Turtle Beach Corp
Form 10-Q
August 09, 2016

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

FORM 10-Q

(Mark one)
ý QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2016
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: 001-35465

TURTLE BEACH CORPORATION
(Exact name of registrant as specified in its charter)

Nevada	27-2767540
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
12220 Scripps Summit Drive, Suite 100 San Diego, California	92131
(Address of principal executive offices)	(Zip Code)

(914) 345-2255
(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. ý 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). ý 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 ý
(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 ý No

The number of shares of the registrant's Common Stock, par value $0.001 per share, outstanding on July 31, 2016 was 49,229,502.

INDEX

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.
Turtle Beach Corporation
Condensed Consolidated Balance Sheets
(unaudited)

	June 30, 2016	December 31, 2015
ASSETS	(in thousands, except par value and share amounts)	
Current Assets:		
Cash and cash equivalents	$1,162	$ 7,114
Accounts receivable, net	18,085	57,192
Inventories	27,898	26,146
Prepaid income taxes	260	260
Prepaid expenses and other current assets	5,698	4,191
Total Current Assets	53,103	94,903
Property and equipment, net	5,522	6,859
Goodwill	—	31,152
Intangible assets, net	35,237	37,956
Deferred income taxes	505	—
Other assets	1,505	1,590
Total Assets	$95,872	$ 172,460
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Revolving credit facilities	$7,192	$ 32,453
Term loan	4,814	4,814
Accounts payable	18,966	17,680
Other current liabilities	8,816	14,236
Total Current Liabilities	39,788	69,183
Term loan, long-term portion	9,711	12,174
Series B redeemable preferred stock	16,797	16,145
Deferred income taxes	—	4
Subordinated notes - related party	16,573	15,365
Other liabilities	2,832	2,937
Total Liabilities	85,701	115,808
Commitments and Contingencies		
Stockholders' Equity		
Common stock, $0.001 par value - 100,000,000 shares authorized; 49,229,502 and 42,529,502 shares issued and outstanding as of June 30, 2016 and December 31, 2015, respectively	49	43
Additional paid-in capital	144,860	136,693
Retained earnings (accumulated deficit)	(134,202)	(79,618)
Accumulated other comprehensive loss	(536)	(466)
Total Stockholders' Equity	10,171	56,652
Total Liabilities and Stockholders' Equity	$95,872	$ 172,460

See accompanying Notes to the Condensed Consolidated Financial Statements (unaudited)

Turtle Beach Corporation
Condensed Consolidated Statements of Operations
(unaudited)

	Three Months Ended		Six Months Ended	
	June 30, 2016	June 30, 2015	June 30, 2016	June 30, 2015
	(in thousands, except per-share data)			
Net Revenue	$29,362	$22,612	$53,390	$42,301
Cost of Revenue	24,249	19,210	44,915	35,783
Gross Profit	5,113	3,402	8,475	6,518
Operating expenses:				
Selling and marketing	7,121	6,961	12,721	14,707
Research and development	2,040	2,824	4,064	5,678
General and administrative	5,287	5,991	10,570	10,731
Goodwill Impairment	31,152	—	31,152	—
Restructuring charges	—	184	225	509
Total operating expenses	45,600	15,960	58,732	31,625
Operating loss	(40,487)	(12,558)	(50,257)	(25,107)
Interest expense	1,686	834	3,465	1,618
Other non-operating expense (income), net	704	(346)	1,069	282
Loss before income tax benefit	(42,877)	(13,046)	(54,791)	(27,007)
Income tax benefit	(304)	(3,148)	(207)	(6,516)
Net loss	$(42,573)	$(9,898)	$(54,584)	$(20,491)
Net loss per share:				
Basic	$(0.86)	$(0.23)	$(1.14)	$(0.49)
Diluted	$(0.86)	$(0.23)	$(1.14)	$(0.49)
Weighted average number of shares:				
Basic	49,230	42,188	47,934	42,113
Diluted	49,230	42,188	47,934	42,113

See accompanying Notes to the Condensed Consolidated Financial Statements (unaudited)

Turtle Beach Corporation
Condensed Consolidated Statements of Comprehensive Income (Loss)
(unaudited)

	Three Months Ended		Six Months Ended	
	June 30, 2016	June 30, 2015	June 30, 2016	June 30, 2015
	(in thousands)			
Net loss	$(42,573)	$(9,898)	$(54,584)	$(20,491)
Other comprehensive income (loss):				
Foreign currency translation adjustment	(49)	357	(70)	30
Other comprehensive income (loss)	(49)	357	(70)	30
Comprehensive loss	$(42,622)	$(9,541)	$(54,654)	$(20,461)

See accompanying Notes to the Condensed Consolidated Financial Statements (unaudited)

Turtle Beach Corporation
Condensed Consolidated Statements of Cash Flows
(unaudited)

	Six Months Ended	
	June 30, 2016	June 30, 2015
	(in thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES		
Net loss	$(54,584)	$(20,491)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	2,471	3,076
Amortization of intangible assets	2,695	453
Amortization of debt financing costs	632	93
Stock-based compensation	2,205	3,395
Accrued interest on Series B redeemable preferred stock	651	599
Paid in kind interest	1,039	151
Deferred income taxes	(510)	(6,691)
Reversal of sales returns reserve	(5,689)	(2,180)
Provision for (reversal of) doubtful accounts	(27)	2
Provision for obsolete inventory	1,596	742
Loss on disposal of property and equipment	—	38
Loss on impairment of assets	31,152	—
Changes in operating assets and liabilities:		
Accounts receivable	44,823	47,552
Inventories	(3,348)	338
Accounts payable	1,798	(13,555)
Prepaid expenses and other assets	(1,183)	(853)
Income taxes payable	81	42
Other liabilities	(5,565)	(4,544)
Net cash provided by operating activities	18,237	8,167
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of property and equipment	(1,645)	(2,483)
Net cash used for investing activities	(1,645)	(2,483)
CASH FLOWS FROM FINANCING ACTIVITIES		
Borrowings on revolving credit facilities	82,701	85,182
Repayment of revolving credit facilities	(107,962)	(107,211)
Repayment of capital leases	(19)	(20)
Repayment of term loan	(2,407)	(641)
Proceeds from sale of common stock, net of issuance costs	5,968	—
Proceeds from exercise of stock options	—	365
Debt financing costs	(761)	(37)
Proceeds from issuance of subordinated notes - related party	—	11,800
Net cash used for financing activities	(22,480)	(10,562)
Effect of exchange rate changes on cash and cash equivalents	(64)	(10)
Net decrease in cash and cash equivalents	(5,952)	(4,888)
Cash and cash equivalents - beginning of period	7,114	7,908
Cash and cash equivalents - end of period	$1,162	$3,020

SUPPLEMENTAL DISCLOSURE OF INFORMATION		
Cash paid for interest	$992	$538
Cash paid for income taxes	$—	$—

See accompanying Notes to the Condensed Consolidated Financial Statements (unaudited)

Turtle Beach Corporation
Condensed Consolidated Statement of Stockholders' Equity
(unaudited)

	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Retained Earnings (Accumulated Deficit)	Accumulated Other Comprehensive Income (Loss)	Total
	(in thousands)					
Balance at December 31, 2015	42,530	$ 43	$ 136,693	$ (79,618)	$ (466)	$ 56,652
Net loss	—	—	—	(54,584)	—	(54,584)
Other comprehensive loss	—	—	—	—	(70)	(70)
Sale of common stock, net of issuance costs	6,700	6	5,962	—	—	5,968
Stock-based compensation	—	—	2,205	—	—	2,205
Balance at June 30, 2016	49,230	$ 49	$ 144,860	$ (134,202)	$ (536)	$ 10,171

See accompanying Notes to the Condensed Consolidated Financial Statements (unaudited)

Turtle Beach Corporation
Notes to Condensed Consolidated Financial Statements
(unaudited)

Note 1. Background and Basis of Presentation
Organization
Turtle Beach Corporation ("Turtle Beach" or the "Company"), headquartered in San Diego, California and incorporated in the state of Nevada in 2010, is a premier audio technology company with expertise and experience in developing, commercializing and marketing innovative products across a range of large addressable markets under the Turtle Beach® and HyperSound® brands. Turtle Beach is a worldwide leading provider of feature-rich headset solutions for use across multiple platforms, including video game and entertainment consoles, handheld consoles, personal computers, tablets and mobile devices. HyperSound technology is an innovative patent-protected sound technology that delivers immersive, directional audio offering unique potential benefits in a variety of commercial settings and consumer devices, including improved clarity and comprehension for listeners with hearing loss with the HyperSound Clear™ 500P product.
VTB Holdings, Inc. ("VTBH"), the parent holding company of the historical business of the headset business, was incorporated in the state of Delaware in 2010 with operations principally located in Valhalla, New York. Voyetra Turtle Beach, Inc. ("VTB") was incorporated in the state of Delaware in 1975.
In October 2012, VTB acquired Lygo International Limited ("Lygo"), a private limited company organized under the laws of England and Wales, which was subsequently renamed Turtle Beach Europe Limited ("TB Europe").

Basis of Presentation
The accompanying interim condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC") and, in the opinion of management, reflect all adjustments (which include normal recurring adjustments) considered necessary for a fair presentation of the financial position, results of operations, and cash flows for the periods presented. All intercompany accounts and transactions have been eliminated in consolidation. Certain information and footnote disclosures, normally included in annual financial statements prepared in accordance with U.S. generally accepted accounting principles ("GAAP"), have been condensed or omitted pursuant to those rules and regulations. We believe that the disclosures made are adequate to make the information presented not misleading. The results of operations for the interim periods are not necessarily indicative of the results of operations for the entire fiscal year.

The December 31, 2015 Condensed Consolidated Balance Sheet has been derived from the Company's most recent audited financial statements included in its Annual Report on Form 10-K.

These financial statements should be read in conjunction with the annual financial statements and the notes thereto included in our Annual Report on Form 10-K filed with the SEC on March 30, 2016 ("Annual Report") that contains information useful to understanding the Company's businesses and financial statement presentations.

Note 2. Summary of Significant Accounting Policies
The preparation of consolidated annual and quarterly financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amount of assets and liabilities, the disclosure of contingent assets and liabilities at the date of our consolidated financial statements, and the reported amounts of revenue and expenses during the reporting periods. The Company can give no assurance that actual results will not differ from those estimates.

There have been no material changes to the critical accounting policies and estimates from the information provided in Note 1 of the notes to our consolidated financial statements in our Annual Report.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2014-09, Revenue from Contracts with Customers, which requires entities to recognize revenue in a way that depicts the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled to in exchange for those goods or services. The new guidance also requires additional disclosure about the nature, amount, timing and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in judgments and assets recognized from costs incurred to obtain or fulfill a contract. On July 9, 2015, the FASB agreed to a one-year deferral of the effective date to annual reporting periods beginning after December 15, 2017 and interim periods within those annual periods, but will permit public business entities to adopt the standard as of the original effective date (annual reporting periods beginning after December 15, 2016). The Company is currently evaluating the impact, if any, this new standard will have on its consolidated financial statements and has not yet determined the method of adoption.

In April 2015, the FASB issued ASU No. 2015-03, Interest—Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs, which requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. ASU 2015-15 further clarified that debt issuance costs related to line-of-credit arrangements may continue to be presented as an asset and amortized ratably over the term of the line-of-credit arrangement, regardless of whether there are any outstanding borrowings on the line-of-credit arrangement. The amendment is effective for annual reporting periods beginning after December 15, 2015 and interim periods within those annual periods with early adoption permitted. The Company adopted this guidance on a retrospective basis as required and as such reclassified $1.4 million of deferred financing fees from “Other Assets” to “Term Loan, long term portion” on the Condensed Consolidated Balance Sheet at December 31, 2015. Refer to Note 8, “Credit Facilities and Long-Term Debt” for further information.

In February 2016, the FASB issued ASU No. 2016-02, Leases, that introduces the recognition of a right-of-use asset, which is an asset that represents the lessee’s right to use, or control the use of, a specified asset for the lease term and, a lease liability, which is a lessee’s obligation to make lease payments arising from a lease, measured on a discounted basis for all leases (with the exception of short-term leases). The guidance will be effective for public companies for annual reporting periods beginning after December 15, 2018, and interim periods within those fiscal years with early adoption permitted. The Company has not yet selected a transition method or determined the effect on its consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-09, Compensation—Stock Compensation, which modifies current guidance related to the accounting for forfeitures, employer tax withholding on share-based compensation and the financial statement presentation of excess tax benefits or deficiencies. This amendment also clarifies the statement of cash flows presentation for certain components of share-based awards. The standard is effective for interim and annual reporting periods beginning after December 15, 2016, although early adoption is permitted. The Company is currently evaluating the impact, if any, this new standard will have on its consolidated financial statements.

Note 3. Equity Offering and Private Placement

On February 2, 2016, the Company entered into an Underwriting Agreement (the “Underwriting Agreement”) with Oppenheimer & Co. Inc., as representative of the several other underwriters named therein, relating to an underwritten public offering (the “Offering”) of 5,000,000 shares of our common stock, at a price to the public of $1.00 per share (the “Offering Price”). Under the terms of the Underwriting Agreement, the Company also granted the underwriters a 30-day option to purchase up to an additional 750,000 shares of common stock at the Offering Price less the underwriting discount and estimated offering expenses payable by the Company, which was not exercised.

In addition, on February 1, 2016, the Company entered into a separate, concurrent, side-by-side private placement of 1,700,000 shares of its common stock at a price of $1.00 per share.

The Company received net proceeds from the Offering and a side by side private placement of approximately $6.0 million after deducting the underwriting discount and offering expenses of $0.7 million. The Company used all net proceeds from the Offering to pay down amounts outstanding under its working capital line of credit, which is consistent with past practice and required under the terms of our Credit Facility and Term Loan Due 2019.

Turtle Beach Corporation
Notes to Condensed Consolidated Financial Statements
(unaudited)

Note 4. Fair Value Measurement
The Company follows a three-level fair value hierarchy that prioritizes the inputs used to measure fair value. This hierarchy requires entities to maximize the use of observable inputs and minimize the use of unobservable inputs. The three levels of inputs used to measure fair value are as follows:

- Level 1 — Quoted prices in active markets for identical assets or liabilities.
- Level 2 — Observable inputs other than quoted prices included in Level 1, such as quoted prices for markets that are not active, or other inputs that are observable or can be corroborated by observable market data.
- 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. This includes certain pricing models, discounted cash flow methodologies and similar techniques that use significant unobservable inputs.

Financial instruments consist of cash and cash equivalents, accounts receivable, accounts payable and certain debt instruments. As of June 30, 2016 and December 31, 2015, there were no outstanding financial assets and liabilities recorded at fair value on a recurring basis and the Company had not elected the fair value option for any financial assets and liabilities for which such an election would have been permitted.

The following is a summary of the carrying amounts and estimated fair values of our financial instruments at June 30, 2016 and December 31, 2015:

	June 30, 2016		December 31, 2015	
	Reported	Fair Value	Reported	Fair Value
	(in thousands)			
Financial Assets and Liabilities:				
Cash and cash equivalents	$1,162	$1,162	$7,114	$7,114
Credit Facility	7,192	7,192	32,453	32,453
Term Loans	15,972	15,811	18,379	18,179
Subordinated Debt	18,285	17,008	17,247	15,892

Cash equivalents are stated at amortized cost, which approximates fair value as of the consolidated balance sheet dates, due to the short period of time to maturity; and accounts receivable and accounts payable are stated at their carrying value, which approximates fair value due to the short time to the expected receipt or payment. The Credit Facility and Term Loan Due 2018 carrying value equals fair value as the stated interest rate approximates market rates currently available to the Company, which are considered Level 2 inputs. The fair values of our Term Loan Due 2019 and Subordinated Debt are based upon an estimated market value calculation that factors principal, time to maturity, interest rate and current cost of debt, which is considered a Level 3 input.

Note 5. Allowance for Sales Returns
The following tables provide the changes in our sales return reserve, which is classified as a reduction of accounts receivable:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
	(in thousands)			
Balance, beginning of period	$3,527	$1,179	$6,268	$4,155

Reserve accrual	2,401	4,756	4,534	6,422
Recoveries and deductions, net	(5,349)	(3,960)	(10,223)	(8,602)
Balance, end of period	$579	$1,975	$579	$1,975

9

Turtle Beach Corporation
Notes to Condensed Consolidated Financial Statements - (Continued)
(unaudited)

Note 6. Composition of Certain Financial Statement Items
Inventories
Inventories consist of the following:

	June 30, 2016	December 31, 2015
	(in thousands)	
Raw materials	$1,837	$ 1,481
Finished goods	26,061	24,665
Total inventories	$27,898	$ 26,146

Property and Equipment, net
Property and equipment, net, consists of the following:

	June 30, 2016	December 31, 2015
	(in thousands)	
Machinery and equipment	$1,357	$ 1,238
Software and software development	422	1,022
Furniture and fixtures	270	284
Tooling	2,056	3,395
Leasehold improvements	1,250	1,255
Demonstration units and convention booths	6,900	16,531
Total property and equipment, gross	12,255	23,725
Less: accumulated depreciation and amortization	(6,733)	(16,866)
Total property and equipment, net	$5,522	$ 6,859

Note 7. Goodwill and Other Intangible Assets
At acquisition, the Company estimates and records the fair value of purchased intangible assets. The fair values of these intangible assets are estimated based on our assessment. Goodwill is the excess of the purchase price over the fair value of identifiable net assets acquired in business combinations. Goodwill and certain other intangible assets having indefinite lives are not amortized to earnings, but instead are subject to periodic testing for impairment. Intangible assets determined to have definite lives are amortized over their remaining useful lives.

We assess the impairment of long-lived assets, intangibles assets and goodwill whenever events or changes in circumstances indicate that full recoverability of net asset balances through future cash flows is in question. Goodwill and indefinite-lived intangible assets are assessed at least annually, but also whenever events or changes in circumstances indicate the carrying values may not be recoverable. Factors that could trigger an impairment review include: (a) significant underperformance relative to historical or projected future operating results; (b) significant changes in the manner of use of the acquired assets or the strategy for our overall business; (c) significant negative industry or economic trends; (d) significant decline in our stock price for a sustained period; and (e) a decline in our market capitalization below net book value.

Since the launch of the HyperSound Clear™ 500P product in October 2015 to a limited initial group of offices, the hearing health product has achieved a high sales conversion rate with customers that attend a demonstration at an audiologist's office. However, the audiologist channel has proven to require a significant amount of resources to fully pursue due to the substantial training efforts along with resistance to integrate the product into the office workflow. This has strained capital resources such that the business has experienced lower than forecasted sales volumes. As a result, the Company has begun the process to explore strategic options for the HyperSound business.

As a result of the shortfall versus plan, Management concluded that indicators of potential goodwill impairment were present and, performed an initial interim impairment assessment of whether it is more-likely-than-not that the carrying amount of the HyperSound

Turtle Beach Corporation
Notes to Condensed Consolidated Financial Statements
(unaudited)

reporting unit is greater than its fair value. The initial impairment test utilized a market approach based primarily on market data and comparables provided by a third-party firm, including the synergistic benefit for a market participant with greater resources, and assumptions about industry conditions, growth rates and profitability as Management believes this represents the most likely use of the assets. This analysis indicated that the Company's net book value exceeded its fair value and as a result, the Company recorded a $31.2 million goodwill impairment charge, which represents the entire goodwill amount for the HyperSound reporting unit.

Management believes that the estimate of goodwill impairment loss is reasonable and represents our best estimate of the goodwill impairment loss to be incurred. However, the Company is currently exploring a wide range of potential business model modifications such as new consumer/retail-oriented sales channels, business partnerships to license the technology or a disposition of all, or a portion of the HyperSound business. The completion of the strategic option exploration may result in significant changes to the estimates used and it is possible that a future impairment charge could result for a portion or all of the other intangible assets. This assessment will be updated in the September 30, 2016 Form 10-Q.

Acquired Intangible Assets

Acquired identifiable intangible assets, and related accumulated amortization, as of June 30, 2016 and December 31, 2015 consist of:

	June 30, 2016		
	Gross Carrying Value	Accumulated Amortization	Net Book Value
	(in thousands)		
Customer relationships	$5,796	$ 3,478	$2,318