ALIGN TECHNOLOGY INC
Form 10-Q
July 30, 2015
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2015

OR

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

For the transition period from to

Commission file number: 0-32259

ALIGN TECHNOLOGY, INC.
(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	94-3267295 (I.R.S. Employer Identification Number)

2560 Orchard Parkway
San Jose, California 95131
(Address of principal executive offices)
(408) 470-1000
(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 x 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 x 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 definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

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

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

The number of shares outstanding of the registrant's Common Stock, $0.0001 par value, as of July 24, 2015 was 80,078,373.

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PART I—FINANCIAL INFORMATION
ITEM 1 FINANCIAL STATEMENTS
ALIGN TECHNOLOGY, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)
(unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
Net revenues	$209,488	$192,531	$407,574	$373,177
Cost of net revenues	50,854	47,055	97,850	90,450
Gross profit	158,634	145,476	309,724	282,727
Operating expenses:				
Selling, general and administrative	100,625	83,455	188,906	165,522
Research and development	15,684	13,289	29,569	26,669
Total operating expenses	116,309	96,744	218,475	192,191
Income from operations	42,325	48,732	91,249	90,536
Interest and other income (expenses), net	174	(93)	(1,278)	508
Net income before provision for income taxes	42,499	48,639	89,971	91,044
Provision for income taxes	11,149	13,039	22,444	23,000
Net income	$31,350	$35,600	$67,527	$68,044
Net income per share:				
Basic	$0.39	$0.44	$0.84	$0.84
Diluted	$0.39	$0.43	$0.83	$0.82
Shares used in computing net income per share:				
Basic	80,257	81,027	80,358	81,073
Diluted	81,394	82,341	81,729	82,651

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

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ALIGN TECHNOLOGY, INC.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(in thousands)
(unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2014	2015	2014
Net income	$31,350	$35,600	$67,527	$68,044
Net change in cumulative translation adjustment	52	(4)	(209)	102
Change in unrealized gains (losses) on available-for-sale securities, net of tax	(133)	70	162	112
Other comprehensive income (loss)	(81)	66	(47)	214
Comprehensive income	$31,269	$35,666	$67,480	$68,258

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

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ALIGN TECHNOLOGY, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except per share data)

	June 30, 2015 (unaudited)	December 31, 2014
ASSETS		
Current assets:		
Cash and cash equivalents	$161,753	$199,871
Marketable securities, short-term	276,789	254,787
Accounts receivable, net of allowances for doubtful accounts and returns of $1,548 and $1,563, respectively	146,466	129,751
Inventories	16,415	15,928
Prepaid expenses and other current assets	26,511	19,770
Deferred tax assets	29,972	37,053
Total current assets	657,906	657,160
Marketable securities, long-term	158,161	147,892
Property, plant and equipment, net	108,029	90,125
Goodwill and intangible assets, net	80,590	82,056
Deferred tax assets	16,014	3,099
Other assets	7,881	7,665
Total assets	$1,028,581	$987,997
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$29,513	$23,247
Accrued liabilities	91,992	87,880
Deferred revenues	101,420	90,684
Total current liabilities	222,925	201,811
Income tax payable	33,726	30,483
Other long-term liabilities	2,129	2,932
Total liabilities	258,780	235,226
Commitments and contingencies (Note 6 and 7)		
Stockholders' equity:		
Preferred stock, $0.0001 par value (5,000 shares authorized; none issued)	—	—
Common stock, $0.0001 par value (200,000 shares authorized; 80,069 and 80,205 issued and outstanding, respectively)	8	8
Additional paid-in capital	775,806	783,410
Accumulated other comprehensive loss, net	(187)	(140)
Accumulated deficit	(5,826)	(30,507)
Total stockholders' equity	769,801	752,771
Total liabilities and stockholders' equity	$1,028,581	$987,997

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

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ALIGN TECHNOLOGY, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Six Months Ended June 30,	
	2015	2014
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$67,527	$68,044
Adjustments to reconcile net income to net cash provided by operating activities:		
Deferred taxes	297	17,496
Depreciation and amortization	8,638	9,130
Stock-based compensation	24,474	19,438
Excess tax benefit from share-based payment arrangements	(6,207)	(16,161)
Other non-cash operating activities	6,162	5,095
Changes in assets and liabilities:		
Accounts receivable	(22,904)	(21,407)
Inventories	(510)	855
Prepaid expenses and other assets	(4,786)	(2,806)
Accounts payable	4,902	(9)
Accrued and other long-term liabilities	8,259	1,343
Deferred revenues	12,733	6,705
Net cash provided by operating activities	98,585	87,723
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of property, plant and equipment	(26,172)	(9,960)
Purchase of marketable securities	(195,399)	(232,178)
Proceeds from maturities of marketable securities	148,685	92,005
Proceeds from sales of marketable securities	12,518	32,683
Other investing activities	46	(133)
Net cash used in investing activities	(60,322)	(117,583)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from issuance of common stock	6,036	12,622
Common stock repurchases	(50,781)	(49,000)
Equity forward contract related to accelerated share repurchase	(21,000)	(21,000)
Excess tax benefit from share-based payment arrangements	6,207	16,161
Employees’ taxes paid upon the vesting of restricted stock units	(15,389)	(4,650)
Net cash used in financing activities	(74,927)	(45,867)
Effect of foreign exchange rate changes on cash and cash equivalents	(1,454)	245
Net decrease in cash and cash equivalents	(38,118)	(75,482)
Cash and cash equivalents, beginning of the period	199,871	242,953
Cash and cash equivalents, end of the period	$161,753	$167,471

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

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ALIGN TECHNOLOGY, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)
Note 1. Summary of Significant Accounting Policies

Basis of presentation

The accompanying unaudited Condensed Consolidated Financial Statements have been prepared by Align Technology, Inc. (“we”, “our”, or “Align”) in accordance with the rules and regulations of the Securities and Exchange Commission ("SEC") and contain all adjustments, including normal recurring adjustments, necessary to present fairly our results of operations for the three and six months ended June 30, 2015 and 2014, our comprehensive income for the three and six months ended June 30, 2015 and 2014, our financial position as of June 30, 2015 and our cash flows for the six months ended June 30, 2015 and 2014. The Condensed Consolidated Balance Sheet as of December 31, 2014 was derived from the December 31, 2014 audited financial statements. Net revenues by geographic area for prior period amounts in Note 12 have been reclassified to conform with the current period presentation. These reclassifications had no impact on our financial position for the three and six months ended June 30, 2015 and 2014.

The results of operations for the three and six months ended June 30, 2015 are not necessarily indicative of the results that may be expected for the year ending December 31, 2015 or any other future period, and we make no representations related thereto. The information included in this Quarterly Report on Form 10-Q should be read in conjunction with “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” “Quantitative and Qualitative Disclosures About Market Risk” and the Consolidated Financial Statements and notes thereto included in Items 7, 7A and 8, respectively, in our Annual Report on Form 10-K for the year ended December 31, 2014.

Use of estimates

The preparation of financial statements in conformity with generally accepted accounting principles ("GAAP") in the United States of America (“U.S.”) requires our management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ materially from those estimates. On an ongoing basis, we evaluate our estimates, including those related to the fair values of financial instruments, long-lived assets and goodwill, useful lives of intangible assets and property and equipment, revenue recognition, stock-based compensation, income taxes, and contingent liabilities, among others. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable, the results of which form the basis for making judgments about the carrying values of assets and liabilities.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-09, “Revenue from Contracts with Customers,” requiring an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The updated standard will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective and permits the use of either the retrospective or cumulative effect transition method. In July 2015, the FASB voted to defer the effective date for annual reporting periods beginning after December, 15, 2017 (including interim reporting periods within those periods) and permitted early adoption of the standard, but not before the original effective date of December 15, 2016. We expect the updated standard to become effective for us in the first quarter of fiscal 2018. We have not yet selected a transition method and we are currently evaluating the effect that the updated standard will have on our consolidated financial statements and related disclosures.

In April 2015, the FASB issued ASU No. 2015-05, "Customer's Accounting for Fees Paid in a Cloud Computing Arrangement." providing guidance to entities about whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license, the entity should account for the software license element of the arrangement consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, the entity should account for the arrangement as a service contract. The new guidance does not change the accounting for an entity's accounting for service contracts. The updated standard becomes effective for interim and annual reporting periods beginning after December 15, 2015. We are currently evaluating the effect that the updated standard will have on our consolidated financial statements and related disclosures.

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Note 2. Marketable Securities and Fair Value Measurements

As of June 30, 2015 and December 31, 2014, the estimated fair value of our short-term and long-term marketable securities, classified as available for sale, are as follows (in thousands):

Short-term

June 30, 2015	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Commercial paper	$23,113	$—	$—	$23,113
Corporate bonds	154,667	21	(105)	154,583
Municipal securities	10,237	2	(1)	10,238
U.S. government agency bonds	62,233	17	(1)	62,249
U.S. government treasury bonds	23,592	14	—	23,606
Agency discount notes	2,999	1	—	3,000
Total Marketable Securities, Short-Term	$276,841	$55	$(107)	$276,789

Long-term

June 30, 2015	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. government agency bonds	$39,489	$46	$(12)	$39,523
Corporate bonds	65,988	5	(82)	65,911
U.S. dollar dominated foreign corporate bonds	517	—	—	517
U.S. government treasury bonds	35,746	66	(1)	35,811
Municipal securities	7,161	4	(6)	7,159
Asset-backed securities	9,240	2	(2)	9,240
Total Marketable Securities, Long-Term	$158,141	$123	$(103)	$158,161

Short-term

December 31, 2014	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Commercial paper	$33,998	$—	$—	$33,998
Corporate bonds	152,055	27	(116)	151,966
U.S. dollar dominated foreign corporate bonds	901	—	—	901
Municipal securities	9,147	13	—	9,160
U.S. government agency bonds	41,574	14	(1)	41,587
U.S. government treasury bonds	15,770	7	—	15,777
Certificates of Deposits	1,398	—	—	1,398
Total Marketable Securities, Short-Term	$254,843	$61	$(117)	$254,787

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Long-term

December 31, 2014	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. government agency bonds	$48,233	$12	$(28)	$48,217
Corporate bonds	57,195	6	(112)	57,089
U.S. dollar dominated foreign corporate bonds	523	—	(2)	521
U.S. government treasury bonds	20,814	5	(6)	20,813
Municipal securities	9,552	5	(6)	9,551
Asset-backed securities	11,713	—	(12)	11,701
Total Marketable Securities, Long-Term	$148,030	$28	$(166)	$147,892

For the three and six months ended June 30, 2015 and 2014, realized gains were immaterial. Unrealized gains and losses for our available for sale securities as of June 30, 2015 and December 31, 2014 were also immaterial. Cash and cash equivalents are not included in the table above as the gross unrealized gains and losses are not material. We have no material short-term or long-term investments that have been in a continuous unrealized loss position for greater than twelve months as of June 30, 2015 and December 31, 2014. Amounts reclassified to earnings from accumulated other comprehensive income related to unrealized gain or losses were immaterial for the three and six months ended June 30, 2015 and 2014.

Our fixed-income securities investment portfolio consists of corporate bonds, certificates of deposits, U.S. dollar dominated foreign corporate bonds, commercial paper, municipal securities, U.S. government agency bonds, U.S. government treasury bonds, agency discount notes and asset-backed securities that have a maximum maturity of 27 months. The securities that we invest in are generally deemed to be low risk based on their credit ratings from the major rating agencies. The longer the duration of these securities, the more susceptible they are to changes in market interest rates and bond yields. As interest rates increase, those securities purchased at a lower yield show a mark-to-market unrealized loss. The unrealized losses are due primarily to changes in credit spreads and interest rates. We expect to realize the full value of all these investments upon maturity or sale. The weighted average remaining duration of these securities was approximately 10 and 11 months as of June 30, 2015 and December 31, 2014, respectively.

As the carrying value approximates the fair value for our short-term and long-term marketable securities shown in the tables above, the following table summarizes the fair value of our short-term and long-term marketable securities classified by maturity as of June 30, 2015 and December 31, 2014 (in thousands):

	June 30, 2015	December 31, 2014
Due in one year or less	$276,789	$254,787
Due in greater than one year	158,161	147,892
Total available for sale short-term and long-term marketable securities	$434,950	$402,679

Fair Value Measurements

We measure the fair value of our cash equivalents and marketable securities as the price that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. We use the GAAP fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. This hierarchy requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The three levels of inputs that may be used to measure fair value:

Level 1 — Quoted (unadjusted) prices in active markets for identical assets or liabilities.

Our Level 1 assets consist of money market funds and U.S. government treasury bonds. We did not hold any Level 1 liabilities as of June 30, 2015 or December 31, 2014.

Level 2 — Observable inputs other than quoted prices included in Level 1, such as quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities 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 asset or liability.

Our Level 2 assets consist of commercial paper, corporate bonds, certificates of deposits, U.S. government agency bonds, asset-backed securities, municipal securities, U.S. dollar dominated foreign corporate bonds, agency discount notes and our Israeli

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funds that are mainly invested in insurance policies. We obtain fair values for Level 2 investments from our asset manager for each of our portfolios. Our custody bank and asset managers independently use professional pricing services to gather pricing data which may include quoted market prices for identical or comparable financial instruments, or inputs other than quoted prices that are observable either directly or indirectly, and we are ultimately responsible for these underlying estimates.

We did not hold any Level 2 liabilities as of June 30, 2015 or December 31, 2014.

Level 3 — Unobservable inputs to the valuation methodology that are supported by little or no market activity and that are significant to the measurement of the fair value of the assets or liabilities. Level 3 assets and liabilities include those whose fair value measurements are determined using pricing models, discounted cash flow methodologies or similar valuation techniques, as well as significant management judgment or estimation.

We did not hold any Level 3 assets or liabilities as of June 30, 2015 or December 31, 2014.
Recurring Fair Value Measurements

The following tables summarize our financial assets measured at fair value on a recurring basis as of June 30, 2015 and December 31, 2014 (in thousands):

Description	Balance as of June 30, 2015	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Cash equivalents:			
Money market funds	$69,376	$69,376	$—
Commercial paper	32,644	—	32,644
Short-term investments:			
Commercial paper	23,113	—	23,113
Corporate bonds	154,583	—	154,583
Municipal securities	10,238	—	10,238
U.S. government agency bonds	62,249	—	62,249
U.S. government treasury bonds	23,606	23,606	—
Agency discount notes	3,000	—	3,000
Long-term investments:			
U.S. government agency bonds	39,523	—	39,523
Corporate bonds	65,911	—	65,911
U.S. dollar dominated foreign corporate bonds	517	—	517
U.S. government treasury bonds	35,811	35,811	—
Municipal securities	7,159	—	7,159
Asset-backed securities	9,240	—	9,240
Other assets:			
Israeli funds	2,396	—	2,396
	$539,366	$128,793	$410,573

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Description	Balance as of December 31, 2014	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Cash equivalents:			
Money market funds	$ 80,786	$80,786	$—
Commercial paper	21,997	—	21,997
Corporate bonds	1,745	—	1,745
Short-term investments:			
Commercial paper	33,998	—	33,998
Corporate bonds	151,966	—	151,966
U.S. dollar denominated foreign corporate bonds	901	—	901
Municipal securities	9,160	—	9,160
U.S. government agency bonds	41,587	—	41,587
U.S. government treasury bonds	15,777	15,777	—
Certificates of Deposits	1,398	—	1,398
Long-term investments:			
U.S. government agency bonds	48,217	—	48,217
Corporate bonds	57,089	—	57,089
U.S. dollar denominated foreign corporate bonds	521	—	521
U.S. government treasury bonds	20,813	20,813	—
Municipal securities	9,551	—	9,551
Asset-backed securities	11,701	—	11,701
Other assets:			
Israeli funds	2,307	—	2,307
	$ 509,514	$117,376	$392,138

Note 3. Balance Sheet Components

Inventories

Inventories consist of the following (in thousands):

	June 30, 2015	December 31, 2014
Raw materials	$7,352	$8,143
Work in process	5,243	2,970
Finished goods	3,820	4,815
Total Inventories	$16,415	$15,928

Work in process includes costs to produce our clear aligner and intra-oral products. Finished goods primarily represent our intra-oral scanners and ancillary products that support our clear aligner products.

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Accrued liabilities

Accrued liabilities consist of the following (in thousands):

	June 30, 2015	December 31, 2014
Accrued payroll and benefits	$48,448	$44,610
Accrued sales rebates	12,647	11,110
Accrued sales and marketing expenses	6,231	5,979
Accrued sales tax and value added tax	5,387	5,456
Accrued accounts payable	3,678	5,736
Accrued warranty	2,986	3,148
Accrued professional fees	2,487	2,494
Accrued income taxes	1,939	2,027
Other accrued liabilities	8,189	7,320
Total Accrued Liabilities	$91,992	$87,880

Warranty

We regularly review the accrued warranty balances and update these balances based on historical warranty trends. Actual warranty costs incurred have not materially differed from those accrued; however, future actual warranty costs could differ from the estimated amounts.

Clear Aligner

We warrant our Invisalign products against material defects until the Invisalign case is complete. We accrue for warranty costs in cost of net revenues upon shipment of products. The amount of accrued estimated warranty costs is primarily based on historical experience as to product failures as well as current information on replacement costs.

Scanners

We warrant our scanners for a period of one year from the date of training and installation. We accrue for these warranty costs which includes materials and labor based on estimated historical repair costs. Extended service packages may be purchased for additional fees.

Warranty accrual as of June 30, 2015 and 2014 consists of the following activity (in thousands):

	Six Months Ended June 30,	
	2015	2014
Balance at beginning of period	$3,148	$3,104
Charged to cost of net revenues	976	1,195
Actual warranty expenditures	(1,138)	(1,047)
Balance at end of period	$2,986	$3,252

Note 4. Goodwill and Long-lived Assets

Goodwill

On April 29, 2011, we acquired Cadent Holdings, Inc. (“Cadent”). In connection with the acquisition, we allocated approximately $58.0 million of goodwill to our Clear Aligner reporting unit based on the expected relative synergies generated by the acquisition. On April 30, 2013, we acquired ICA Holdings Pty Limited in a purchase business combination of which $3.6 million was recorded to goodwill, which was attributed to our Clear Aligner reporting unit.

The change in the carrying value of goodwill for the six months ended June 30, 2015, all attributable to our Clear Aligner reporting unit, is as follows (in thousands):

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	Clear Aligner
Balance as of December 31, 2014	$61,369
Adjustments [1]	(166)
Balance as of June 30, 2015	$61,203

[1] The adjustments to goodwill during the six months ended June 30, 2015 were due to foreign currency translation.

During the fourth quarter of fiscal 2014, we performed the annual goodwill impairment testing and found no impairment events as the fair value of our Clear Aligner reporting unit was significantly in excess of the carrying value.

Acquired intangible assets, arising either as a direct result from the Cadent acquisition or individually acquired, are being amortized as follows (in thousands):

	Weighted Average Amortization Period (in years)	Gross Carrying Amount as of June 30, 2015	Accumulated Amortization	Accumulated Impairment Loss	Net Carrying Value as of June 30, 2015
Trademarks	15	$7,100	$ (1,423)	$(4,179)	$1,498
Existing technology	13	12,600	(3,296)	(4,328)	4,976
Customer relationships	11	33,500	(10,027)	(10,751)	12,722
Other	8	285	(94)	—	191
Total Intangible Assets		$53,485	$ (14,840)	$(19,258)	$19,387

	Weighted Average Amortization Period (in years)	Gross Carrying Amount as of December 31, 2014	Accumulated Amortization	Accumulated Impairment Loss	Net Carrying Value as of December 31, 2014
Trademarks	15	$7,100	$(1,354)	$ (4,179)	$ 1,567
Existing technology	13	12,600	(3,015)	(4,328)	5,257
Customer relationships	11	33,500	(9,095)	(10,751)	13,654
Other	8	285			