ILLUMINA INC
Form 10-Q
July 28, 2009

Table of Contents

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

þ **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the Quarterly Period Ended June 28, 2009

o **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the transition period from __________to__________

Commission file number 000-30361
Illumina, Inc.
(Exact name of registrant as specified in its charter)

Delaware	33-0804655
(State or other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
9885 Towne Centre Drive, San Diego, CA	92121
(Address of Principal Executive Offices)	(Zip Code)

(858) 202-4500
(Registrant s telephone number, including area code)

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

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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o No o

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

Large accelerated filer þ	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

As of July 15, 2009, there were 124,138,502 shares of the Registrant s Common Stock outstanding.

ILLUMINA, INC.
INDEX

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

Illumina, Inc.
Condensed Consolidated Balance Sheets
(In thousands)

	June 28, 2009 (Unaudited)	December 28, 2008 (1)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 352,097	$ 327,024
Short-term investments	382,472	313,051
Accounts receivable, net	154,251	133,266
Inventory, net	70,666	73,431
Deferred tax assets, current portion	9,929	8,635
Prepaid expenses and other current assets	12,344	14,154
Total current assets	981,759	869,561
Property and equipment, net	103,907	89,436
Long-term investments	55,750	55,900
Goodwill	228,734	228,734
Intangible assets, net	44,805	47,755
Deferred tax assets, long-term portion	37,618	30,960
Other assets	24,595	4,825
Total assets	$ 1,477,168	$ 1,327,171
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 41,158	$ 29,204
Accrued liabilities	84,436	80,355
Long-term debt, current portion	279,703	276,889
Total current liabilities	405,297	386,448
Other long-term liabilities	21,835	18,946
Commitments and contingencies		
Conversion option subject to cash settlement	110,296	123,110
Stockholders equity:		
Preferred stock		
Common stock	1,421	1,389
Additional paid-in capital	1,566,899	1,469,770
Accumulated other comprehensive income	2,837	2,422
Accumulated deficit	(309,010)	(352,507)
Treasury stock, at cost	(322,407)	(322,407)
Total stockholders equity	939,740	798,667

Total liabilities and stockholders equity	$ 1,477,168	$ 1,327,171

(1) The Condensed Consolidated Balance Sheet at December 28, 2008 has been derived from the audited financial statements as adjusted for the required retroactive adoption of FSP APB 14-1.

See accompanying notes to the condensed consolidated financial statements.

Table of Contents

Illumina, Inc.
Condensed Consolidated Statements of Operations
(Unaudited)
(In thousands, except per share amounts)

	Three Months Ended		Six Months Ended	
	June 28, 2009	**June 29, 2008 (1)**	**June 28, 2009**	**June 29, 2008 (1)**
Revenue:				
Product revenue	$ 153,204	$ 128,552	$ 309,403	$ 239,235
Service and other revenue	8,439	11,625	17,997	22,803
Total revenue	161,643	140,177	327,400	262,038
Costs and expenses:				
Cost of product revenue (excluding impairment of manufacturing equipment and amortization of intangible assets)	45,812	47,148	96,519	89,673
Cost of service and other revenue	3,003	3,311	6,318	6,867
Research and development	33,117	23,493	65,843	44,057
Selling, general and administrative	41,939	35,616	84,770	69,443
Impairment of manufacturing equipment		4,069		4,069
Amortization of intangible assets	1,670	2,669	3,340	5,084
Total costs and expenses	125,541	116,306	256,790	219,193
Income from operations	36,102	23,871	70,610	42,845
Interest and other income (expense), net	(1,079)	(3,682)	(6,236)	(4,525)
Income before income taxes	35,023	20,189	64,374	38,320
Provision for income taxes	10,335	7,530	20,875	14,919
Net income	$ 24,688	$ 12,659	$ 43,499	$ 23,401
Net income per basic share	$ 0.20	$ 0.11	$ 0.35	$ 0.21
Net income per diluted share	$ 0.18	$ 0.09	$ 0.32	$ 0.18
Shares used in calculating basic net income per share	123,511	113,574	122,633	112,620
Shares used in calculating diluted net income per share	139,465	133,396	136,220	130,462

(1) Adjusted for the required retroactive adoption of FSP APB 14-1.

See accompanying notes to the condensed consolidated financial statements.

Table of Contents

Illumina, Inc.
Condensed Consolidated Statements of Cash Flows
(Unaudited)
(In thousands)

	Six Months Ended	
	June 28, 2009	**June 29, 2008 (1)**
Cash flows from operating activities:		
Net income	$ 43,499	$ 23,401
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of intangible assets	3,340	5,084
Amortization of debt discount	9,787	9,265
Amortization of debt issuance costs	367	348
Gain on extinguishment of debt	(767)	
Depreciation expense	11,712	7,730
Impairment of manufacturing equipment		4,069
Stock-based compensation expense	29,761	23,131
Incremental tax benefit related to stock options exercised	(25,700)	
Deferred income taxes	19,039	12,691
Other non-cash adjustments	181	(79)
Changes in operating assets and liabilities:		
Accounts receivable	(18,059)	(17,281)
Inventory	3,007	(13,371)
Prepaid expenses and other current assets	(484)	4,127
Other assets	(2,835)	(1,142)
Accounts payable	11,135	6,682
Accrued liabilities	1,178	(3,171)
Litigation settlements payable		(54,536)
Accrued income taxes	3,150	(1,964)
Other long-term liabilities	1,806	5,484
Net cash provided by operating activities	90,117	10,468
Cash flows from Investing activities:		
Purchases of available-for-sale securities	(334,764)	(247,451)
Sales and maturities of available-for-sale securities	266,177	231,767
Investments in other entities	(17,950)	
Purchases of property and equipment	(26,591)	(29,823)
Cash paid for intangible assets		(36,000)
Net cash used in investing activities	(113,128)	(81,507)
Cash flows from financing activities:		
Payments on current portion of long-term debt	(10,000)	(16)
Proceeds from the exercise of warrants	7,113	2,184
Proceeds from issuance of common stock	24,133	27,982
Incremental tax benefit related to stock options exercised	25,700	

Net cash provided by financing activities	46,946	30,150
Effect of foreign currency translation on cash and cash equivalents	1,138	(1,084)
Net increase (decrease) in cash and cash equivalents	25,073	(41,973)
Cash and cash equivalents at beginning of period	327,024	174,941
Cash and cash equivalents at end of period	$ 352,097	$ 132,968

(1) Adjusted for the required retroactive adoption of FSP APB 14-1.

See accompanying notes to the condensed consolidated financial statements.

Table of Contents

Illumina, Inc.
Notes to Condensed Consolidated Financial Statements
(Unaudited)

1. Summary of Significant Accounting Principles

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. The unaudited condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All intercompany transactions and balances have been eliminated in consolidation. In management s opinion, the accompanying financial statements reflect all adjustments, consisting of normal recurring accruals, considered necessary for a fair presentation of the results for the interim periods presented.

Interim financial results are not necessarily indicative of results anticipated for the full year. These unaudited financial statements should be read in conjunction with the Company s 2008 audited financial statements and footnotes included in the Company s Annual Report on Form 10-K for the fiscal year ended December 28, 2008, as filed with the Securities and Exchange Commission (SEC) on February 26, 2009. Subsequent events for these unaudited financial statements have been evaluated up to and including July 28, 2009 which is the date these financial statements were issued.

The preparation of financial statements requires that management make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingent assets and liabilities. Actual results could differ from those estimates.

Fiscal Year

The Company s fiscal year consists of 52 or 53 weeks ending the Sunday closest to December 31, with quarters of 13 or 14 weeks ending the Sunday closest to March 31, June 30, and September 30. The three and six months ended June 28, 2009 and June 29, 2008 were both 13 and 26 weeks, respectively.

Segment Information

During the first quarter of 2008, the Company reorganized its operating structure into a newly created Life Sciences Business Unit, which includes all products and services related to the research market, namely the BeadArray, Veracode and Sequencing product lines. The Company also created a Diagnostics Business Unit to focus on the emerging opportunity in molecular diagnostics. For the three and six months ended June 28, 2009, the Company had limited activity related to the Diagnostics Business Unit and operating results were reported on an aggregate basis to the chief operating decision maker of the Company, the chief executive officer. In accordance with Statement of Financial Accounting Standards (SFAS) No. 131, *Disclosures about Segments of an Enterprise and Related Information*, the Company operated in one segment for the three and six months ended June 28, 2009. The Company will begin reporting in two segments once revenues, operating profit or loss, or assets of the Diagnostics Business Unit exceed 10% of the consolidated amounts.

Table of Contents

Revenue Recognition

The Company s revenue is generated primarily from the sale of products and services. Product revenue primarily consists of sales of arrays, reagents, flow cells and instrumentation. Service and other revenue consists of revenue received for performing genotyping and sequencing services, extended warranty sales and amounts earned under research agreements with government grants, which are recognized in the period during which the related costs are incurred.

The Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the seller s price to the buyer is fixed or determinable and collectibility is reasonably assured. In instances where final acceptance of the product or system is required, revenue is deferred until all the acceptance criteria have been met. All revenue is recorded net of any discounts.

Revenue for product sales is recognized generally upon shipment and transfer of title to the customer, provided no significant obligations remain and collection of the receivable is reasonably assured. Revenue for genotyping and sequencing services is recognized when earned, which is generally at the time the genotyping or sequencing analysis data is delivered to the customer or agreed to milestones are reached.

In order to assess whether the price is fixed or determinable, the Company ensures there are no refund rights. If payment terms are based on future performance, the Company defers revenue recognition until the price becomes fixed or determinable. The Company assesses collectibility based on a number of factors, including past transaction history with the customer and the creditworthiness of the customer. If the Company determines that collection of a payment is not reasonably assured, revenue recognition is deferred until the time collection becomes reasonably assured, which is generally upon receipt of payment.

Sales of instrumentation generally include a standard one-year warranty. The Company also sells separately priced maintenance (extended warranty) contracts, which are generally for one year, upon the expiration of the initial warranty. Revenue for extended warranty sales is recognized ratably over the term of the extended warranty period. Reserves are provided for estimated product warranty expenses at the time the associated revenue is recognized. If the Company were to experience an increase in warranty claims or if costs of servicing its warrantied products were greater than its estimates, gross margins could be adversely affected.

While the majority of its sales agreements contain standard terms and conditions, the Company does enter into agreements that contain multiple elements or non-standard terms and conditions. Emerging Issues Task Force (EITF) 00-21, *Revenue Arrangements with Multiple Deliverables*, provides guidance on accounting for arrangements that involve the delivery or performance of multiple products, services, or rights to use assets within contractually binding arrangements. For arrangements with multiple elements, revenue recognition is based on the individual units of accounting determined to exist in the arrangement. A delivered item is considered a separate unit of accounting when the delivered item has value to the customer on a stand-alone basis and there is objective and reliable evidence of the fair value of the undelivered items. 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. The fair value of an item is generally the price charged for the product, if the item is regularly sold on a stand-alone basis. When objective and reliable evidence of fair value exists for all units of accounting in an arrangement, the arrangement consideration is generally allocated to each unit of accounting based upon its relative fair value. In those instances when objective and reliable evidence of fair value exists for the undelivered items but not for the delivered items, the residual method is used to allocate the arrangement consideration. Under the residual method, the amount of arrangement consideration allocated to the delivered items equals the total arrangement consideration less the aggregate fair value of the undelivered items. When the Company is unable to establish stand-alone value for delivered items or when fair value of undelivered items has not been established, revenue is deferred until all elements are delivered and services have been performed, or until fair value can objectively be determined for any remaining undelivered elements. The Company recognizes revenue for delivered elements only when it determines that the fair values of undelivered elements are known and there are no uncertainties regarding customer acceptance. Changes in the allocation of the sales price between delivered and undelivered elements can impact the timing of revenue recognition but do not change the total revenue recognized on any arrangement.

Table of Contents

Fair Value Measurements

The Company determines fair value of its assets and liabilities in accordance with SFAS No. 157, *Fair Value Measurements*, and 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*. Fair value is defined under SFAS No. 157 as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Valuation techniques used to measure fair value under SFAS No. 157 must maximize the use of observable inputs and minimize the use of unobservable inputs. The standard describes a fair value hierarchy based on three levels of inputs, of which the first two are considered observable and the last unobservable, that may be used to measure fair value:

Level 1 Quoted prices in active markets for identical assets or liabilities.

Level 2 Inputs, other than Level 1, that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

Functional Currency

Historically, the Company identified the local currency as the functional currency in each of its foreign subsidiaries, with all translation adjustments recorded as part of other comprehensive income. Beginning in the third quarter of 2008, the Company reorganized its international structure to execute a more efficient relationship between product development, product manufacturing and sales. This reorganization increased the foreign subsidiaries dependence on the U.S. entity for management decisions, financial support, production assets and inventory, thereby making the foreign subsidiaries a direct and integral component of the U.S. entity s operations. As a result, the Company reassessed the primary economic environment of its foreign subsidiaries, resulting in a U.S. dollar functional currency determination. Beginning in the third quarter of 2008, the Company remeasures its foreign subsidiaries assets and liabilities and income and expense accounts related to monetary assets and liabilities to the U.S. dollar and records the net gains or losses resulting from remeasurement in its condensed consolidated statements of operations within interest and other income (expense), net.

Derivatives

The Company is exposed to foreign exchange rate risks in the normal course of business. To manage a portion of the accounting exposure resulting from changes in foreign currency exchange rates, the Company enters into foreign exchange contracts to hedge monetary assets and liabilities that are denominated in currencies other than the functional currency of its subsidiaries. These foreign exchange contracts are carried at fair value and do not qualify for hedge accounting treatment and are not designated as hedging instruments under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Changes in the value of the derivative are recognized in interest and other income (expense), net, in the condensed consolidated statements of operations for the current period, along with an offsetting gain or loss on the underlying assets or liabilities.

Stock-Based Compensation

The Company accounts for share-based compensation using the fair value recognition provisions of SFAS No. 123(R), *Share-Based Payment*, using the Black-Scholes-Merton option-pricing model to estimate the fair value of stock options granted and stock purchases under the Employee Stock Purchase Plan (ESPP). This model incorporates various assumptions, including volatility, expected life and interest rates. The Company determines volatility by equally weighing the historical and implied volatility of the Company s common stock. The historical volatility of the Company s common stock over the most recent period is generally commensurate with the estimated expected life of the Company s stock options, adjusted for the impact of unusual fluctuations not reasonably expected to recur and other relevant factors. The implied volatility is calculated from the implied market volatility of exchange-traded call options on the Company s common stock. The expected life of an award is based on historical experience and on the terms and conditions of the stock awards granted to employees.

Table of Contents

The assumptions used for the specified reporting periods and the resulting estimates of weighted-average fair value per share of options granted and for stock purchases under the ESPP during those periods are as follows:

	Three Months Ended		Six Months Ended	
	June 28, 2009	June 29, 2008	June 28, 2009	June 29, 2008
Interest rate stock options	1.97%	2.86 3.14%	1.69 1.97%	2.86 3.14%
Interest rate stock purchases	0.39 0.51%	4.47 4.71%	0.39 2.25%	4.47 4.71%
Volatility stock options	55%	52 54%	55 58%	52 56%
Volatility stock purchases	58%	58 69%	53 58%	58 69%
Expected life stock options	5 years	6 years	5 years	6 years
Expected life stock purchases	6 12 months	6 12 months	6 12 months	6 12 months
Expected dividend yield	0%	0%	0%	0%
Weighted average fair value per share of options granted	$17.93	$20.27	$14.79	$17.95
Weighted average fair value per share of employee stock purchases	$ 8.51	$ 8.32	$ 9.11	$ 8.32

The fair value of restricted stock units granted during the three and six months ended June 28, 2009 and June 29, 2008 was based on the market price of our common stock on the date of grant.

As of June 28, 2009, approximately $156.9 million of total unrecognized compensation cost related to stock options, restricted stock units and ESPP shares issued to date is expected to be recognized over a weighted-average period of approximately 1.72 years.

Total share-based compensation expense for employee stock options and stock purchases under the ESPP consists of the following (in thousands, except per share data):

	Three Months Ended		Six Months Ended	
	June 28, 2009	June 29, 2008	June 28, 2009	June 29, 2008
Cost of product revenue	$ 1,198	$ 1,337	$ 2,472	$ 2,642
Cost of service and other revenue	143	80	284	179
Research and development	4,979	3,448	9,601	6,754
Selling, general and administrative	8,581	7,410	17,404	13,556
Share-based compensation expense before taxes	14,901	12,275	29,761	23,131
Related income tax benefits	(4,683)	(4,462)	(9,536)	(7,798)
Share-based compensation expense, net of taxes	$ 10,218	$ 7,813	$ 20,225	$ 15,333
Net share-based compensation expense per share of common stock:				
Basic	$ 0.08	$ 0.07	$ 0.16	$ 0.14
Diluted	$ 0.07	$ 0.06	$ 0.15	$ 0.12

Net Income per Share

On July 22, 2008, the Company announced a two-for-one stock split in the form of a 100% stock dividend with a record date of September 10, 2008 and a distribution date of September 22, 2008. Share and per share amounts have been restated to reflect the stock split for all periods presented.

Basic net income or loss per share is computed by dividing net income or loss by the weighted-average number of common shares outstanding during the reporting period. Diluted net income per common share is computed by dividing net income by the weighted average number of common shares outstanding during the reporting period increased to include dilutive potential common shares using the treasury stock method. Dilutive potential common shares consist of stock options with combined exercise prices and unrecognized compensation expense that are less than the average market price for the Company s common stock, restricted stock units with unrecognized compensation expense, convertible debt when the average market price is above the conversion price of $21.83 and warrants with exercise prices that are less than the average market price of the Company s common stock. Under the treasury stock method, the amount that must be paid to exercise stock options and warrants, the amount of compensation expense for future services that the Company has not yet recognized for stock options and RSUs and the amount of tax benefits that will be recorded in additional paid-in capital when the awards become deductible are assumed to be used to repurchase shares. In loss periods, basic net loss per share and diluted net loss per share are identical since the effect of potential common shares is anti-dilutive and therefore excluded.

The following table presents the calculation of weighted-average shares used to calculate basic and diluted net income per share (in thousands):

	Three Months Ended		Six Months Ended	
	June 28, 2009	June 29, 2008	June 28, 2009	June 29, 2008
Weighted-average shares outstanding	123,511	113,574	122,633	112,620
Effect of dilutive potential common shares:				
Dilutive Convertible Senior Notes	7,136	8,086	6,279	7,335
Dilutive equity awards	4,710	5,791	4,414	5,603
Dilutive warrants sold in connection with the Convertible Senior Notes	2,546	3,582	1,273	2,501
Dilutive warrants assumed in the acquisition of Solexa	1,562	2,363	1,621	2,403
Weighted-average shares used in calculating diluted net income per share	139,465	133,396	136,220	130,462
Weighted average shares excluded from calculation due to anti-dilutive effect	1,558	1,087	2,453	1,169

Comprehensive Income

Total comprehensive income consisted of the following (in thousands):

	Three Months Ended		Six Months Ended	
	June 28, 2009	June 29, 2008	June 28, 2009	June 29, 2008
Net income	$ 24,688	$ 12,659	$ 43,499	$ 23,401
Foreign currency translation adjustments		(219)		155
Unrealized gain (loss) on available-for-sale securities, net of deferred tax	965	(958)	415	(2,242)
Total comprehensive income	$ 25,653	$ 11,482	$ 43,914	$ 21,314

Recent Accounting Pronouncements

Adopted Accounting Pronouncements

Effective December 29, 2008, we adopted FASB Staff Position (FSP) Accounting Principles Board Opinions (APB) 14-1, *Accounting for Convertible Debt Instruments that May be Settled in Cash upon Conversion (Including Partial Cash Settlement)* (FSP APB 14-1 or the FSP). This FSP impacts the accounting for the Company s Convertible Senior Notes by requiring the Company to account separately for the liability and equity components of the convertible debt. The liability component is measured at its estimated fair value such that the effective interest expense associated with the convertible debt reflects the issuer s borrowing rate at the date of issuance for similar debt instruments without the conversion feature. The difference between the cash proceeds associated with the convertible debt and this estimated fair value is recorded as a debt discount and amortized to interest expense over the life of the convertible debt using the effective interest rate method. Upon application of this guidance, the only change to diluted earnings per share is the effects of increased interest expense and the associated tax effects. The FSP requires retrospective application to the terms of instruments as they existed for all periods presented. See Note 6 for information on the impact of our adoption of FSP APB 14-1 and the assumptions we used to estimate the fair value of the liability component.

Additionally, effective December 29, 2008, we adopted EITF 07-5, *Determining Whether an Instrument (or Embedded Feature) is Indexed to an Entity s Own Stock* (EITF 07-5). EITF 07-5 provides that an entity should use a two-step approach to evaluate whether an equity-linked financial instrument (or embedded feature) is indexed to its own stock, including evaluating the instrument s contingent exercise and settlement provisions. The adoption of this pronouncement required the Company to perform additional analyses on both its freestanding equity derivatives and embedded equity derivative features. However, the adoption of EITF 07-05 did not have a material effect on the Company s condensed consolidated financial statements.

During the second quarter of 2009, the Company adopted three FSPs on the fair value of financial instruments issued by the FASB in April 2009:

- FSP SFAS No. 157-4*, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability has Significantly Decreased and Identifying Transactions That Are Not Orderly* (SFAS No. 157-4) amends SFAS No.&