CASTELLE \CA\
Form 10-Q
May 14, 2001

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

FORM 10-Q

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

For the quarterly period ended March 30, 2001

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

Commission File Number: 0-220-20

CASTELLE
(Exact name of Registrant as specified in its charter)

California 77-0164056
(State or other jurisdiction of (IRS Employer Identification No.)
incorporation or organization)

855 Jarvis Drive, Suite 100, Morgan Hill, California 95037
(Address of principal executive offices, including zip code)

(408) 852-8000
(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act: NONE

Securities registered pursuant to Section 12(g) of the Act: COMMON STOCK, NO PAR VALUE

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 __

The number of shares of Common Stock outstanding as of May 8, 2001 was 4,742,060

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SPECIAL NOTE ON FORWARD-LOOKING STATEMENTS

This document contains forward-looking statements that involve risks and uncertainties. The Company's operating results may vary significantly from quarter to quarter due to a variety of factors, including without limitation, the timely development, acceptance, and pricing of new products, changes in the Company's product and customer mix, constraints in the Company's manufacturing and assembling operations, shortages or increases in the prices of raw materials and components, changes in pricing policy by the Company or its competitors, a slowdown in the growth of the networking market, seasonality, timing of expenditures and economic conditions in the United States, Europe and Asia. Words such as "believes," "anticipates," "expects," "intends" and similar expressions are intended to identify forward-looking statements, but are not the exclusive means of identifying such statements. Unless the context otherwise requires, references in this Form 10-Q to "we," "us," or the "Company" refer to Castelle. Readers are cautioned that the forward-looking statements reflect management's analysis only as of the date hereof, and the Company assumes no obligation to update these statements. Actual events or results may differ materially from the results discussed in the forward-looking statements. Factors that might cause such a difference include, but are not limited to the risks and uncertainties discussed herein, as well as other risks set forth under the caption "Risk Factors" in the Company's Annual Report on Form 10-K and Form 10-K/A for the fiscal year ended December 31, 2000. We urge you to consider these cautionary statements in evaluating our forward-looking statements. Except as required by laws, we undertake no obligations to publicly update any forward-looking statements to reflect subsequent events and circumstances.

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Part I - Financial Information

Item 1. Financial Statements

CASTELLE AND SUBSIDIARIES
Consolidated Balance Sheets
(in thousands)

	March 30, 2001 (unaudited)	Dece
Assets:		
Current assets:		
Cash and cash equivalents	$ 3,571	
Restricted cash	-	
Accounts receivable, net of allowance for doubtful accounts of $323 in 2001 and $285 in 2000	1,297	
Inventories, net	1,513	
Prepaid expense and other current assets	229	
Total current assets	6,610	
Property, plant & equipment, net	760	
Other non-current assets, net	100	
Total assets	$ 7,470	
Liabilities & Shareholders' Equity:		
Current liabilities:		
Long-term debt, current portion	$ 7	
Accounts payable	523	
Accrued liabilities	2,505	
Total current liabilities	3,035	
Long term debt, net of current portion	63	
Total liabilities	3,098	
Shareholders' equity:		
Common stock, no par value:		
Authorized: 25,000 shares		
Issued and outstanding: 4,742 and 4,741 respectively	28,979	
Deferred compensation	(16)	
Accumulated deficit	(24,591)	

Total shareholders' equity	4,372	
Total liabilities & shareholders' equity	$ 7,470	

See accompanying notes to condensed consolidated financial statements.

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CASTELLE AND SUBSIDIARIES
Consolidated Statements of Operations
(in thousands, except per share amounts)
(unaudited)

	Three months ended	
	March 30, 2001	March 3
Net sales	$ 2,349	$
Cost of sales	698	
Gross profit	1,651	
Operating expenses:		
Research and development	385	
Sales and marketing	1,126	
General and administrative	444	
Restructuring charges	180	
Total operating expenses	2,135	
Income/(loss) from operations	(484)	
Interest income, net	33	
Other income/(expense), net	43	
Income/(loss) before provision for income taxes	(408)	
Provision for income taxes	-	
Net income/(loss)	$ (408)	
Earnings per share:		
Net income/(loss) per common share - basic	$ (0.09)	$
Shares used in per share calculation - basic	4,741	
Net income/(loss) per common share - diluted	$ (0.09)	$
Shares used in per share calculation - diluted	4,741	

See accompanying notes to condensed consolidated financial statements.

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CASTELLE AND SUBSIDIARIES
Consolidated Statements of Cash Flows
(in thousands)
(unaudited)

	Three months ended	
	March 30, 2001	March 3
Cash flows from operating activities:		
Net income (loss)	$ (408)	$
Adjustment to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	64	
Provision for doubtful accounts and sales returns	134	
Provision for excess and obsolete inventory	72	
Compensation expense related to grant of stock options	4	
Changes in assets and liabilities:		
Accounts receivable	652	
Inventories	(222)	
Prepaid expenses and other current assets	(20)	
Accounts payable	(491)	
Accrued liabilities and other long-term liabilities	(176)	
Decrease in other assets	2	
Net cash used in operating activities	(389)	
Cash flows from investing activities:		
Return of restricted cash	125	
Acquisition of property, plant and equipment	(56)	
Net cash provided by/(used in) investing activities	69	
Cash flows from financing activities:		
Repayment of loan	(2)	
Proceeds from issuance of common stock and warrants, net of repurchases	-	
Net cash used in financing activities	(2)	
Net decrease in cash and cash equivalents	(322)	
Cash and cash equivalents at beginning of period	3,893	
Cash and cash equivalents at end of period	$ 3,571	$

See accompanying notes to condensed consolidated financial statements.

CASTELLE AND SUBSIDIARIES
Notes To Consolidated Financial Statements
(unaudited)

1. Basis of Presentation:

The accompanying unaudited consolidated financial statements include the accounts of Castelle and its wholly owned subsidiaries in the United Kingdom and the Netherlands, and have been prepared in accordance with accounting principles generally accepted in the United States of America. All intercompany balances and transactions have been eliminated. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of the Company's financial position, results of operations and cash flows at the dates and for the periods indicated have been included. The result of operations for the interim period presented is not necessarily indicative of the results for the year ending December 31, 2001. Because all of the disclosures required by accounting principles generally accepted in the United States of America are not included in the accompanying consolidated financial statements and related notes, they should be read in conjunction with the audited consolidated financial statements and related notes included in the Company's Form 10-K and Form 10-K/A for the fiscal year-ended December 31, 2000. The year ended condensed balance sheet data was derived from our audited financial statements and does not include all of the disclosures required by accounting principles generally accepted in the United States of America. The income statements for the periods presented are not necessarily indicative of results that we expect for any future period, nor for the entire year. Prior year amounts have been reclassified to conform with current presentation.

2. Net Income/Loss Per Share:

Basic net income/loss per share is computed by dividing net income/loss available to common shareholders by the weighted average number of common shares outstanding for that period. Diluted net income/loss per share reflects the potential dilution from the exercise or conversion of other securities into common stock that were outstanding during the period. Shares that are potentially dilutive consist of incremental common shares issuable upon exercise of stock options and warrants.

Basic and diluted earnings per share are calculated as follows for first quarters of 2001 and 2000:

	(in thousands, except per share amounts) (unaudited)	
	March 30, 2001	March 31, 2000

Basic:		
Weighted average common shares outstanding	4,741	4,660
Net income/(loss)	$ (408)	$ 169
Net income/(loss) per common share - basic	$ (0.09)	$ 0.04
Diluted:		
Weighted average common shares outstanding	4,741	4,660
Common equivalent shares from stock warrants	-	55
Common equivalent shares from stock options	-	615
Shares used in per share calculation - diluted	4,741	5,330
Net income/(loss)	$ (408)	$ 169
Net income/(loss) per common share - diluted	$ (0.09)	$ 0.03

The calculation of diluted shares outstanding at March 30, 2001 excludes 1,314,000 stock options, as their effect was antidilutive in the period. At March 31, 2000 warrants totaling 100,000 were excluded, because their exercise price was greater than the average common stock market price for the period.

3. Inventories:

Inventories are stated at the lower of standard cost (which approximates cost on a first-in, first-out basis) or market and net of reserves for excess and obsolete inventory. Inventory details are as follows:

	(in thousands) (unaudited)	
	March 30, 2001	December 31, 2000
Raw material	$ 354	$ 488
Work in process	315	201
Finished goods	960	773
Inventory Reserve	(453)	(381)
Total Inventory	$ 1,513	$ 1,363

4. Revenue Recognition:

Product revenue is recognized upon shipment if a signed contract exists, the fee is fixed and determinable, collection of the resulting receivables is probable and product returns are reasonably estimable. The Company enters into agreements with certain of its distributors which permit limited stock rotation rights. These stock rotation rights allow the distributor to return products for credit but require the purchase of additional products of equal value. Revenues subject to stock rotation rights are reduced by management's estimates of anticipated exchanges. Provisions for estimated warranty costs and anticipated retroactive price adjustments are recorded at the time products are shipped. The Company recognizes revenue from the sale of extended warranty contracts ratably over the period of the contracts.

5. Segments Disclosure:

The Company has determined that it operates in one segment.

6. Comprehensive Income:

Under SFAS No. 130, "Reporting Comprehensive Income" disclosure of comprehensive income and its components is required in financial statements. Comprehensive income is the change in equity from transactions and other events and circumstances other than those resulting from investments by owners and distributions to owners. There are no significant components of comprehensive income excluded from net income, therefore, no separate statement of comprehensive income has been presented.

The Company recognized a restructuring charge of $180,000 in the first quarter of fiscal 2001, which included an asset write-off and other direct expenses associated with the consolidation of our operations in the United Kingdom and El Dorado Hills, California. In addition, the Company made an announcement in April 2001 to eliminate 17 regular, temporary and contractor positions, which constitutes approximately 25% of our workforce. This action will result in a severance charge of approximately $100,000 in the second quarter of fiscal 2001.

7. New accounting pronouncements:

Under SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," companies are required to recognize all derivatives as either assets or liabilities in the statement of financial position and to measure those instruments at fair value. Changes in fair value shall be recognized currently in earnings. This standard was effective for the Company from January 1, 2001. At that time, the Company did not have any derivative instruments, nor has it engaged in hedging activities to date.

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

This Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements that are subject to many risks and uncertainties that could cause actual results to differ significantly from expectations. For more information on forward-looking statements, refer to the "Special Note on Forward-Looking Statements" at the front on this Form 10-Q. The following discussion should be read in conjunction with the Financial Statements and the Notes thereto included in Item 1 of this Quarterly Report on Form 10-Q and in the Company's Form 10-K and Form 10-K/A for the fiscal year ended December 31, 2000.

Consolidated Statements of Income - As a Percentage of Net Sales

	(unaudited) Three months ended	
	March 30, 2001	March 31, 20
Net sales	100%	100%
Cost of sales	30%	40%
Gross profit	70%	60%
Operating expenses:		
Research and development	16%	13%
Sales and marketing	48%	32%
General and administrative	19%	11%
Restructuring charges	8%	--
Total operating expense	91%	56%
Income/(loss) from operations	(21%)	4%
Interest income, net	2%	*
Other income/(expense), net	2%	*
Income/(loss) before provision for income taxes	(17%)	4%
Provision for income taxes	--	*
Net Income/(loss)	(17%)	4%

* Less than 1%

Results of Operations

Net Sales

Net sales for the first quarter of fiscal 2001 were $2.3 million, as compared to $4.1 million for the same period in fiscal 2000. The $1.8 million reduction was primarily attributable to continued decline in the sales of print server products which amounted to $624,000 mostly attribuatble to a decline in sales in international channels and a shortfall in the sales of fax server products of $1.1 million domestically.

International sales in the first quarter of fiscal 2001 were $451,000 as compared to $1.2 million for the same period in fiscal 2000, representing 19% and 28%, respectively, of total net sales. The decline was largely due to reduced demand of print server products in the Asia Pacific Region. In addition, beginning in the first quarter of fiscal 2001, we changed from a model of selling our print server products directly to our distributor in Japan to a royalty collection model. The royalty amounts received by us in the first quarter of fiscal 2001 were not significant.

Domestic sales in the first quarter of fiscal 2001 were $1.9 million as compared to $2.9 million for the same period in fiscal 2000, representing 81% and 72%, respectively, of total net sales. The decrease was principally due to a weaker demand of fax server products.

Cost of Sales; Gross Profit

Gross profit was $1.7 million, or 70% of net sales, for the first quarter of fiscal 2001 as compared to $2.5 million, or 60% for the same period in fiscal 2000. The higher gross profit percentage in the first quarter of fiscal 2001 was mostly due to the mix of products sold at a higher average selling price. The change in the first quarter of fiscal 2001 to a royalty collection model from directly selling our print server products to our distributor in Japan also contributed to the higher gross profit. However, the amount of royalties received was not significant.

Research & Development

Research and product development expenses were $385,000 or 16% of net sales for the first quarter of fiscal 2001, as compared to $505,000 or 13% of net sales for the same period in fiscal 2000. The decrease was primarily due to lower compensation and outside consulting expenses.

Sales & Marketing

Sales and marketing expenses were $1.1 million or 48% of net sales for the first quarter of fiscal 2001 as compared to $1.3 million or 32% of net sales for the same period in fiscal 2000. The reduction of sales and marketing expenses was primarily associated with lower compensation expenses.

General & Administrative

General and administrative expenses were $444,000 or 19% of net sales for the first quarter of fiscal 2001, comparable to $466,000 or 11% of net sales for the first quarter of fiscal 2000.

Restructuring

We recognized a restructuring charge of $180,000 in the first quarter of fiscal 2001, which included an asset write-off and other direct expenses associated with the consolidation of our operations in the United Kingdom and El Dorado Hills, California. In addition, we made an announcement in April 2001 to eliminate 17 regular, temporary and contractor positions, which constitutes approximately 25% of our workforce. This action will result in a severance charge of approximately $100,000 in the second quarter of fiscal 2001.

Liquidity and Capital Resources

As of March 30, 2001, we had $3.6 million of cash and cash equivalents, a decrease of $322,000 from December 31, 2000. Working capital decreased to $3.6 million at March 30, 2001, from $4.0 million at December 31, 2000. The decrease in working capital was primarily due to the overall decrease in sales.

The restricted cash of $125,000 appearing on our balance sheet as of

December 31, 2000, which was a certificate of deposit to collateralize a loan, was returned to us in February 2001. The loan was completely paid off as of December 31, 2000.

We have a $3.0 million secured revolving line of credit with a bank from which we may borrow 100% against pledges of cash at the bank's prime rate. Borrowings under this line of credit agreement are collateralized by all of our assets. This loan agreement has been renegotiated and its term has been extended until March 17, 2002. As of March 30, 2001, we had not borrowed against this line.

In December 2000, as a source of capital asset financing, we entered into a loan and security agreement with a finance company for an amount of $75,000. This loan is subject to interest of 12.8% and is repayable by December 2006. As of March 30, 2001, the future minimum payments were $99,000.

In April 2001, as a source of capital asset financing, we entered into a loan and security agreement with a finance company for an amount of $25,000. This loan is subject to interest of 12.5% and is repayable by April 2004. As of April 30, 2001, the future minimum payments were $30,000.

As of March 30, 2001, net accounts receivable were $1.3 million, down from $2.1 million at December 31, 2000. The decrease in net accounts receivable was chiefly attributed to improved collection of outstanding balances and reduced sales in the first quarter of fiscal 2001. The number of days for which payment for sales is outstanding was reduced from 58 days at December 31, 2000 to 50 days at March 30, 2001.

Net inventories as of March 30, 2001 were $1.5 million, up from $1.3 million at December 31, 2000. The increase was largely attributable to the slower sales in the first quarter of fiscal 2001. Inventory turnover for this current quarter slowed to an equivalent of 1.8 turns per year from 3.5 turns per year in the prior quarter.

Although we believe that our existing capital resources, anticipated cash flows from operations and available lines of credit will be sufficient to meet our capital requirements for at least the next 12 months, we may be required to seek additional equity or debt financing. The timing and amount of such capital requirements cannot be determined at this time and will depend on a number of factors, including demand for our existing and new products and the pace of technological change in the networking industry. There can be no assurance that such additional financing will be available on satisfactory terms when needed, if at all.

We believe that, for the periods presented, inflation has not had a material effect on our operations.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

None.

Item 2. Changes in Securities and use of proceeds

None

Item 3. Quantitative and Qualitative disclosure about market risk

The Company believes that there have been no material changes in the reported market risks faced by the Company since the fiscal year ended December 31, 2000. These and other risk factors are discussed in more detail in our Form 10-K and Form 10-K/A for the fiscal year ended December 31, 2000 under the section "Risk Factors".

Item 4. Submission of Matters to a Vote of Security Holders

None.

Item 5. Other Information

In April 2001, we announced a worldwide restructuring of the Company and consolidated our operations in the United Kingdom and El Dorado Hills, California. We recognized a restructuring charge of $180,000 in the first quarter of fiscal 2001, which included an asset write-off and other direct expenses associated with this consolidation. We also eliminate 17 regular, temporary and contractor positions, which constitutes approximately 25% of our workforce, which will result in a severance charge of approximately $100,000 in the second quarter of fiscal 2001.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits:

99.1 Press Release dated May 14, 2001

(b) Reports on Form 8-K

None

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.

CASTELLE

By: /s/ Donald L. Rich Date: May 14, 2001
Donald L. Rich
Chairman of the Board and Director
Chief Executive Officer and President
(Principal Executive Officer)

By: /s/ Paul Cheng Date: May 14, 2001
Paul Cheng
Vice President of Finance and Administration
Chief Financial Officer
(Principal Financial and Chief Accounting Officer)
Secretary