new products could reduce our ability to compete and could harm our business.\****

We intend to continue spending substantial amounts to grow our business. We may need to obtain additional financing to pursue our business strategy, develop new products, respond to competition and market opportunities and acquire complementary businesses or technologies. We may not be able to obtain such financing on favorable terms or at all. The maximum credit available to us under the terms of our existing Loan and Security Agreement, as amended, with SVB, was reduced in April 2010 from \$10.0 million to \$5.0 million at our request, but we have no assurance that we will be able to increase our line of credit or obtain additional credit from other lenders when and if a need arises.

If we were to raise additional capital through further sales of our equity securities, our stockholders would suffer dilution of their equity ownership. If we engage in debt financing, we may be required to accept terms that restrict our ability to incur additional indebtedness, prohibit us from paying dividends, repurchasing our stock or making investments, and force us to maintain specified liquidity or other ratios, any of which could harm our business, operating results and financial condition. If we need additional capital and cannot raise it on acceptable terms, we may not be able to, among other things:

develop or enhance our products;

continue to expand our product development and sales and marketing organizations;

acquire complementary technologies, products or businesses;

expand operations, in the United States or internationally;

hire, train and retain employees; or

respond to competitive pressures or unanticipated working capital requirements.

Our failure to do any of these things could seriously harm our ability to execute our business strategy and may force us to curtail our research and development plans or existing operations.

*Our effective tax rate may increase or fluctuate, and we may not derive the anticipated tax benefits from any expansion of our international operations.*

Our effective tax rate could be adversely affected by various factors, many of which are outside of our control. Our effective tax rate is directly affected by the relative proportions of revenue and income before taxes in the various domestic and international jurisdictions in which we operate. We are also subject to changing tax laws, regulations and interpretations in multiple jurisdictions in which we operate as well as the requirements of certain tax rulings. Changes in applicable tax laws may cause fluctuations between reporting periods in which the changes take place. If our business

**Table of Contents**

opportunities outside the United States continue to grow, we may expand our international operations and staff to better support our expansion into international markets. We anticipate that this expansion will include the implementation of an international organizational structure that could result in an increasing percentage of our consolidated pre-tax income being derived from, and reinvested in, our international operations. Moreover, we anticipate that this pre-tax income will be subject to foreign tax at relatively lower tax rates when compared to the U.S. federal statutory tax rate and as a consequence, our future effective income tax rate may be lower than the U.S. federal statutory rate. There can be no assurance that significant pre-tax income will be derived from or reinvested in our international operations, that our international operations and sales will result in a lower effective income tax rate, or that we will implement an international organizational structure. In addition, our future effective income tax rate could be adversely affected if tax authorities challenge any international tax structure that we implement or if the relative mix of U.S. and international income changes for any reason. Accordingly, there can be no assurance that our effective income tax rate will be less than the U.S. federal statutory rate.

***Our ability to utilize our net operating loss and tax credit carryforwards may be limited, which could result in our payment of income taxes earlier than if we were able to fully utilize our net operating loss and tax credit carryforwards.***

As of December 31, 2009, we had federal, state and foreign net operating loss carryforwards and capital loss carryforwards of approximately \$67.9 million, \$50.1 million and \$0.8 million, respectively, and federal and state research and development tax credit carryforwards of \$9.8 million and \$9.4 million, respectively. The tax benefits related to utilization of net operating loss and tax credit carryforwards may be limited due to ownership changes or as a result of other events. For example, Section 382 of the Internal Revenue Code of 1986, as amended, or Internal Revenue Code, imposes an annual limitation on the amount of net operating loss carryforwards and tax credit carryforwards that may be used to offset federal taxable income and federal tax liabilities when a corporation has undergone a significant change in its ownership. While prior changes in our ownership, including as a result of our acquisition of RF Magic, have resulted in annual limitations on the amount of our net operating loss and tax credit carryforwards that may be utilized in the future, we do not anticipate that such annual limitations will preclude the utilization of substantially all the net operating loss and tax credit carryforwards described above in the event we become profitable. However, to the extent our use of net operating loss and tax credit carryforwards is further limited by the issuance of common stock in our initial public offering or in future offerings or transactions or by our implementation of an international tax structure or other future events, our income would be subject to cash payments of income tax earlier than it would be if we were able to fully utilize our net operating loss and tax credit carryforwards without such further limitation.

***We devote significant monetary and managerial resources to ensure our compliance with public company regulations.\****

As a public company, we incur significant legal, accounting and other expenses to ensure our compliance with various public company regulations, including the Sarbanes-Oxley Act of 2002, or the Sarbanes-Oxley Act, and various rules and regulations adopted by the SEC and The NASDAQ Stock Market, or NASDAQ. The Sarbanes-Oxley Act requires us to maintain effective disclosure controls and procedures and internal controls for financial reporting, and our management and other personnel devote a substantial amount of time to ensure our compliance with the Sarbanes-Oxley Act's requirements. Compliance with the Sarbanes-Oxley Act requires us to adopt processes and procedures that make some activities more time-consuming and costly, thereby adding to our cost of operations. To ensure that we are in compliance with the Sarbanes-Oxley Act, and as required by the Sarbanes-Oxley Act, we perform system and process evaluation and testing of our internal controls over financial reporting annually to allow management and our independent registered public accounting firm to report on the effectiveness of our internal controls. If we identify deficiencies in our internal controls over financial reporting that are deemed to be material weaknesses, the market price of our stock could decline and we could be subject to sanctions or investigations by NASDAQ, the SEC or other regulatory authorities.

***If we fail to manage our exposure to global financial and securities market risk successfully, our operating results could be adversely impacted.\****

We are exposed to financial market risks, including changes in interest rates, foreign currency exchange rates, credit markets and prices of marketable equity and fixed-income securities. We do not use derivative financial instruments for speculative or trading purposes.

The primary objective of most of our investment activities is to preserve principal while at the same time maximizing yields without significantly increasing risk. To achieve this objective, a majority of our marketable investments are investment grade, liquid, fixed-income securities and money market instruments denominated in U.S. dollars. If the carrying value of our investments exceeds the fair value, and the decline in fair value is deemed to be other-than-temporary,

---

## **Table of Contents**

we will be required to further write down the value of our investments, which could materially harm our results of operations and financial condition. Moreover, the performance of certain securities in our investment portfolio is affected by the credit condition of the U.S. financial sector. Although there have been recent signs of improvement within the U.S. financial sector, the sector remains fragile and conditions may deteriorate rapidly, which could adversely affect the value, realized or unrealized, of our investments and cause us to record significant impairment losses.

### **Risks Related to Our Intellectual Property**

#### ***Our ability to compete and our business could be jeopardized if we are unable to secure or protect our intellectual property.\****

We rely on a combination of patent, copyright, trademark and trade secret laws, confidentiality procedures and licensing arrangements to establish and protect our proprietary rights. However, these legal means afford only limited protection and may not adequately protect our rights or permit us to gain or keep any competitive advantage. Our patent applications may not issue as patents at all or they may not issue as patents in a form that will be advantageous to us. Our issued patents and those that may issue in the future may be challenged, invalidated, rendered unenforceable or circumvented, which could limit our ability to stop competitors from marketing related products. Although we have taken steps to protect our intellectual property and proprietary technology, there is no assurance that third parties will not be able to invalidate, render unenforceable or design around our patents. Furthermore, although we have entered into confidentiality agreements and intellectual property assignment agreements with our employees, consultants and advisors, such agreements may not be enforceable or may not provide meaningful protection for our trade secrets or other proprietary information in the event of unauthorized use or disclosure or other breaches of the agreements. Moreover, we are required to license any of our patent claims that are essential to implement MoCA specifications to other MoCA members, who could potentially include our competitors, on reasonable and non-discriminatory terms. In addition, in connection with commercial arrangements with our customers and the service providers who deploy equipment containing our products, we may be required to license our intellectual property to third parties, including competitors or potential competitors.

Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy or otherwise obtain and use our trademarks, products or technology. Monitoring unauthorized use of our trademarks and technology is difficult and we cannot be certain that the steps we have taken to prevent such unauthorized use will be successful, particularly in foreign countries where the laws may not protect our proprietary rights as comprehensively as in the United States. In addition, if we become aware of a third party's unauthorized use or misappropriation of our trademarks or technology, it may not be practicable, effective or cost-efficient for us to enforce our intellectual property and contractual rights, particularly where the initiation of a claim might harm our business relationships or risk a costly and protracted lawsuit, including a potential countersuit by a competitor with patents that may implicate our products. If competitors engage in unauthorized use or misappropriation of our trademarks or technology, our ability to compete effectively could be harmed.

#### ***Our participation in patent pools and standards setting organizations, or other business arrangements, may require us to license our patents to competitors and other third parties and limit our ability to enforce or collect royalties for our patents.***

In addition to our existing obligations to license our patent claims that are essential to implement the MoCA specifications to other MoCA members, in the course of participating in patent pools and other standards setting organizations or pursuant to other business arrangements, we may agree to license certain of our technologies on a reasonable and non-discriminatory basis and, as a result, our control over the license of such technologies may be limited. We may also be unable to limit to whom we license some of our technologies, and may be unable to restrict many terms of the license. Consequently, our competitors may obtain the right to use our technology. In addition, our control over the application and quality control of our technologies that are included in patent pools or otherwise necessary for implementing industry standards may be limited.

#### ***Any dispute with a MoCA member regarding what patent claims are necessary to implement MoCA specifications could result in litigation which could have an adverse effect on our business.\****

We are required to grant to other MoCA members a non-exclusive and world-wide license on reasonable and non-discriminatory, or RAND, terms to any of our patent claims that are essential to implement MoCA specifications. The meaning of RAND has not been settled on by the courts, and accordingly, it is not a well-defined concept. If we had a disagreement with a MoCA member regarding which of our patent claims are necessary to implement MoCA specifications or on whether the terms of any license by us under RAND fall within the scope and meaning of RAND, this could result in litigation. Any such litigation, regardless of its merits, could be time-consuming, expensive to resolve, divert our management's time and attention and harm our reputation. In addition, any such litigation related to which of our





---

**Table of Contents**

patent claims are necessary to implement MoCA could result in us being required to license on RAND terms certain of our patent claims which we previously believed did not need to be licensed under our MoCA agreement. Significant disagreements or any litigation between us and any MoCA member regarding patent claims necessary to implement MoCA or the scope and meaning of our RAND licensing terms could have an adverse effect on our business and harm our competitive position.

***Possible third-party claims of infringement of proprietary rights against us, our customers or the service providers that purchase products from our customers, or other intellectual property claims or disputes, could have a material adverse effect on our business, results of operation or financial condition.***

The semiconductor industry is characterized by a relatively high level of litigation based on allegations of infringement of proprietary rights. Numerous U.S. and foreign issued patents and pending patent applications owned by third parties exist in the fields in which we are selling and developing products. Because patent applications take many years to issue, currently pending applications, known or unknown to us, may later result in issued patents that we infringe. In addition, third parties continue to actively seek new patents in our field. It is difficult or impossible to keep fully abreast of these developments, and therefore, as we develop new and enhanced products, we may sell or distribute products that inadvertently infringe patents held by third parties.

We have in the past received and we, our customers or the service providers that purchase products from our customers may in the future receive inquiries from other patent holders and may become subject to claims that we infringe their intellectual property rights. Any intellectual property claim or dispute, regardless of its merits, could force us, our customers or the service providers that purchase our products from our customers to license the third-party's patents for substantial royalty payments or cease the sale of the alleged infringing products or use of the alleged infringing technologies, or force us to defend ourselves and possibly our customers or contract manufacturers in litigation. Any cessation of product sales by us, our customers or the service providers that purchase products from our customers could have a substantial negative impact on our revenues. Any litigation, regardless of its outcome, could result in substantial expense and significant diversion of our management's time and other resources. Moreover, any such litigation could subject us, our customers or the service providers that purchase our products from our customers to significant liability for damages (including treble damages), temporary or permanent injunctions, or the invalidation of proprietary rights or require us, our customers or the service providers that purchase products from our customers to license the third-party patents for substantial royalty or other payments.

In addition, we may also be required to indemnify our customers and contract manufacturers for damages they suffer as a result of such infringement or litigation.

***Our use of open source and third-party software could impose limitations on our ability to commercialize our products.***

We incorporate open source software into our products, including certain open source code which is governed by the GNU General Public License, Lesser GNU General Public License and Common Development and Distribution License. The terms of many open source licenses have not been interpreted by U.S. courts, and there is a risk that these licenses could be construed in a manner that could impose unanticipated conditions or restrictions on our ability to commercialize our products. In such event, we could be required to seek licenses from third parties in order to continue offering our products, make our proprietary code generally available in source code form (for example, proprietary code that links in particular ways to certain open source modules), which would result in our trade secrets being disclosed to the public and the potential loss of intellectual property rights in our software, re-engineer our products, discontinue the sale of our products if re-engineering cannot be accomplished on a cost-effective and timely basis, or become subject to other consequences, any of which could adversely affect our business, operating results and financial condition.

In addition to technologies we have already licensed, we may find that we need to incorporate certain proprietary third-party technologies, including software programs, into our products in the future. However, licenses to relevant third-party technologies may not be available to us on commercially reasonable terms, if at all. Therefore, we could face delays in product releases until alternative technology can be identified, licensed or developed, and integrated into our current products. Such alternative technology may not be available to us on reasonable terms, if at all, and may ultimately not be as effective as the preferred technology. Any such delays or failures to obtain licenses, if they occur, could materially adversely affect our business, operating results and financial condition.

## **Table of Contents**

*Because we license some of our software source code directly to customers, we face increased risks that our trade secrets will be exposed through inadvertent or intentional disclosure, which could harm our competitive position or increase our costs.*

We license some of our software source code to our customers, which increases the number of people who have access to some of our trade secrets and other proprietary rights. Contractual obligations of our licensees not to disclose or misuse our source code may not be sufficient to prevent such disclosure or misuse. The costs of enforcing contractual rights could substantially increase our operating costs and may not be cost-effective, reasonable under the circumstances or ultimately succeed in protecting our proprietary rights. If our competitors access our source code, they may gain further insight into the technology and design of our products, which would harm our competitive position.

### **Risks Related to International Operations**

*We expect a significant portion of our future revenues to come from our international customers, and, as a result, our business may be harmed by political and economic conditions in foreign markets and the challenges associated with operating internationally.\**

We have derived, and expect to continue to derive, a significant portion of our revenues from international markets. Net revenues outside of the United States comprised 97% of our total revenues for the six months ended June 30, 2010 and 2009. International business activities involve certain risks, including:

difficulties involved in the staffing and management of geographically dispersed operations;

longer sales cycles in certain countries, especially on initial entry into a new geographical market;

greater difficulty evaluating a customer's ability to pay, longer accounts receivable payment cycles and greater difficulty in the collection of past-due accounts;

general economic conditions in each country;

challenges associated with operating in diverse cultural and legal environments;

seasonal reductions in business activity specific to certain markets;

loss of revenue, property and equipment from expropriation, nationalization, war, insurrection, terrorism and other political risks;

foreign taxes and the overlap of different tax structures, including modifications to the United States tax code as a result of international trade regulations;

foreign technical standards;

changes in currency exchange rates; and

## Edgar Filing: ENTROPIC COMMUNICATIONS INC - Form 10-Q

import and export licensing requirements, tariffs, and other trade and travel restrictions.

To the extent our international sales are adversely affected by any of these risks or are otherwise unsuccessful, we could experience a reduction in revenue and our operating results could suffer.

In addition, certain foreign countries where we sell our products, such as China and Korea, have historically limited recognition and enforcement of contractual and intellectual property rights. In particular, we may have difficulty preventing ODMs and OEMs in these countries from incorporating our inventions, technologies, copyrights or trademarks into their products without our authorization or without paying us licensing fees. We may also experience difficulty enforcing our intellectual property rights in these countries, where intellectual property rights are not as respected as they are in the United States, Japan and Europe. Unauthorized use of our technologies and intellectual property rights may dilute or undermine the strength of our brand. Further, if we are not able to adequately monitor the use of our technologies by foreign-based ODMs and OEMs, or enforce our intellectual property rights in foreign countries, our revenue potential could be adversely affected.

## **Table of Contents**

***Our products are subject to export and import controls that could subject us to liability or impair our ability to compete in international markets.***

Our products are subject to U.S. export controls and may be exported outside the United States only with the required level of export license or through an export license exception, in most cases because we incorporate encryption technology into our products. In addition, various countries regulate the import of certain encryption technology and have enacted laws that could limit our ability to distribute our products or could limit our customers' ability to implement our products in those countries. Changes in our products or changes in export and import regulations may create delays in the introduction of our products in international markets, prevent our customers with international operations from deploying our products throughout their global systems or, in some cases, prevent the export or import of our products to certain countries altogether. Any change in export or import regulations or related legislation, or change in the countries, persons or technologies targeted by such regulations or legislation, could result in decreased use of our products by, or in our decreased ability to export or sell our products to, existing or potential customers internationally.

In addition, we may be subject to customs duties and export quotas, which could have a significant impact on our revenue and profitability. The future imposition of significant increases in the level of customs duties or export quotas could have a material adverse effect on our business.

***Our third-party contractors are concentrated primarily in areas subject to earthquakes and other natural disasters. Any disruption to the operations of these contractors could cause significant delays in the production or shipment of our products.***

Substantially all of our products are manufactured by third-party contractors located in the Pacific Rim. The risk of an earthquake in these areas is significant due to the proximity of major earthquake fault lines to the facilities of our foundry, assembly and test subcontractors. The occurrence of earthquakes or other natural disasters could result in the disruption of our foundry or assembly and test capacity. Any disruption resulting from such events could cause significant delays in the production or shipment of our products until we are able to shift our manufacturing, assembling or testing from the affected contractor to another third-party vendor. We may not be able to obtain alternate capacity on favorable terms, if at all.

## **Risks Related to Ownership of Our Common Stock**

***Our stock price is volatile and may decline regardless of our operating performance, and you may not be able to resell your shares at or above the price at which you purchased such shares.***

The market price for our common stock is volatile and may fluctuate significantly in response to a number of factors, most of which we cannot control, including:

price and volume fluctuations in the overall stock market;

market conditions or trends in our industry or the economy as a whole;

changes in operating performance and stock market valuations of other technology companies generally, or those that sell semiconductor products in particular;

the timing of customer or service provider orders that may cause quarterly or other periodic fluctuations in our results that may, in turn, affect the market price of our common stock;

the seasonal nature of the deployment of products that incorporate our products by certain service providers which may affect the timing of orders for our products;

## Edgar Filing: ENTROPIC COMMUNICATIONS INC - Form 10-Q

the timing of revenue recognition on sales arrangements, which may include multiple deliverables, and the effect of our use of inventory hubbing arrangements;

the financial projections we may provide to the public, any changes in these projections or our failure to meet these projections;

changes in financial estimates or ratings by any securities analysts who follow our common stock, our failure to meet these estimates or failure of those analysts to initiate or maintain coverage of our common stock;

**Table of Contents**

the public's response to press releases or other public announcements by us or third parties, including our filings with the SEC and announcements relating to product development, litigation and intellectual property impacting us or our business;

the sustainability of an active trading market for our common stock;

future sales of our common stock by our executive officers, directors and significant stockholders;

announcements of mergers or acquisition transactions;

our inclusion or deletion from certain stock indices;

announcements of technical innovations, new products or design wins by our competitors or customers;

announcements of changes in our senior management;

other events or factors, including those resulting from war, incidents of terrorism, natural disasters or responses to these events; and

changes in accounting principles.

In addition, the stock markets, and in particular The NASDAQ Global Market, have experienced extreme price and volume fluctuations that have affected and continue to affect the market prices of equity securities of many technology companies. Stock prices of many technology companies have fluctuated in a manner unrelated or disproportionate to the operating performance of those companies. In the past, stockholders have instituted securities class action litigation following periods of market volatility. If we were involved in securities litigation, we could incur substantial costs and our resources and the attention of management could be diverted from our business.

***Future sales of our common stock or the issuance of securities convertible into or exercisable for shares of our common stock may depress our stock price.\****

A significant number of shares of our common stock are held by a small number of stockholders. Sales of a substantial number of shares of our common stock, the issuance of securities convertible into or exercisable for shares of our common stock or the expectation or perception in the market that the holders of a large number of our shares of common stock intend to sell their shares, could significantly reduce the market price of our common stock. Although the average daily trading volume of our common stock has slowly increased in recent months, our common stock is still less liquid than the stock of companies with broader public ownership and, as a result, the trading of a relatively small volume of our common stock may have a greater impact on the trading price for our stock and lead to increased volatility in our stock price.

***Anti-takeover provisions in our charter documents and Delaware law might deter acquisition bids for us that you might consider favorable.***

Our amended and restated certificate of incorporation and bylaws contain provisions that may make the acquisition of our company more difficult without the approval of our board of directors. These provisions:

establish a classified board of directors so that not all members of our board are elected at one time;

## Edgar Filing: ENTROPIC COMMUNICATIONS INC - Form 10-Q

authorize the issuance of undesignated preferred stock, the terms of which may be established and shares of which may be issued without stockholder approval, and which may include rights superior to the rights of the holders of common stock;

prohibit stockholder action by written consent, which requires all stockholder actions to be taken at a meeting of our stockholders;

provide that the board of directors is expressly authorized to make, alter, or repeal our bylaws;

establish advance notice requirements for nominations for elections to our board or for proposing matters that can be acted upon by stockholders at stockholder meetings; and

provide that in addition to any vote required by law or by our amended and restated certificate of incorporation, the approval by holders of at least 66<sup>2</sup>/<sub>3</sub>% of our then outstanding common stock is required to adopt, amend or repeal any provision of our amended and restated bylaws.



## **Table of Contents**

In addition, because we are incorporated in Delaware, we are governed by the provisions of Section 203 of the Delaware General Corporation Law which, subject to certain exceptions, prohibits stockholders owning in excess of 15% of our outstanding voting stock from merging or combining with us. These anti-takeover provisions and other provisions under Delaware law could discourage, delay or prevent a transaction involving a change in control of our company, even if doing so would benefit our stockholders. These provisions could also discourage proxy contests and make it more difficult for you and other stockholders to elect directors of your choosing and cause us to take other corporate actions you desire.

***Our principal stockholders, executive officers and directors have substantial control over the company, which may prevent you and other stockholders from influencing significant corporate decisions and may harm the market price of our common stock.\****

As of June 30, 2010, our executive officers, directors and holders of five percent or more of our outstanding common stock, beneficially owned, in the aggregate, 13% of our outstanding common stock. These stockholders may have interests that conflict with our other stockholders and, if acting together, have the ability to substantially influence or determine the outcome of matters submitted to our stockholders for approval, including the election and removal of directors and any merger, consolidation or sale of all or substantially all of our assets. In addition, these stockholders, acting together, may have the ability to control our management and affairs. Accordingly, this concentration of ownership may harm the market price of our common stock by:

delaying, deferring or preventing a change in control;

impeding a merger, consolidation, takeover or other business combination involving us; or

discouraging a potential acquirer from making a tender offer or otherwise attempting to obtain control of us.

***If securities or industry analysts publish inaccurate or unfavorable research about our business, our stock price and trading volume could decline.\****

The trading market for our common stock will depend in part on the research and reports that securities or industry analysts publish about us or our business. A downgrade of our stock or the publication of inaccurate or unfavorable research about our business by one or more of the analysts who covers us have in the past caused, and may in the future cause, our stock price to decline. If one or more of these analysts ceases coverage of us or fails to publish reports on us regularly, demand for our stock could decrease, which could cause our stock price and trading volume to decline.

***We do not expect to pay any cash dividends for the foreseeable future.***

The continued expansion of our business will require substantial funding. Accordingly, we do not anticipate that we will pay any cash dividends on shares of our common stock for the foreseeable future. Any determination to pay dividends in the future will be at the discretion of our board of directors and will depend upon our results of operations, financial condition, contractual restrictions, restrictions imposed by applicable law and other factors our board of directors deems relevant. Investors seeking cash dividends in the foreseeable future should not purchase or hold our common stock.

---

**Table of Contents**

**Item 2. *Unregistered Sales of Equity Securities and Use of Proceeds.***  
**Recent Sales of Unregistered Securities**

The following sets forth information regarding all of our unregistered securities that were sold during the three months ended June 30, 2010:

- (1) As of March 31, 2010, options to purchase up to 1,959,391 shares of our common stock were outstanding under our 2001 Stock Option Plan, or 2001 Plan. Of these options, during the three months ended June 30, 2010, options exercisable for up to 15,962 shares of common stock were cancelled without being exercised and options to purchase 99,390 shares of common stock were exercised at a weighted average exercise price of \$1.12 per share. As of June 30, 2010, options to purchase up to 1,844,039 shares of our common stock remained outstanding under the 2001 Plan.
  
- (2) As of March 31, 2010, options to purchase up to 980,380 shares of our common stock were outstanding under our RF Magic Plan, Inc. 2000 Incentive Stock Plan, or RF Magic Plan. During the three months ended June 30, 2010, 6,581 of these options were cancelled without being exercised and options to purchase 166,189 shares of common stock were exercised at a weighted average exercise price of \$0.65 per share. As of June 30, 2010, options to purchase up to 807,538 shares of our common stock remained outstanding under the RF Magic Plan.

All of the offers, sales and issuances of the securities described in paragraphs (1) and (2) were deemed to be exempt from registration under the Securities Act of 1933, as amended, or the Securities Act, in reliance on Rule 701 in that the transactions were under compensatory benefit plans and contracts relating to compensation as provided under Rule 701. The recipients of such securities were our employees, directors or bona fide consultants and received the securities under the 2001 Plan or RF Magic Plan, as the case may be. Appropriate legends were affixed to the securities issued in these transactions. Each of the recipients of securities in these transactions had adequate access, through employment, business or other relationships, to information about us.

**Issuer Purchases of Equity Securities**

Pursuant to the terms of the 2001 Plan, options may be exercised prior to vesting. Shares of common stock issued prior to vesting that remain unvested are subject to a repurchase option in our favor that lapses in accordance with the original vesting schedule for the option. During the three months ended June 30, 2010, we did not repurchase any shares of our common stock.

**Working Capital Restrictions and Other Limitations upon the Payment of Dividends**

Under the terms of our Loan and Security Agreement, as amended, with SVB, we are not permitted to pay cash dividends without SVB's prior consent. Accordingly, we do not anticipate that we will pay any cash dividends on shares of our common stock for the foreseeable future. Any determination to pay dividends in the future will be at the discretion of our board and will depend upon our results of operations, financial condition, contractual restrictions, restrictions imposed by applicable law and other factors our board deems relevant.

**Item 6. *Exhibits.***

The exhibits listed in the accompanying Index to Exhibits are filed with, or incorporated by reference into, this Quarterly Report. The exhibit numbers on the Index to Exhibits that are followed by an asterisk (\*) indicate exhibits filed with this Quarterly Report. All other exhibit numbers indicate exhibits filed by incorporation by reference. Exhibit number 10.2 is a management contract or compensatory plan or arrangement.

**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.

**ENTROPIC COMMUNICATIONS, INC.**

Date: July 29, 2010

By: */s/ David Lyle*  
David Lyle  
*Chief Financial Officer*  
(Duly Authorized Officer and  
Principal Financial Officer)

**Table of Contents**

**INDEX TO EXHIBITS**

**Exhibit**

<b>Number</b>	<b>Description of Document</b>
3.1 (1)	Amended and Restated Certificate of Incorporation of the Registrant.
3.2 (2)	Amended and Restated Bylaws of the Registrant.
4.1	Reference is made to Exhibits 3.1 and 3.2 above.
4.2 (3)	Form of Common Stock Certificate of the Registrant.
10.1 (4)	Amendment to Loan and Security Agreement dated April 9, 2010 by and between the Registrant and Silicon Valley Bank.
10.2 (4)+	Entropic Communications, Inc. Management Bonus Plan.
21.1 (5)	Submission of matters to a vote of Security Holders.
31.1 *	Certification of the Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2 *	Certification of the Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32 *	Certification of the Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

+ Indicates management contract or compensatory plan.

\* Filed herewith.

(1) Incorporated herein by reference to the Registrant's Current Report on Form 8-K filed with the SEC on December 13, 2007.

(2) Incorporated herein by reference to the Registrant's Current Report on Form 8-K filed with the SEC on December 5, 2008.

(3) Incorporated herein by reference to the Registrant's Registration Statement on Form S-1 (No. 333-144899), as amended, filed with the SEC.

(4) Incorporated herein by reference to the Registrant's Current Report on Form 8-K filed with the SEC on April 14, 2010.

(5) Incorporated herein by reference to the Registrant's Current Report on Form 8-K filed with the SEC on May 24, 2010.