Starent Networks, Corp.
Form 10-Q
November 06, 2009
Table of Contents

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 September 30, 2009

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: 001-33511

STARENT NETWORKS, CORP.

(Exact name of registrant as specified in its charter)

Delaware	**04-3527533**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

30 International Place

Tewksbury, MA 01876

(Address of principal executive offices) (zip code)

(978) 851-1100

(Registrant s telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

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. x Yes ¨ No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ¨ No ¨

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

Large accelerated filer	¨	Accelerated filer	x
Non-accelerated filer	¨ (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 x No

As of November 2, 2009, there were 72,120,431 shares of the registrant s $0.001 par value per share common stock outstanding.

Table of Contents

STARENT NETWORKS, CORP.

QUARTERLY REPORT ON FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2009

Table of Contents

Item		Page
PART I. FINANCIAL INFORMATION		
ITEM 1.	Condensed Consolidated Financial Statements (unaudited)	3
	Condensed Consolidated Balance Sheets as of September 30, 2009 and December 31, 2008	3
	Condensed Consolidated Statements of Operations for the Three and Nine Months Ended September 30, 2009 and 2008	4
	Condensed Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2009 and 2008	5
	Notes to Condensed Consolidated Financial Statements	6
ITEM 2.	Management s Discussion and Analysis of Financial Condition and Results of Operations	14
ITEM 3.	Quantitative and Qualitative Disclosures About Market Risk	28
ITEM 4.	Controls and Procedures	28
PART II. OTHER INFORMATION		
ITEM 1.	Legal Proceedings	29
ITEM 1A.	Risk Factors	29
ITEM 2.	Unregistered Sales of Equity Securities and Use of Proceeds	43
ITEM 6.	Exhibits	43

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

STARENT NETWORKS, CORP.

CONDENSED CONSOLIDATED BALANCE SHEETS

(unaudited and in thousands, except share and per share data)

	September 30, 2009	December 31, 2008
Assets		
Current assets:		
Cash and cash equivalents	$ 407,456	$ 369,351
Accounts receivable	53,836	53,689
Inventories	56,476	48,734
Deferred tax assets, net	6,924	3,449
Prepaid expenses and other current assets	7,830	4,709
Total current assets	532,522	479,932
Property and equipment, net	38,541	29,632
Deferred tax assets, net	15,967	9,699
Other assets	10,910	8,011
Restricted cash	821	943
Total assets	$ 598,761	$ 528,217
Liabilities and stockholders equity		
Current liabilities:		
Accounts payable	$ 13,753	$ 9,042
Accrued expenses and other current liabilities	12,586	8,164
Accrued payroll and related expenses	12,216	15,195
Accrued income taxes	14,180	1,945
Current portion of deferred revenue	129,505	141,726
Total current liabilities	182,240	176,072
Deferred revenue, net of current portion	7,737	10,959
Other long-term liabilities	2,762	2,985
Commitments and contingencies (Note 8 and 11)		
Stockholders equity:		
Preferred stock, $0.001 par value; 5,000,000 shares authorized and no shares outstanding		
Common stock, $0.001 par value; 250,000,000 shares authorized; 71,739,454 and 69,867,985 shares issued and outstanding at September 30, 2009 and December 31, 2008, respectively	72	70
Additional paid-in capital	396,397	371,655
Retained earnings (accumulated deficit)	9,553	(33,524)
Total stockholders equity	406,022	338,201

Total liabilities and stockholders equity	$	598,761	$	528,217

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

Table of Contents

STARENT NETWORKS, CORP.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited and in thousands, except per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Revenues:				
Product	$ 73,160	$ 55,450	$ 202,119	$ 156,497
Service	12,810	10,611	35,372	26,960
Total revenues	85,970	66,061	237,491	183,457
Cost of revenues:				
Product	10,100	10,151	29,711	28,697
Service	6,405	4,107	16,957	11,823
Total cost of revenues	16,505	14,258	46,668	40,520
Gross profit	69,465	51,803	190,823	142,937
Operating expenses:				
Research and development	16,892	13,750	47,478	38,594
Sales and marketing	18,677	17,894	52,009	52,918
General and administrative	10,569	6,129	23,946	17,215
Total operating expenses	46,138	37,773	123,433	108,727
Income from operations	23,327	14,030	67,390	34,210
Interest income	252	1,940	1,022	6,232
Foreign currency exchange gain (loss)	1,299	(1,308)	2,057	(556)
Other income (expense), net	31		(5)	
Income before income tax (expense) benefit	24,909	14,662	70,464	39,886
Income tax (expense) benefit	(9,787)	4,926	(27,388)	3,131
Net income	$ 15,122	$ 19,588	$ 43,076	$ 43,017
Net income per common share (Note 3):				
Basic	$ 0.21	$ 0.28	$ 0.61	$ 0.62
Diluted	$ 0.20	$ 0.26	$ 0.57	$ 0.58
Weighted-average shares outstanding used in computing net income per common share (Note 3):				

Basic	71,418	69,683	70,720	69,328
Diluted	76,356	74,192	75,752	74,343

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

Table of Contents

STARENT NETWORKS, CORP.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited and in thousands)

	Nine Months Ended September 30,	
	2009	**2008**
Cash flows from operating activities:		
Net income	$ 43,076	$ 43,017
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	12,715	8,090
Share-based compensation	15,941	12,430
Loss on disposal of property and equipment	92	36
Benefit from deferred income taxes, net	(9,746)	(6,622)
Changes in operating assets and liabilities:		
Accounts receivable	(85)	(390)
Inventories	(7,603)	(12,901)
Prepaid expenses and other current assets	(3,041)	1,133
Other assets	147	(116)
Accounts payable	4,688	2,399
Accrued expenses and other liabilities	477	1,448
Accrued income taxes	12,181	1,821
Deferred revenue	(15,477)	86,920
Net cash provided by operating activities	53,365	137,265
Cash flows from investing activities:		
Purchases of property and equipment and other technologies	(22,802)	(16,820)
Proceeds from maturities of short-term investments		9,610
Investments in and advances to unconsolidated companies	(1,000)	
Change in restricted cash	122	(43)
Net cash used in investing activities	(23,680)	(7,253)
Cash flows from financing activities:		
Proceeds from exercises of stock options	8,608	2,683
Additional expenses from public offerings		(87)
Net cash provided by financing activities	8,608	2,596
Effect of exchange rate changes on cash and cash equivalents	(188)	(208)
Net increase in cash and cash equivalents	38,105	132,400
Cash and cash equivalents, beginning of year	369,351	223,987
Cash and cash equivalents, end of year	$ 407,456	$ 356,387

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

Table of Contents

STARENT NETWORKS, CORP.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

1. Overview

Business Description

Starent Networks, Corp. (Starent or the Company) was incorporated in Delaware on August 11, 2000 and is a leading provider of infrastructure hardware and software products and services that enable mobile operators to deliver multimedia services to their subscribers. The Company s products and services integrate multiple network functions and services needed for the delivery of advanced multimedia services, such as video, Internet access, voice-over-IP, e-mail, mobile TV, photo sharing and gaming.

Proposed Merger

As discussed below under Note 11, Subsequent Event , on October 12, 2009, the Company entered into a definitive Agreement and Plan of Merger (the Merger Agreement) with Cisco Systems, Inc. (Cisco) and Barcelona Acquisition Corp. (Barcelona), a wholly-owned subsidiary of Cisco. Pursuant to the terms of the Merger Agreement, and subject to the conditions thereof, Barcelona will merge with and into the Company and the Company will become a wholly-owned subsidiary of Cisco (the Merger). If the Merger is completed, the Company s stockholders will be entitled to receive $35.00 in cash for each share of the Company s common stock owned by them as of the date of the Merger.

Basis of Presentation

The accompanying interim condensed consolidated financial statements have been prepared by the Company, are unaudited and, in the opinion of management, include all adjustments, consisting only of normal, recurring adjustments and accruals necessary for a fair statement of the Company s financial position at September 30, 2009, results of operations for the three and nine months ended September 30, 2009 and 2008, and cash flows for the nine months ended September 30, 2009 and 2008 in accordance with generally accepted accounting principles in the United States (GAAP). Interim results are not necessarily indicative of results for any other interim period or a full year. The condensed consolidated balance sheet presented as of December 31, 2008 has been derived from the audited consolidated financial statements as of that date.

The condensed consolidated financial statements and notes are presented as permitted by Form 10-Q and do not contain all of the information that is included in the annual financial statements and notes of the Company. The condensed consolidated financial statements and notes presented herein should be read in conjunction with the financial statements and notes included in the Company s Annual Report on Form 10-K for the year ended December 31, 2008.

The Company has evaluated subsequent events through November 6, 2009, the date it filed its report on Form 10-Q for the quarter ended September 30, 2009 with the Securities and Exchange Commission (SEC), and has disclosed all material subsequent events in Note 11.

Significant Estimates and Assumptions

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenue and expenses during the reporting periods. On an ongoing basis, the Company evaluates its estimates and judgments, including those related to revenue recognition, the realizable value of accounts receivable and inventories, valuation of share-based compensation instruments, loss contingencies and valuation allowances for deferred tax assets. Actual amounts could differ from these estimates. Changes in estimates are recorded in the period in which they become known.

Reclassification

Certain prior year amounts related to the classification of foreign currency gains or losses within the operating cash flows section of the condensed consolidated statements of cash flows have been reclassified to conform to the current year presentation. These reclassifications had no impact on previously reported net cash provided by operating activities, results of operations, or any balance sheet captions.

Table of Contents

STARENT NETWORKS, CORP.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

Concentrations of Risk and Off-Balance-Sheet Risk

The Company has no significant off-balance-sheet risk such as foreign exchange contracts, option contracts or other foreign hedging arrangements. Financial instruments that potentially subject the Company to concentrations of credit risk are principally cash equivalents and accounts receivable. The Company s cash equivalents are principally maintained in a limited number of highly rated financial institutions and consisted primarily of money market funds.

The Company had two customers for the three months ended September 30, 2009 that each accounted for more than 10% of revenues and in the aggregate accounted for 85% of revenues. The Company had one customer for the nine months ended September 30, 2009 that accounted for 70% of revenues. The Company had two customers for the three and nine months ended September 30, 2008, that each accounted for more than 10% of revenues and in the aggregate accounted for 79% and 80% of revenues for each of the respective periods. At September 30, 2009, the Company had two customers that in the aggregate accounted for 52% of accounts receivable. At December 31, 2008, the Company had two customers that in the aggregate accounted for 76% of accounts receivable.

The Company relies on a single contract manufacturer to manufacture and assemble its products. The Company has no long-term supply arrangements with this manufacturer and accordingly no obligation exists for the manufacturer to supply products to the Company in specific quantities or within specific time frames.

In addition, certain of the components included in the Company s products are sourced from single or limited sources, and lead times for some of these components may be significant. The Company has no long-term contracts to purchase these components.

2. Share-Based Compensation

The fair value of share-based option awards was estimated at the date of grant using the Black-Scholes stock option pricing model. The following assumptions were used in determining the fair value:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Risk-free interest rates	2.47%	3.30%	2.14% - 2.71%	3.01 - 3.30%
Expected dividend yield	0%	0%	0%	0%
Expected life	6.25 years	6.25 years	6.25 years	6.25 years
Expected volatility	58%	56%	58% - 59%	54 - 56%

The Company uses the simplified method to estimate the expected term for share option grants as it does not have enough historical experience to provide a reasonable estimate due to the limited period that the Company s common stock has been publicly traded. In 2008, the Company modified its computation of expected volatility to base it on the combination of historical trading activity of the Company s common stock, the Company s implied volatility, and an analysis of comparable companies from a representative peer group selected based on industry and market capitalization in order to derive an expected volatility. Prior to the modification, the computation of expected volatility was based on the historical volatility of comparable companies from a representative peer group selected based on industry and market capitalization. The risk-free interest rate is based on a U.S. Treasury instrument whose term is consistent with the expected life of the stock options. In addition to the assumptions above, management makes an estimate of expected forfeitures and is recognizing compensation costs only for those equity awards expected to vest.

For restricted stock and restricted stock units, the quoted market price of our common stock at the time of grant is used to estimate fair value.

The Company recognizes the compensation cost of share-based awards on a graded-vesting basis over the requisite service period of each award, which is generally the vesting period.

Table of Contents

STARENT NETWORKS, CORP.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

The Company s results for the periods below included share-based compensation expense classified in the following expense categories of the condensed consolidated statements of operations (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Share-based compensation included in:				
Cost of revenues	$ 596	$ 376	$ 1,488	$ 1,070
Total share-based compensation included in cost of revenues	596	376	1,488	1,070
Research and development	2,379	1,594	5,766	4,701
Sales and marketing	1,927	1,457	4,923	3,750
General and administrative	1,404	1,115	3,764	2,909
Total share-based compensation included in operating expenses	5,710	4,166	14,453	11,360
Total share-based compensation	$ 6,306	$ 4,542	$ 15,941	$ 12,430

3. Net Income per Common Share

The following table presents the calculation of basic and diluted net income per common share (in thousands, except per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Net income	$ 15,122	$ 19,588	$ 43,076	$ 43,017
Weighted-average common shares outstanding - basic	71,418	69,683	70,720	69,328
Dilutive effect of stock options and unvested restricted stock	4,938	4,509	5,032	5,015
Weighted-average common shares outstanding - diluted	76,356	74,192	75,752	74,343
Net income per common share:				
Basic	$ 0.21	$ 0.28	$ 0.61	$ 0.62
Diluted	$ 0.20	$ 0.26	$ 0.57	$ 0.58

Basic net income per common share is computed by dividing net income by the weighted-average number of common shares outstanding during the period, excluding the dilutive effects of common stock equivalents. Common stock equivalents include stock options and restricted stock. Diluted net income per common share includes the dilutive effect of stock options and unvested restricted stock under the treasury stock method.

The following outstanding options and unvested restricted common stock subject to repurchase were excluded from the computation of diluted net income per common share for the periods presented as their effect would have been antidilutive (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Options to purchase common stock and unvested restricted common stock subject to repurchase	525	3,361	996	2,544

4. Fair Value Measurements

On January 1, 2009, the Company adopted a newly issued accounting standard for fair value measurements of all nonfinancial assets and nonfinancial liabilities not recognized or disclosed at fair value in the financial statements on a recurring basis. The accounting standard for those assets and liabilities did not have a material impact on its financial position, results of operations or liquidity. The Company did not have any significant nonfinancial assets or nonfinancial liabilities that would be recognized or disclosed at fair value on a recurring basis as of September 30, 2009.

Table of Contents

STARENT NETWORKS, CORP.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

The accounting standard for fair value measurements provides a framework for measuring fair value and requires expanded disclosures regarding fair value measurements. Fair value is defined as the price that would be received for an asset or the exit price that would be paid to transfer a liability in the principal or most advantageous market in an orderly transaction between market participants on the measurement date. The accounting standard established a fair value hierarchy which requires an entity to maximize the use of observable inputs, where available. The following summarizes the three levels of inputs required as well as the assets and liabilities that we value using those levels of inputs.

The three levels of inputs that may be used to measure fair value are described below:

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

Level 2 Observable inputs other than Level 1 prices, 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.

The following table summarizes the Company s assets that were measured at fair value on a recurring basis (in thousands):

	Fair Value Measurements at September 30, 2009			
	Level 1	Level 2	Level 3	Total
	(in thousands)			
Cash equivalents:				
Money market funds [1]	$ 349,704	$	$	$ 349,704

	Fair Value Measurements at December 31, 2008			
	Level 1	Level 2	Level 3	Total
	(in thousands)			
Cash equivalents:				
Money market funds [1]	$ 348,204	$	$	$ 348,204

(1) Included in Cash and cash equivalents in the accompanying Condensed Consolidated Balance Sheets.

The carrying amounts reflected in the condensed consolidated balance sheets for accounts receivable, other current assets, accounts payable and accrued expenses and other current liabilities approximate fair values due to their short-term maturities.

5. Inventories

Inventories principally include the cost of raw materials and subassemblies, the cost of third-party contract manufacturers and cost of sales deferred until such time as related revenue is recognized. Deferred costs of sales are included as a component of finished goods. Inventories consisted of the following (in thousands):

	September 30, 2009	December 31, 2008
Raw materials	$ 2,218	$ 2,656
Work in process	7,725	7,545
Finished goods	46,533	38,533
	$ 56,476	$ 48,734

Table of Contents

STARENT NETWORKS, CORP.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

6. Purchased Technologies

The Company may purchase software licenses for use in its products. The cost of purchased software to be sold, leased or otherwise marketed that has no alternative future use are accounted in the same manner as if the costs were incurred to develop the software internally. Purchased software is required to be capitalized if technological feasibility has been established and all research and development activities for the other components of the product have been completed. The Company has established technological feasibility by the current use of the software licenses in its products, for which all research and development activities for the other components of the product have been completed. Purchased software licenses are classified as other non-current assets in the condensed consolidated balance sheets.

The following table summarizes the Company s purchased software licenses and related amortization (in thousands):

	September 30, 2009	December 31, 2008
Software licenses	$ 2,100	$ 100
Accumulated amortization	(181)	(56)
Software licenses, net	$ 1,919	$ 44

Amortization expense is recorded to product cost of sales on a straight-line basis, which approximates the pattern of economic benefit of the software licenses over the economic life of the software licenses, which is generally 3 to 5 years. For the three and nine months ended September 30, 2009, amortization expense was $0.1 million for each of the respective periods. For the three and nine months ended September 30, 2008, amortization expense was approximately $8,000 and $25,000, respectively.

7. Income Taxes

The Company s effective income tax rate was 39.3% and 38.9% for the three and nine months ended September 30, 2009, respectively. The Company s effective income tax rate was (33.6)% and (7.8)% for the three and nine months ended September 30, 2008, respectively. The effective income tax rate was based upon the estimated income for the year, the estimated composition of the income in different jurisdictions and adjustments, if any, in the applicable quarterly periods for potential tax consequences, benefits, resolution of tax audits or other tax contingencies. For the three and nine months ended September 30, 2009, the effective income tax rate varied from the U.S. federal statutory tax rate of 35% primarily due to the effects of nondeductible share-based compensation and state income taxes, both partially offset by federal and state research and development tax credits. The tax rate in the first nine months of 2009 was nearer the statutory tax rate than in the same period of 2008, due to the Company reversing the valuation allowance recorded against its deferred tax assets in the third quarter of 2008. The Company s income tax provision for the three and nine months ended September 30, 2008 included (i) a tax benefit of $6.6 million recorded upon the Company s decision to release a substantial portion of the valuation allowance recorded against net deferred tax assets and (ii) a provision of $0.2 million to reserve an uncertain tax position in a foreign jurisdiction. Excluding the effect of this one-time tax benefit and tax reserve, the Company s remaining income tax provisions for the three and nine months ended September 30, 2008 were primarily attributable to federal and state income taxes in the U.S. and taxes related to foreign jurisdictions. The federal and state tax provisions for those periods included amounts in relation to the Company s income generated in the U.S., partially reduced by the utilization of available net operating loss carryforwards and tax credits that were recorded on its balance sheet with a full valuation allowance prior to their utilization.

8. Litigation

On October 15, 2009, the Company and UTStarcom, Inc. agreed to settle all legal disputes between the two companies. Under the settlement, Starent made a one-time payment to UTStarcom in the amount of $3.5 million and received a perpetual royalty-free license to UTStarcom patents. Included in the settlement was the dismissal of two previously pending actions in the United States District Courts for the Northern District of Illinois (filed on May 8, 2007) and the Northern District of California (filed on February 16, 2005). During the three months ended September 30, 2009, the Company recognized the $3.5 million settlement payment as a general and administrative expense.

On October 14, 2009, The Company, its directors and Cisco were named as defendants in a putative class action complaint, captioned *Whitmeyer v. Starent Networks Corp., et al.,* C.A. No. 09-4378-BLS, filed in the Superior Court, Business Litigation Session, of Suffolk County of the Commonwealth of Massachusetts. That action, purportedly brought on behalf of a class of stockholders, alleges that the Company s directors breached their fiduciary duties in connection with the proposed merger by, among other things, failing to maximize stockholder value, fully inform themselves of the Company s market value, obtain the best financial and other terms, and act in the best interests of public stockholders, and seeking to benefit themselves improperly. The suit further alleges that the Company and Cisco aided and abetted the directors purported breaches. Plaintiff seeks declaratory, injunctive and other equitable relief, including to enjoin the Company and Cisco from consummating the merger, in addition to fees and costs. On October 28, 2009, the defendants filed an answer to the complaint.

On October 20, 2009, the Company, our directors and Cisco were named as defendants in a second putative class action complaint, captioned *Laborers Local 235 Benefit Funds v. Starent Networks Corp,. et al.,* C.A. No. 5002, filed in the Court of Chancery of the State of Delaware. On November 3, 2009, the Plaintiff filed a Verified Amended Complaint. In the amended complaint, the Plaintiff purports to represent a class of stockholders and seeks equitable relief, including to enjoin the Company and Cisco from consummating the merger, in addition to fees and costs. Plaintiff alleges in the amended complaint that our directors breached their fiduciary duties by, among other things, agreeing to a proposed merger in which the consideration is unfair and inadequate, failing to take steps to maximize stockholder value, and putting their own interests above those of stockholders, and that the preliminary proxy statement the Company filed with the SEC on October 30, 2009 included materially misleading information concerning the merger. The amended complaint further alleges that Cisco aided and abetted the directors purported breaches. Also on November 3, 2009, the Plaintiff filed a Motion for Preliminary Injunction seeking to enjoin the merger, and a Motion for Expedited Proceedings. The defendants have yet to file a response to these motions.

The Company believes that the claims asserted in both these suits are without merit.

In addition, the Company is subject to other legal proceedings, claims and litigation arising in the ordinary course of business. Defending lawsuits requires significant management attention and financial resources and the outcome of any litigation is inherently uncertain. The Company does not, however, currently expect that the ultimate costs to resolve pending matters will have a material adverse effect on its consolidated financial position, results of operations or cash flows.

Table of Contents

STARENT NETWORKS, CORP.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

9. Business Segments

The Company views its operations and manages its business as one operating segment. Revenue by geography is based on the billing address of the customer. The following tables set forth revenue and long-lived assets by geographic area (in thousands):

Revenues

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
United States and Canada	$ 59,541	$ 54,977	$ 195,819	$ 164,619
Japan	20,670	6,788	31,208	11,927
Korea	842	3,427	2,558	5,501
Rest of world	4,917	869	7,906	1,410
Total	$ 85,970	$ 66,061	$ 237,491	$ 183,457

Long-lived Assets

	September 30, 2009	December 31, 2008
United States	$ 29,987	$ 21,059
India	7,983	7,857
Rest of world	571	716
Total	$ 38,541	$ 29,632

10. Recent Accounting Standards

In January 2009, the Company adopted the accounting standard for fair value measurement for all non-financial assets and non-financial liabilities that are recognized or disclosed at fair value in the financial statements on a non-recurring basis. The adoption of this standard did not have a material impact on the Company s consolidated financial statements.

In January 2009, the Company adopted the accounting standard for determining whether instruments granted in share-based payment transactions are participating securities. This standard provides that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of earnings per share pursuant to the two-class method. Upon adoption, a company is required to retrospectively adjust its earnings per share data (including any amounts related to interim periods, summaries of earnings and selected financial data) to conform to these provisions. The adoption of this standard did not have a material impact on the Company s consolidated financial statements.

In January 2009, the accounting standard relating to business combinations became effective for the Company. This standard significantly changes the accounting for business combinations in a number of areas including the treatment of contingent consideration, contingencies, acquisition costs, in process research and development and restructuring costs. In addition, under this statement, changes in deferred tax asset valuation allowances and acquired income tax uncertainties in a business combination after the measurement period will impact income tax expense. This standard may have a material impact on the Company s consolidated financial statements if or when it enters into a business combination.

In January 2009, the accounting standard for noncontrolling interests in consolidated financial statements became effective for the Company. This standard changes the accounting and reporting for minority interests, which will be recharacterized as noncontrolling interests and classified as a component of equity. This new consolidation method significantly changes the accounting for transactions with minority interest holders. The adoption of this standard did not have an impact on the Company s consolidated financial statements.

Table of Contents

STARENT NETWORKS, CORP.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

In June 2009, the Company adopted the accounting standard that amends the requirements for disclosures about fair value of financial instruments for annual, as well as in interim financial statements. This standard requires those disclosures in all interim financial statements. The adoption of this standard did not have a material impact on the Company s consolidated financial statements.

In June 2009, the accounting standard for determining whether a market is not active and a transaction is not distressed, became effective for the Company. This standard provides additional authoritative guidance in determining whether a market is active or inactive and whether a transaction is distressed, is applicable to all assets and liabilities (i.e., financial and nonfinancial) and will require enhanced disclosures. This standard did not have an impact on the Company s consolidated financial statements.

In June 2009, the accounting standard for recognition and presentation of other-than-temporary impairments, became effective for the Company. This standard amends the other-than-temporary impairment guidance for debt and equity securities. The adoption of this standard did not have an impact on the Company s consolidated financial statements.

In June 2009, the Company adopted the accounting standard regarding the general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. The disclosures required by this standard are reflected in Note 1 of the Company s consolidated financial statements.

In June 2009, the FASB issued a new standard pertaining to the consolidation of variable interest entities that requires an analysis to determine whether a variable interest gives the entity a controlling financial interest in a variable interest entity. This standard also requires an ongoing reassessment of the primary beneficiary of the variable interest entity and eliminates the quantitative approach previously required for determining whether an entity is the primary beneficiary. This standard is effective for fiscal years beginning after November 15, 2009. The company is currently evaluating the impact of adopting the provisions of this standard.

In August 2009, the company adopted the accounting standard pertaining to measuring liabilities at fair value. This standard provides clarification that in circumstances in which a quoted price in an active market for the identical liability is not available, a reporting entity is required to measure fair value using one or more of the following methods: 1) a valuation technique that uses a) the quoted price of the identical liability when traded as an asset or b) quoted prices for similar liabilities or similar liabilities when traded as assets and/or 2) a valuation technique that is consistent with the fair value measurements accounting standard. This standard also clarifies that when estimating the fair value of a liability, a reporting entity is not required to adjust to include inputs relating to the existence of transfer restrictions on that liability. The adoption of this standard did not have an impact on the Company s consolidated financial statements.

In September 2009, the FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles became effective for the Company for interim and annual periods. The Codification does not change U.S. GAAP, but combines all authoritative standards, such as those issued by the FASB, the American Institute of Certified Public Accountants and the Emerging Issues Task Force, into a comprehensive, topically organized online database. The Codification is the single source of authoritative U.S. GAAP applicable for all non-governmental entities, except for rules and interpretive releases of the SEC. The codification did not have a material impact on the Company s consolidated financial statements.

In October 2009, the FASB issued an accounting standard for multiple-deliverable revenue arrangements, which amends previously issued guidance to require an entity to use an estimated selling price when vendor specific objective evidence or acceptable third party evidence does not exist for any products or services included in a multiple element arrangement. The arrangement consideration should be allocated among the products and services based upon their relative selling prices, thus eliminating the use of the residual method of allocation. This standard also requires expanded qualitative and quantitative disclosures regarding significant judgments made and changes in applying this guidance. This standard is effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. Early adoption and retrospective application are also permitted. The company is currently evaluating the impact of adopting the provisions of this standard.

In October 2009, the FASB issued an accounting standard for certain revenue arrangements that include software elements. This standard amends previously issued guidance to exclude tangible products containing software components and non-software components that function together to deliver the product s essential functionality. Entities that sell joint hardware and software products that meet this scope exception will be required to follow the guidance for multiple-deliverable revenue arrangements. This standard is effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. Early adoption and retrospective application are also permitted. The company is currently evaluating the impact of adopting the provisions of this standard.

Table of Contents

STARENT NETWORKS, CORP.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

11. Subsequent Event

On October 12, 2009, the Company entered into the Merger Agreement with Cisco and Barcelona. Pursuant to the terms of the Merger Agreement, and subject to the conditions thereof, Barcelona will merge with and into the Company and the Company will become a wholly-owned subsidiary of Cisco (the Merger). If the Merger is completed, the Company s stockholders will be entitled to receive $35.00 in cash for each share of the Company s common stock owned by them as of the date of the Merger. Holders of shares of the Company s common stock that are subject to vesting will only be entitled to receive merger consideration for such shares if and to the extent vesting conditions are met following the Merger. The consummation of the Merger is subject to customary conditions, including adoption of the Merger Agreement by the Company s stockholders and expiration or termination of any waiting period (and any extension thereof) under the Hart-Scott Rodino Antitrust Improvement Act of 1976, as amended. Dates for closing the Merger and for the Company s stockholders meeting have not yet been determined. The Company has made various representations and warranties and agreed to specified covenants in the Merger Agreement, including covenants relating to the conduct of the Company s business between the date of the Merger Agreement and the closing of the Merger, restrictions on solicitation of proposals with respect to alternative transactions, governmental filings and approvals, public disclosures and other matters. The Merger Agreement contains certain termination rights of Cisco and the Company and provides that, upon the termination of the Merger Agreement under specified circumstances, the Company will be required to pay Cisco a termination fee of $63.5 million.

Table of Contents

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
Cautionary Statement

This Quarterly Report on Form 10-Q, including the information incorporated by reference herein, contains, in addition to historical information, forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These forward-looking statements are based on our current expectations, assumptions, estimates and projections regarding our business and industry, and we do not undertake an obligation to update our forward-looking statements to reflect future events or circumstances. We may, in some cases, use words such as project, believe, anticipate, plan, expect, estimate, intend, continue, should, would, could, potentially, will, may or similar words and expressions that convey uncertainty of future events or outcomes to identify these forward-looking statements. Forward-looking statements in this Quarterly Report on Form 10-Q may include statements about:

- *our ability to attract and retain customers;*
- *our financial performance;*
- *our development activities;*
- *the advantages of our technology as compared to that of others;*
- *our ability to establish and maintain intellectual property rights;*
- *our ability to retain and hire necessary employees and appropriately staff our operations;*
- *our ability to manage growth, both in the United States and internationally;*
- *the spending of our proceeds from public offerings of our common stock;*
- *our cash needs; and*
- *our proposed merger with Cisco Systems, Inc.*

The outcome of the events described in these forward-looking statements is subject to known and unknown risks, uncertainties and other factors, including the factors set forth in Part II Item 1A Risk Factors in this Quarterly Report on Form 10-Q, that could cause actual results to differ materially from the results anticipated by these forward-looking statements. You should read these factors and the risks described in other documents that we file from time to time with the Securities and Exchange Commission, or SEC, in conjunction with the unaudited condensed consolidated financial statements and related notes included elsewhere in this Quarterly Report on Form 10-Q and in the audited consolidated financial statements in our Annual Report on Form 10-K for the year ended December 31, 2008.

References to Starent Networks, Corp. , registrant , we , us , our and similar pronouns refer to Starent Networks, Corp. and its consolidated subsidiaries.

Overview

Starent Networks is a leading provider of infrastructure hardware and software products and services that enable mobile operators to deliver multimedia services to their subscribers. We have created hardware and software products that provide core network functions and services, including access from a wide range of radio networks to the mobile operator s packet core network. Our products and services also provide management of subscriber sessions moving between networks and application of billing and other session policies. Our products and services provide high performance and system intelligence by combining significant computing power, memory and traffic handling capabilities with a flexible, high availability operating system and other proprietary software. Our products integrate multiple network functions and services needed for the delivery of advanced multimedia services, such as video, Internet access, voice-over-IP, e-mail, mobile TV, photo sharing and gaming.

Consumers and professionals are increasingly using mobile phones and other multimedia handheld devices to stay connected to each other, to access the Internet, to utilize business applications and for entertainment. At the same time, mobile operators are experiencing declining profits from voice services and increasing competitive pressures. To address these changes, mobile operators are deploying or planning to deploy next-generation wireless networks, such as third generation and fourth generation, or 3G/4G, networks, that are capable of delivering high quality, mobile multimedia services to subscribers. In deploying these new networks, mobile operators are seeking packet core network products and services that can deliver higher performance and functionality than has been available from products repurposed from wireline applications.

We have developed our multimedia core network hardware platforms, the ST16 and the ST40, and our proprietary software specifically to address the needs of packet-based mobile networks. Our products are designed to provide mobile operators with new revenue opportunities while also reducing their costs. Our products possess a high degree of system intelligence that allows a mobile operator to understand the details of each subscriber session, enabling individual subscriber management and network traffic flow control. Our products also offer high performance capabilities, such as high capacity, significant data processing rates and high transaction rates, which increase the efficiency of the network and enhance the mobile subscriber s experience. To increase reliability, our platforms employ hardware redundancy and high-availability software techniques. By integrating several network functions into a single element, we allow mobile operators to simplify their networks. We designed our products to be access independent so they can function across a range of 2.5G, 3G and 4G mobile and wireless radio access networks.

We sell our products and services to mobile operators around the world both directly and indirectly through our relationships with original equipment manufacturers, or OEMs, system integrators and distributors. We were founded in 2000 and our products were first used commercially by a mobile operator in the first quarter of 2003. Since 2003, our products have been deployed by over 100 mobile operators in over 45 countries.

We maintain our corporate headquarters in Tewksbury, Massachusetts, and have sales and development offices in various locations worldwide. We conduct our research and development activities at two locations in India and two locations in the United States. As of September 30, 2009, we had 1,009 employees worldwide. Our revenues for the year ended December 31, 2008, were $254.1 million and for the three and nine months ended September 30, 2009 were $86.0 million and $237.5 million, respectively. Our net income for the year ended December 31, 2008 was $60.5 million and for the three and nine months ended September 30, 2009 was $15.1 million and $43.1 million, respectively.

Recent Developments

Merger Agreement

On October 12, 2009, we entered into a definitive Agreement and Plan of Merger, which we refer to as the Merger Agreement with Cisco Systems, Inc., or Cisco, and Barcelona Acquisition Corp., or Barcelona, a wholly-owned subsidiary of Cisco. Pursuant to the terms of the Merger Agreement, and subject to the conditions thereof, Barcelona will merge with and into us and we will become a wholly-owned subsidiary of Cisco, which we refer to as the Merger. If the Merger is completed, our stockholders will be entitled to receive $35.00 in cash for each share of our common stock owned by them as of the date of the Merger. The consummation of the Merger is subject to customary conditions, including adoption of the Merger Agreement by our stockholders and expiration or termination of any waiting period (and any extension thereof) under the Hart-Scott Rodino Antitrust Improvement Act of 1976, as amended. Dates for closing the Merger and for our stockholders meeting have not yet been determined. We have made various representations and warranties and agreed to specified covenants in the Merger Agreement, including covenants relating to the conduct of our business between the date of the Merger Agreement and the closing of the Merger, restrictions on solicitation of proposals with respect to alternative transactions, governmental filings and approvals, public disclosures and other matters. Holders of shares of our common stock that are subject to vesting will only be entitled to receive merger consideration for such shares if and to the extent vesting conditions are met following the Merger. The Merger Agreement contains certain termination rights of Cisco and us and provides that, upon the termination of the Merger Agreement under specified circumstances, we will be required to pay Cisco a termination fee of $63.5 million.

Table of Contents

Settlement of UTStarcom Litigation

On October 15, 2009, we agreed with UTStarcom, Inc. to settle all legal disputes between us. Under the settlement, we made a one-time payment to UTStarcom in the amount of $3.5 million and receive a perpetual royalty-free license to UTStarcom patents. Included in the settlement was the dismissal of two pending actions in the United States District Courts for the Northern District of Illinois (filed on May 8, 2007) and the Northern District of California (filed on February 16, 2005). During the three months ended September 30, 2009, we recognized the $3.5 million settlement payment as a charge to general and administrative expense.

Statement of Operations Components

Revenues

Our revenues consist of both product revenues and service revenues. We derive product revenues from the sale of our hardware products and the licensing of our software. Service revenues are generated from:

- maintenance and technical support associated with our software;
- hardware repair and maintenance services; and
- implementation, training and professional services.

We recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred, the price is fixed or determinable and collection is probable.

Mobile operators can purchase our products and license our software in various configurations, depending on their requirements for capacity, features and protocols. Typically, a mobile operator will use a small amount of equipment for testing and trial purposes and, once testing is complete, will purchase the necessary products to meet their initial capacity and feature requirements. As their capacity requirements increase, operators may purchase additional hardware or license additional software. The level of our sales is significantly influenced by the extent to which mobile operators make capital investments to enhance and expand their networks to provide multimedia services. Mobile operators capital investments will be influenced by the demand for multimedia services by their customers.

We offer our products and services through our direct sales force to mobile operators and indirectly through relationships with OEMs, system integrators and distributors. The OEMs, system integrators and distributors generally purchase our products after they have received a purchase order from their customers and do not maintain an inventory of our products in anticipation of sales to their customers.

We believe our revenues will vary significantly from period to period as a result of the following:

- *Fluctuations in the timing of customer orders.* Mobile operators require significant lead times to incorporate changes and enhancements into their networks to ensure the various network components are interoperable. These lead times and interoperability testing requirements result in an extended sales cycle and can lead to uneven purchasing patterns. In addition, our reliance on a relatively small number of customers contributes to the variability of our revenues.
- *The timing of revenue recognition in relation to the shipment of products.* Our products contain software which is not incidental to our products. We are often required to defer recognition of revenue for a significant period of time after shipment, as a consequence of certain features of our customer arrangements (such as customer acceptance provisions), as well as the requirement that we establish company-specific evidence of the fair values of our products and services.

The variability of our revenues directly impacts our operating results in any particular period since a significant portion of our operating costs, such as personnel costs, depreciation expense and sales commissions are either fixed in the short term or may not vary proportionately with

recorded revenues.

Cost of Revenues

Cost of revenues consists of costs of products sold and services provided. Cost of products consists primarily of payments to a third party manufacturer for purchased materials and services as well as internal costs, such as salaries and benefits related to personnel, provisions for inventory obsolescence, related overhead and share-based compensation. The use of an outsourced

Table of Contents

manufacturer enables us to conserve working capital, adjust to fluctuations in demand and provide for timely delivery to our customers. Cost of services consists primarily of salaries, benefits and share-based compensation related to professional services and technical support personnel, product repair costs, depreciation and related overhead.

Gross Profit

Our gross profit has been, and will be, affected by many factors, including the demand for our products and services, the average selling price of our products, which in turn depends on the mix of product configurations sold, new product introductions, the region of the world in which our customers are located, the volume and costs of manufacturing our hardware products and the cost associated with implementing our products in our customer networks.

Operating Expenses

Our operating expenses consist primarily of personnel costs, including salaries, commissions, bonuses, share-based compensation and related benefits and taxes; prototype costs related to the design and development of new products and enhancement of existing products; and consulting, travel and depreciation expenses. The expenses are classified into the following categories for reporting purposes: research and development, sales and marketing and general and administrative. The following is a brief description of the key types of expenses in each of these categories:

Research and development expense consists primarily of personnel costs, prototype costs, consulting services and depreciation. Research and development activities, including hardware and software development and quality assurance testing, primarily occur at two locations in the United States and two locations in India.

Sales and marketing expense consists primarily of personnel costs, consulting services, travel and marketing programs such as trade shows. Commissions are a significant component of our sales personnel costs and are recorded as expense when earned, which is not necessarily directly proportionate to the amount of revenues recorded.

General and administrative expense consists primarily of personnel costs related to our executive, finance, legal, human resource and information technology organizations, professional fees, insurance and other related overhead expenses.

Other Income and Expense Items

Interest Income

Interest income primarily consists of interest earned on cash and short-term investments. We have historically invested our cash in money market funds and other short-term, high-grade investments.

Foreign Currency Exchange Gain (Loss)

Foreign currency gain (loss) primarily consists of foreign currency transactions with international customers and our foreign subsidiaries. The functional currency of our foreign operations is the U.S. dollar. Accordingly, all assets and liabilities of these foreign subsidiaries are remeasured into U.S. dollars using the exchange rates in effect at the balance sheet date, with the exception of certain non-monetary items which are remeasured at historical rates. Revenues and expenses of these foreign subsidiaries are remeasured into U.S. dollars at the average rates in effect during the year.

Income Tax (Expense) Benefit

Our income tax expense consists of provisions for income taxes in both the United States and foreign jurisdictions. We provide for income taxes during interim periods based on the estimated effective tax rate for the full fiscal year and record certain discrete items in the period in which they occur, such as incremental tax deductions related to employee stock options as well as changes in tax position uncertainties. Our income tax benefit consisted primarily of a one-time tax benefit due to the release of a substantial portion of the valuation allowance recorded against net deferred tax assets in the United States,

Application of Critical Accounting Policies and Use of Estimates

Our financial statements are prepared in accordance with generally accepted accounting principles, or GAAP, in the United States of America. The preparation of these financial statements and related disclosures require us to make estimates, assumptions and judgments that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. We evaluate our estimates and assumptions on an ongoing basis. Our actual results may differ significantly from these estimates under different assumptions or conditions.

Table of Contents

Our critical accounting policies are those that require application of management s most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain and may change in subsequent periods. Our critical accounting policies are described in the Management s Discussion and Analysis of Financial Condition and Results of Operations section included in our Annual Report on Form 10-K for the year ended December 31, 2008. There have been no significant changes to our critical accounting policies since December 31, 2008.

Results of Operations

Revenues

The following table sets forth our revenues by type and geographic location of our customers.

	Three Months Ended September 30,		Period-to-Period Change		Nine Months Ended September 30,		Period-to-Period Change	
	2009	2008	$	%	2009	2008	$	%
	(dollars in thousands)				(dollars in thousands)			
Revenues:								
Product	$ 73,160	$ 55,450	$ 17,710	32%	$ 202,119	$ 156,497	$ 45,622	29%
Percentage of revenues	*85%*	*84%*			*85%*	*85%*		
Service	12,810	10,611	2,199	21	35,372	26,960	8,412	31
Percentage of revenues	*15%*	*16%*			*15%*	*15%*		
Total revenues	$ 85,970	$ 66,061	$ 19,909	30%	$ 237,491	$ 183,457	$ 54,034	29%
Revenues by Customer Type:								
Direct	$ 59,157	$ 54,070	$ 5,087	9%	$ 194,624	$ 163,391	$ 31,233	19%
Percentage of revenues	*69%*	*82%*			*82%*	*89%*		
Indirect	26,813	11,991	14,822	124	42,867	20,066	22,801	114
Percentage of revenues	*31%*	*18%*			*18%*	*11%*		
Total revenues	$ 85,970	$ 66,061	$ 19,909	30%	$ 237,491	$ 183,457	$ 54,034	29%
Revenues by Geography:								
United States and Canada	$ 59,541	$ 54,977	$ 4,564	8%	$ 195,819	$ 164,619	$ 31,200	19%
Percentage of revenues	*69%*	*83%*			*82%*	*90%*		
Japan	20,670	6,788	13,882	205	31,208	11,927	19,281	162
Percentage of revenues	*24%*	*10%*			*13%*	*7%*		
Korea	842	3,427	(2,585)	(75)	2,558	5,501	(2,943)	(53)
Percentage of revenues	*1%*	*5%*			*1%*	*3%*		
Rest of world	4,917	869	4,048	466	7,906	1,410	6,496	461
Percentage of revenues	*6%*	*1%*			*3%*	*1%*		
Total revenues	$ 85,970	$ 66,061	$ 19,909	30%	$ 237,491	$ 183,457	$ 54,034	29%

Revenues increased $19.9 million, or 30%, during the three months ended September 30, 2009 compared to the same period in 2008, due to an increase in product revenues of $17.7 million and an increase in service revenues of $2.2 million. Product revenues, which include hardware and software, increased primarily due to product shipments in the United States, Canada and Japan for which we received customer acceptances and recognized revenue during the three months ended September 30, 2009 as compared to the same period in 2008. The $2.2 million increase in service revenues for the three months ended September 30, 2009 compared to the same period in 2008 was due to an increase in the amount of our products installed at mobile operators, which is generally the basis of maintenance and service fees. Direct revenues increased $5.1 million, or 9%, primarily due to increased sales to existing customers. Indirect revenues increased $14.8 million, or 124%, primarily due to the initial

recognition of revenue related to a new customer in Japan.

Table of Contents

Revenues increased $54.0 million, or 29%, during the nine months ended September 30, 2009 compared to the same period in 2008, due to an increase in product revenues of $45.6 million and an increase in service revenues of $8.4 million. Product revenues, which include hardware and software, increased primarily due to product shipments in the United States, Canada and Japan for which we received customer acceptances and recognized revenue during the nine months ended September 30, 2009 as compared to the same period in 2008. The $8.4 million increase in service revenues for the nine months ended September 30, 2009 compared to the same period in 2008 was due to an increase in the amount of our products installed at mobile operators. Direct revenues increased $31.2 million, or 19%, primarily due to increased sales to existing customers. Indirect revenues increased $22.8 million, or 114%, as described above.

Cost of Revenues and Gross Profit

The following table sets forth our cost of revenues and gross profit.

	Three Months Ended September 30,		Period-to-Period Change		Nine Months Ended September 30,		Period-to-Period Change	
	2009	2008	$	%	2009	2008	$	%
	(dollars in thousands)							
Cost of revenues:								
Product	$ 10,100	$ 10,151	$ (51)	-1%	$ 29,711	$ 28,697	$ 1,014	4%
Percentage of related revenues	*14%*	*18%*			*15%*	*18%*		
Service	6,405	4,107	2,298	56	16,957	11,823	5,134	43
Percentage of related revenues	*50%*	*39%*			*48%*	*44%*		
Total cost of revenues	$ 16,505	$ 14,258	$ 2,247	16%	$ 46,668	$ 40,520	$ 6,148	15%
Percentage of revenues	*19%*	*22%*			*20%*	*22%*		
Gross profit:								
Product	$ 63,060	$ 45,299	$ 17,761	39%	$ 172,408	$ 127,800	$ 44,608	35%
Product gross margin	*86%*	*82%*			*85%*	*82%*		
Service	6,405	6,504	(99)	(2)	18,415	15,137	3,278	22
Service gross margin	*50%*	*&*						