Starent Networks, Corp.
Form 10-Q
August 09, 2007

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, 2007

Or

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

For the transition period from to

Commission File Number: 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. o Yes x No

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

Large accelerated filer o Accelerated filer o Non-accelerated filer x

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

As of August 6, 2007, there were 64,545,751 shares of the registrant s $0.001 par value per share common stock outstanding.

STARENT NETWORKS, CORP.

QUARTERLY REPORT ON FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2007

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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)

	June 30, 2007	December 31, 2006
Assets		
Current assets		
Cash and cash equivalents	$ 136,400	$ 24,010
Short-term investments	20,765	36,144
Accounts receivable	16,694	13,619
Inventories	16,853	14,578
Prepaid expenses and other current assets	4,119	3,193
Total current assets	194,831	91,544
Property and equipment, net	18,201	10,839
Other assets	1,085	845
Restricted cash	592	1,039
Total assets	$ 214,709	$ 104,267
Liabilities, redeemable convertible preferred stock and stockholders equity (deficit)		
Current liabilities		
Accounts payable	$ 8,053	$ 4,249
Accrued expenses	3,910	2,675
Accrued payroll and related expenses	7,762	7,977
Income taxes payable	552	232
Current portion of deferred revenue	35,113	57,106
Total current liabilities	55,390	72,239
Deferred revenue, net of current portion	5,829	6,562
Refundable exercise price of restricted common stock	1,046	707
Commitments and contingencies (Note 7)		
Redeemable convertible preferred stock		130,270
Stockholders equity (deficit)		
Common stock, $0.001 par value, 250,000,000 and 120,000,000 shares authorized, 63,969,483 and 7,456,672 shares issued and outstanding at June 30, 2007 and December 31, 2006, respectively	64	7
Additional paid-in capital	252,220	
Accumulated other comprehensive loss	(9)	(1)
Accumulated deficit	(99,831)	(105,517)
Total stockholders equity (deficit)	152,444	(105,511)
Total liabilities, redeemable convertible preferred stock and stockholders equity (deficit)	$ 214,709	$ 104,267

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

STARENT NETWORKS, CORP.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited and in thousands, except per share data)

	Three Months Ended June 30, 2007	2006	Six Months Ended June 30, 2007	2006
Revenues:				
Product	$ 25,121	$ 17,744	$ 49,573	$ 29,466
Service	5,733	2,645	8,923	5,357
Total revenues	30,854	20,389	58,496	34,823
Cost of revenues:				
Product	6,316	3,401	10,754	7,294
Service	1,942	363	3,329	704
Total cost of revenues	8,258	3,764	14,083	7,998
Gross profit	22,596	16,625	44,413	26,825
Operating expenses:				
Research and development	7,585	6,064	17,651	9,705
Sales and marketing	8,867	7,584	15,936	12,745
General and administrative	3,398	1,983	6,242	3,499
Total operating expenses	19,850	15,631	39,829	25,949
Income from operations	2,746	994	4,584	876
Interest income	890	495	1,598	912
Foreign currency exchange loss	(91)	(28)	(89)	(23)
Other income (expenses)		(39)		(41)
Income before income tax expense	3,545	1,422	6,093	1,724
Income tax expense	(164)	(92)	(407)	(143)
Net income	$ 3,381	$ 1,330	$ 5,686	$ 1,581
Net income (loss) per share applicable to common stockholders (Note 3):				
Basic	$ 0.03	$ (0.10)	$ 0.04	$ (0.35)
Diluted	$ 0.03	$ (0.10)	$ 0.03	$ (0.35)
Weighted-average shares used in computing net income (loss) per common share (Note 3):				
Basic	23,919	6,821	15,864	6,838
Diluted	30,197	6,821	21,769	6,838

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

STARENT NETWORKS, CORP.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited and in thousands)

	Six Months Ended June 30, 2007	2006
Cash flows from operating activities:		
Net income	$ 5,686	$ 1,581
Adjustments to reconcile net income to net cash provided by(used in) operating activities		
Depreciation expense	2,788	1,305
Share-based compensation	4,754	232
Foreign currency losses	(26)	7
Changes in operating assets and liabilities		
Accounts receivable	(3,066)	(9,746)
Inventories	(2,271)	(569)
Prepaid expenses and other current assets	(878)	(876)
Other assets	(240)	(4)
Accounts payable	3,780	2,030
Accrued expenses	897	2,032
Income taxes payable	327	(215)
Deferred revenue	(22,727)	15,201
Net cash provided by (used in) operating activities	(10,976)	10,978
Cash flows from investing activities:		
Purchases of property and equipment	(10,138)	(3,748)
Purchases of short-term investments	(11,208)	(19,833)
Proceeds from maturities of short-term investments	26,580	17,545
Change in restricted cash	452	33
Net cash provided by (used in) investing activities	5,686	(6,003)
Cash flows from financing activities:		
Proceeds from Initial Public Offering, net of expenses	116,037	
Repayment of long-term debt		(33)
Proceeds from exercise of stock options	1,208	109
Proceeds from issuance of restricted common stock	347	
Net cash provided by financing activities	117,592	76
Effect of exchange rate changes on cash and cash equivalents	88	10
Net increase (decrease) in cash and cash equivalents	112,390	5,061
Cash and cash equivalents, beginning of period	24,010	20,036
Cash and cash equivalents, end of period	$ 136,400	$ 25,097

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

STARENT NETWORKS, CORP.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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.

Basis of Presentation

The accompanying interim condensed consolidated financial statements presented herein have been prepared by Starent, 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 June 30, 2007, results of operations for the three and six month periods ended June 30, 2007 and June 30, 2006 and cash flows for the six month periods ended June 30, 2007 and June 30, 2006 in accordance with accounting principles generally accepted in the United States. 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, 2006 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 Registration Statement on Form S-1 declared effective by the Securities and Exchange Commission, or SEC, (File No. 333-141092) on June 5, 2007.

Significant Estimates and Assumptions

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, and disclosures of contingent assets and liabilities. Management evaluates these estimates and assumptions on an ongoing basis. Significant estimates and assumptions relied upon by management in preparing these financial statements include revenue recognition, allowances for doubtful accounts, net realizable value of inventories, expensing and capitalization of research and development costs for software, the determination of fair value of share-based compensation and the recoverability of the Company s net deferred tax assets and related valuation allowance.

Although the Company regularly assesses these estimates, actual results could differ materially from these estimates. Changes in estimates are recorded in the period in which they become known. The Company bases its estimates on historical experience and various other assumptions that it believes to be reasonable under the circumstances. Actual results could differ from management s estimates if past experience or other assumptions do not turn out to be substantially accurate.

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 and cash equivalents, short-term investments, accounts receivable and inventories. The Company s cash equivalents and its short-term investments are principally maintained with one commercial bank.

The Company had three and four customers for the three and six months ended June 30, 2007, respectively, that each accounted for more than 10% of revenues and in the aggregate accounted for 89% and 90%, of revenues for each of the respective periods. The Company had two and one 10% customers for the three and six months ended June 30, 2006, respectively, that accounted for 84% and 65% of revenues for the respective periods.

At June 30, 2007, the Company had three customers that accounted for 71% of accounts receivable. At December 31, 2006, the Company had three customers who 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. Stock-Based Compensation

In December 2004, the Financial Accounting Standards Board, or FASB, issued Statement of Financial Accounting Standard, or SFAS, 123(Revised), *Share-Based Payment*, which is a revision of SFAS 123, *Accounting for Stock-Based Compensation*. SFAS 123R supersedes Accounting Principles Board, or APB, Opinion 25, *Accounting for Stock Issued to Employees* and SFAS 123 and amends SFAS 95, *Statement of Cash Flows*. Generally, the approach in SFAS 123R is similar to the approach described in SFAS 123. However, SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their grant date fair value. The Company adopted SFAS 123R effective January 1, 2006 utilizing the prospective transition method, which requires the Company to apply the provisions of SFAS 123R only to new awards granted, and to awards modified, repurchased or cancelled on of after January 1, 2006.

The fair value of options granted for the three and six months ended June 30, 2007 and 2006 was estimated at the date of grant using the following assumptions:

	Three Months Ended June 30,				**Six Months Ended June 30,**			
	2007		**2006**		**2007**		**2006**	
Risk-free interest rates	4.76	%	4.99	%	4.61-4.76	%	4.55-4.99	%
Expected dividend yield	0	%	0	%	0	%	0	%
Expected life	6.25 years		6.25 years		6.25 years		6.25 years	
Expected volatility	64	%	68	%	64-68	%	68	%

The expected life was calculated based on the simplified method as permitted by the SEC s Staff Accounting Bulletin 107, *Share-Based Payments*. 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 was based on a treasury instrument whose term is consistent with the expected life of the stock options. In addition to the assumptions above, as required under SFAS 123R, management made an estimate of expected forfeitures and is recognizing compensation costs only for those equity awards expected to vest.

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

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2007	**2006**	**2007**	**2006**
Share based compensation included in:				
Cost of revenue	$ 130	$ 8	$ 198	$ 8
Total share-based compensation in cost of revenue	130	8	198	8
Research and development	1,660	66	2,141	82
Sales and marketing	644	86	993	98
General and administrative	847	44	1,422	44
Total share-based compensation in operating expenses	3,151	196	4,556	224
Total share-based compensation	$ 3,281	$ 204	$ 4,754	$ 232

3. Net Income (Loss) per Share

Basic and diluted net income (loss) per share applicable to common stockholders is presented in conformity with SFAS 128, *Earnings per Share* and the related interpretation in Emerging Issues Task Force 03-06, *Participating Securities and the Two-Class Method under FASB Statement No. 128.* Basic net income (loss) per share applicable to common stockholders is computed by dividing net income (loss) applicable to common stockholders by the weighted-average number of common shares outstanding during the period, excluding the dilutive effects of common stock equivalents. Income applicable to common stockholders includes accretion of redeemable convertible preferred stock and earnings allocated to participating preferred stockholders. Common stock equivalents include stock options, restricted stock and, in certain circumstances, convertible securities such as the convertible preferred stock. Diluted net income (loss) per share assumes the conversion of the convertible preferred stock using the if converted method, if dilutive, and includes the dilutive effect of stock options and restricted stock under the treasury stock method. The following table presents the calculation of basic and diluted net income (loss) per share (in thousands, except per share data):

	Three Months Ended June 30, 2007	**2006**	**Six Months Ended June 30, 2007**	**2006**
Net income	$ 3,381	$ 1,330	$ 5,686	$ 1,581
Accretion on redeemable convertible preferred stock	(1,448)	(1,997)	(3,445)	(3,994)
Income allocated to preferred stockholders	(1,108)		(1,583)	
Net income (loss) applicable to common stockholders	$ 825	$ (667)	$ 658	$ (2,413)
Weighted-average common shares outstanding basic	23,919	6,821	15,864	6,838
Dilutive effect of stock options and restricted stock	6,278		5,905	
Weighted average common shares outstanding dilutive	30,197	6,821	21,769	6,838
Net income (loss) per share:				
Basic	$ 0.03	$ (0.10)	$ 0.04	$ (0.35)
Diluted	$ 0.03	$ (0.10)	$ 0.03	$ (0.35)

The following outstanding options, restricted common stock subject to repurchase and convertible preferred stock were excluded from the computation of diluted net income (loss) per common share for the periods presented because including them would have had an antidilutive effect (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	**2006**	**2007**	**2006**
Options to purchase common stock and common stock subject to repurchase	66	6,173	66	6,255
Convertible preferred stock (as converted basis)	32,121	44,288	38,171	44,288

4. Inventories

Inventories are stated at the lower of cost (first-in, first-out) or market (net realizable value). Inventories principally included the cost of raw materials, subassemblies, the cost of third-party contract manufacturers and cost of sales related to deferred revenue which is included in finished goods. Inventories consisted of the following (in thousands):

	June 30, 2007	**December 31, 2006**
Raw materials	$ 4,387	$ 1,617
Work in process	4,903	2,950
Finished goods	7,563	10,011
	$ 16,853	$ 14,578

5. Redeemable Convertible Preferred Stock and Stockholders Equity

Redeemable Convertible Preferred Stock

The following table summarizes redeemable convertible preferred activity during the six months ended June 30, 2007 (in thousands):

	Series A	Series B	Series C	Series D	Series E	Total
Balance at December 31, 2006	$ 15,307	$ 31,591	$ 30,491	$ 32,750	$ 20,131	$ 130,270
Accretion of dividends on preferred stock	350	759	794	921	621	3,445
Conversion of preferred stock	(15,657)	(32,350)	(31,285)	(33,671)	(20,752)	(133,715)
Balance at June 30, 2007	$	$	$	$	$	$

In June 2007, the Company completed an initial public offering of its common stock in which it sold and issued 10,580,226 shares of its common stock, including 1,580,226 shares pursuant to the underwriters full exercise of their over-allotment option, at a price of $12.00 per share. The offering raised a total of $127.0 million in gross proceeds and $116.0 million in net proceeds after deducting underwriting discounts and commissions of $8.9 million and other offering expenses of approximately $2.1 million. In connection with the offering, all outstanding shares of the Company s redeemable convertible preferred stock automatically converted into an aggregate of 44,287,985 shares of the Company s common stock.

Reverse Stock Split

On April 26, 2007, the board of directors of the Company approved, and on April 30, 2007, the stockholders of the Company approved, a 2-for-3 reverse stock split of the Company s common stock, which was effective on May 1, 2007. All share data shown in the accompanying condensed consolidated financial statements and related notes have been retroactively revised to reflect the reverse stock split.

6. Income Taxes

On January 1, 2007, the Company adopted the provisions of FASB Interpretation, or FIN, No. 48, *Accounting for Uncertainty in Income Taxes,* an interpretation of SFAS 109, *Accounting for Income Taxes*. The new standard defines the threshold for recognizing the benefits of tax return positions in the financial statements as more-likely-than-not to be sustained by the taxing authorities based solely on the technical merits of the position. If the recognition threshold is met, the tax benefit is measured and recognized as the largest amount of tax benefit, in the Company s judgment, which is greater than 50% likely to be realized. The Company did not recognize any change in its reserve for uncertain tax positions as a result of the adoption of this standard. At the adoption date of January 1, 2007, the Company had approximately $134,000 of unrecognized tax benefits the benefit of which, if recognized, would favorably affect the income tax rate in future periods. At June 30, 2007, the Company had a liability of approximately $134,000 related to unrecognized tax benefits.

The Company recognizes interest and penalties related to uncertain tax positions in income tax expense. Upon adoption of FIN 48 and at June 30, 2007, the Company had an immaterial amount of accrued interest and penalties associated with its uncertain tax positions.

The Company has accumulated significant losses from its inception in August 2000. Since the net operating losses may potentially be utilized in future years to reduce taxable income, all of the Company s tax years remain open to examination by the major taxing jurisdictions to which it is subject.

At December 31, 2006, the Company had U.S. federal net operating loss carryforwards of $63.1 million that expire beginning in 2022 and state net operating loss carryforwards of $65.5 million that expire beginning in 2007. The Company also had U.S. federal tax credits of $3.0 million that expire beginning in 2020 and state research and development credits of $652,000 that expire beginning in 2018. The Internal Revenue Code contains provisions that may limit the net operating losses and tax credit carryforwards available to be used in any given year in the event of certain circumstances, including significant changes in ownership interests.

7. Litigation

In February, 2005, UTStarcom filed a complaint against the Company in the United States District Court Northern District of California seeking unspecified damages and injunctive relief. The complaint alleges infringement by the Company of UTStarcom s U.S. Patent No. 6,829,473, entitled Roaming and Hand-Off Support for Prepaid Billing for Wireless Data Networks, which is referred to as the 473 patent. UTStarcom notified the Company that it had served the complaint on May 6, 2005. On May 31, 2005, the Company answered the complaint, denied the infringement allegations contained in the complaint, and filed counterclaims against UTStarcom seeking a declaratory judgment that the Company did not infringe the 473 patent and that the 473 patent was invalid and unenforceable. On July 27, 2005, the Company filed an amended answer and counterclaims to the 473 patent complaint. A claim construction hearing had been scheduled on February 14, 2007, however, on December 7, 2006, UTStarcom filed a reissue patent application on the 473 patent. On January 29, 2007, by agreement of the parties, the Court stayed the case pending the outcome of the reissue application. The Company believes that it has meritorious defenses against any resulting reissued patent, and is prepared to vigorously defend the 473 patent case through trial.

In May 2007, UTStarcom filed an additional complaint against the Company and a number of its employees and former employees with the United States District Court for the Northern District of Illinois alleging violations of the Illinois trades secret act, infringement of five patents assigned to UTStarcom, intentional interference with UTStarcom s business relations and declarations of ownership relating to one of the Company s patents and three patent applications. The complaint contains allegations, among others, that a number of former employees of a business unit UTStarcom acquired, who subsequently worked for the Company, took UTStarcom s trade secrets with them and improperly used those trade secrets to develop, manufacture and market the Company s 3G wireless products, and that such products incorporate UTStarcom confidential technical information, including UTStarcom s proprietary virtual private network and EV-DO features. UTStarcom further alleges that the Company has disclosed UTStarcom s trade secrets in one of its patents and three of its patent applications, and that these patent applications legally belong to UTStarcom based on the inventors previous work at the business unit acquired by UTStarcom. The complaint seeks unspecified monetary damages, injunctive relief, declarations of ownership relating to the specified patent and three patent applications owned by the Company, costs and attorneys fees. On July 25, 2007, in lieu of filing answers to the complaint, the Company and the individual defendants named in the complaint filed a motion to dismiss all state law claims asserted in the complaint. If successful, only the patent infringement allegations against the Company would remain in the case. On July 30, 2007, UTStarcom filed a pleading in response to this motion, and the District Court has taken the issues raised under advisement. The Company believes it has meritorious defenses to each of UTStarcom s claims in this lawsuit and is prepared to vigorously defend the lawsuit.

In addition, the Company is subject to other legal proceedings, claims and litigation arising in the ordinary course of business. While the outcomes of these matters, including the matters described above, are currently not determinable, the Company does not expect that the ultimate costs to resolve these matters will have a material adverse effect on its consolidated financial position, results of operations or cash flows.

8. Business Segments

SFAS 131, *Disclosures About Segments of an Enterprise and Related Information*, establishes standards for reporting information about operating segments in annual financial statements and requires selected information of segments to be presented in financial reports issued to stockholders. Operating segments are defined as components of an enterprise about which separate financial information is available and that is evaluated regularly by the chief operating decision maker, or decision making group, in determining how to allocate resources and assess performance. The Company s chief operating decision maker, as defined under SFAS 131, is the chief executive officer. 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 June 30, 2007	2006	Six Months Ended June 30, 2007	2006
United States and Canada	$ 16,317	$ 16,462	$ 36,936	$ 27,353
Japan	12,828	806	13,524	2,144
Korea	539	162	6,273	324
Rest of world	1,170	2,959	1,763	5,002
Total	$ 30,854	$ 20,389	$ 58,496	$ 34,823

Long-lived Assets

	June 30, 2007	December 31, 2006
United States	$ 14,530	$ 8,396
India	3,482	2,231
Rest of world	189	212
Total	$ 18,201	$ 10,839

9. Comprehensive Income

Comprehensive income consists of the following (in thousands):

	Three Months Ended June 30, 2007	2006	Six Months Ended June 30, 2007	2006
Net income	$ 3,381	$ 1,330	$ 5,686	$ 1,581
Unrealized gain (loss) on short-term investments	(3)	(2)	(8)	5
Comprehensive income	$ 3,378	$ 1,328	$ 5,678	$ 1,586

10. Recent Accounting Pronouncements

In September 2006, the FASB issued SFAS 157, *Fair Value Measurement*, which provides guidance for using fair value to measure assets and liabilities. In addition, SFAS 157 also provides guidance for expanded information about the extent to which companies measure assets and liabilities at fair value, the information used to measure fair value and the effect of fair value measurements on earnings. SFAS 157 applies whenever other standards require (or permit) assets or liabilities to be measured at fair value, but does not expand the use of fair value in any new circumstances. The provisions of SFAS 157 will be effective for the Company beginning January 1, 2008. The Company is in the process of determining the effect, if any, the adoption of SFAS 157 will have on its consolidated financial statements.

In February 2007, the FASB issued SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities, Including an Amendment of FASB Statement No. 115*. SFAS 159 allows entities to measure many financial instruments and certain other assets and liabilities at fair value on an instrument-by-instrument basis (the fair value option). The fair value option represents a step in the evolution of financial reporting because it considerably expands the ability of entities to select the measurement attribute for certain assets and liabilities. The Company will be required to adopt the provisions of SFAS 159 on January 1, 2008. The Company is in the process of determining the effect, if any, the adoption of SFAS 159 will have on its consolidated financial statements.

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;*
- *the spending of our proceeds from our initial public offering; and*
- *our cash needs.*

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 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 such factors and risks in conjunction with the unaudited condensed consolidated financial statements and related notes included elsewhere in this Quarterly Report on Form 10-Q, and in conjunction with the audited consolidated financial statements contained in our Registration Statement on Form S-1 declared effective by the SEC (File No. 333-141092) on June 5, 2007. You should also read such factors and risks described in other documents that we file from time to time with the Securities and Exchange Commission, or SEC.

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 network functions and services, including access from a wide range of radio networks to the 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.

Our products consist of both hardware and software and can be configured to meet a number of customer needs. 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.

In June 2007, we completed an initial public offering of our common stock in which we sold and issued 10,580,226 shares of our common stock, including 1,580,226 shares sold by us pursuant to the underwriters full exercise of their over-allotment option, at a price of $12.00 per share. We raised a total of $127.0 million in gross proceeds from the initial public offering, or $116.0 million in net proceeds after deducting underwriting discounts and commissions of $8.9 million and other offering expenses of approximately $2.1 million. In connection with the offering, all outstanding shares of our convertible preferred stock automatically converted into an aggregate of 44,287,985 shares of our common stock.

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 June 30, 2007, we had 501 employees worldwide. Our revenues for the year ended December 31, 2006 were $94.4 million, and $30.9 million and $58.5 million for the three and six months ended June 30, 2007. Our net income for the year ended December 31, 2006 was $3.6 million, and $3.4 million and $5.7 million for the three and six months ended June 30, 2007.

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 in accordance with Statement of Position, or SOP, 97-2, *Software Revenue Recognition* and SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions*. Accordingly, revenue is recognized 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 purchases a small amount of equipment for testing and trial purposes and, once testing is complete, purchases 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.

In 2004, we entered into OEM agreements with Nortel Networks relating to the CDMA and the GSM/UMTS markets. Sales to Nortel Networks, all of which were made under the CDMA agreement, accounted for more than 40% of our revenues in 2006. In December 2006, we terminated both OEM agreements. Under the terms of the CDMA agreement, Nortel Networks has a right to continue to purchase our CDMA products for delivery through December 2008. Although the termination of the CDMA agreement could disrupt our relationships with CDMA mobile operators formerly serviced by Nortel Networks, we have established and continue seeking to establish additional direct sales relationships with some of the CDMA operators formerly serviced by Nortel Networks. In addition, we are currently in discussions to establish a new reseller relationship with Nortel Networks. As a result, we do not believe that the termination of the Nortel Networks OEM agreements will significantly impact our revenues.

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. Therefore, we recognize revenue pursuant to the requirements of SOP 97-2. Due to these requirements, certain features of our customer arrangements, such as customer acceptance terms in many of our customer contracts and the need for us to establish fair values of our products and services based on facts specific to our operations, we often defer recognition of revenue for a significant period of time after shipment.

The variability of our revenues directly impacts our operating performance in any particular period since a significant portion of our operating costs, such as prototypes and related equipment 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 and internal costs, such as salaries and benefits related to personnel, provision for inventory obsolescence and related overhead. The use of an outsourced 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 and benefits 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 and the volume and costs of manufacturing our hardware products.

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. 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, 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 since commissions are generally earned at the time we accept customer orders and revenue is recorded once all revenue recognition criteria have been met.

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

Other Income (Expense)

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

Other income (expense) also includes gains (losses) from foreign currency transactions of our foreign subsidiaries. The functional currency of our foreign operations is the U.S. dollar. Accordingly, all assets and liabilities, except certain long-term assets, of these international subsidiaries are remeasured into U.S. dollars using the exchange rates in effect at the balance sheet date. Revenues and expenses of these international subsidiaries are generally remeasured into U.S. dollars at the average rates in effect during the year.

Application of Critical Accounting Policies and Use of Estimates

Our financial statements are prepared in accordance with accounting principles generally accepted 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.

We believe that of our significant accounting policies, which are described in note 3 to the consolidated financial statements included in our Registration Statement on Form S-1 declared effective by the Securities and Exchange Commission, or SEC, (File No. 333-141092) on June 5, 2007, the following accounting policies involve a greater degree of judgment and complexity. Accordingly, we believe these are the most critical to fully understand and evaluate our financial condition and results of operations.

Revenue Recognition

Generally, our revenues are generated through fulfillment of contractual arrangements that contain multiple elements, including equipment with embedded software and services, such as installation, training, consulting and maintenance and support, or M&S. We recognize revenue in accordance with SOP 97-2 and SOP 98-9. Accordingly, revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred, the price is fixed or determinable and collection is probable. Certain of these requirements, most notably the customer acceptance terms generally included in our contracts and our need to establish fair values of our products and services based on facts specific to our operations, are critical to the timing and extent of our revenue recognition. As a result of these factors, a significant majority of our contractual arrangements result in the deferral of revenue and the time period for deferral may be significant. In addition, in certain circumstances, pricing considerations must be assessed to determine whether the price is fixed or determinable.

Product revenues consist of revenues from sales of our hardware and licensing of our software. Product sales generally include a perpetual license to our software. Product revenues are generally recognized at shipment or upon customer acceptance, assuming all other revenue recognition criteria are met. Substantially all of our products have been sold in conjunction with product support services, which consist of software updates and product support. Software updates provide customers with rights to unspecified software product upgrades and to maintenance releases and patches released during the term of the support period. Revenues for support services are recognized on a straight-line basis over the service contract term, which is generally 12 to 15 months.

Pursuant to SOP 97-2, revenue is allocated to deliverables based on vendor specific objective evidence of fair value, or VSOE, when VSOE exists. Generally, all revenues for an arrangement are deferred when VSOE does not exist for any undelivered element. However, revenue is recognized ratably over the contractual M&S period when M&S is the only undelivered element. If VSOE exists for the undelivered elements, but not the delivered elements, revenue is recognized under the residual method set forth in SOP 98-9, which provides that revenue is recognized based on the difference between the total arrangement fee and the VSOE of the undelivered elements. Revenue for the undelivered elements is then recorded as those elements are delivered. When we defer revenue in an arrangement, the related product costs are also deferred, subject to their realizability, and recognized over the same period as the related revenue.

The determination of VSOE is highly judgmental and is a key factor in determining whether revenue may be recognized or must be deferred and the extent to which it may be recognized once the various elements of an arrangement are delivered. We assess VSOE based on previous sales of products and services, the type and size of customer, renewal rates in contracts and the geographic location of the customer. We monitor VSOE on an ongoing basis. As noted above, most of our arrangements include multiple elements, some of which are delivered in or over future periods. Therefore a change in our assessment of, or our inability to establish, VSOE for products or services may result in significant variation in our revenues and operating results.

In arrangements where cash consideration is paid to a customer, the payments are recorded in accordance with Emerging Issues Task Force, or EITF, 01-9, *Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor s Products)*, which generally requires the consideration be recorded as a reduction of revenues.

Share-Based Compensation

Prior to January 1, 2006, we accounted for our stock-based awards to employees using the intrinsic value method prescribed in Accounting Principles Board, or APB, Opinion 25, *Accounting for Stock Issued to Employees*, and related interpretations. Under the intrinsic value method, compensation expense is measured on the date of the grant as the difference between the deemed fair value of our common stock and the exercise or purchase price multiplied by the number of stock options or restricted stock awards granted. In addition, through December 31, 2005, we accounted for share-based compensation expense for non-employees using the fair value method prescribed by SFAS 123, applying the Black-Scholes option-pricing model, and recorded the fair value, for financial reporting purposes, of non-employee stock options as an expense over either the vesting term of the option or the service period.

In December 2004, the Financial Accounting Standards Board, or FASB, issued SFAS 123R, *Share-Based Payment*, which requires companies to expense the fair value of employee stock options and other forms of share-based compensation. We adopted SFAS 123R effective January 1, 2006. SFAS 123R requires nonpublic companies that used the minimum value method in SFAS 123 for either recognition or pro forma disclosures to apply SFAS 123R using the prospective-transition method. As such, we will continue to apply APB Opinion 25 in future periods to equity awards outstanding prior to the date of our adoption of SFAS 123R. In accordance with SFAS 123R, we will recognize the compensation cost of stock-based awards on a graded-vesting basis over the vesting period of the award. Effective with the adoption of SFAS 123R, we elected to use the Black-Scholes option pricing model to determine the weighted average fair value of stock options granted or modified.

For the three and six months ended June 30, 2007, we recorded expense of $3.3 million and $4.8 million, respectively, in connection with stock-based awards. As of June 30, 2007, we had $14.8 million of unrecognized expense related to non-vested options that is expected to be recognized over a weighted average period of 1.2 years.

Inventory

We carry our inventory at the lower of historical cost or net realizable value assuming inventory items are consumed on a first-in, first-out basis. We recognize inventory losses based on obsolescence and levels in excess of forecasted demand. In these cases, inventory is written down to estimated realizable value based on historical usage and expected demand. Inherent in our estimates of market value in determining inventory valuation are estimates related to economic trends, future demand for our products and technical obsolescence of our products. If future demand or market conditions are less favorable than our projections, additional inventory write-downs could be required and would be reflected in the cost of revenues in the period the revision is made. To date, we have not been required to revise any of our assumptions or estimates used to determine our inventory valuations.

When products have been delivered, but the product revenues associated with the arrangement have been deferred as a result of not meeting the revenue recognition criteria required by SOP 97-2, we defer the related inventory costs for the delivered items.

Income Taxes

We are subject to income taxes in both the United States and foreign jurisdictions and we use estimates in determining our provisions for income taxes. We account for income taxes in accordance with SFAS 109, *Accounting for Income Taxes*, which is the asset and liability method for accounting and reporting for income taxes. Under SFAS 109, deferred tax assets and liabilities are recognized based on temporary differences between the financial reporting and income tax bases of assets and liabilities using statutory rates.

As of December 31, 2006, we had U.S. federal net operating loss carryforwards for income tax purposes of $63.1 million that expire beginning in 2022 and state net operating loss carryforwards of $65.5 million that expire beginning in 2007. We also had U.S. federal tax credits of $3.0 million that expire beginning in 2020 and state research and development credits of $652,000 that expire beginning in 2018. The Internal Revenue Code contains provisions that limit the net operating losses and tax credit carryforwards available to be used in any given year in the event of certain circumstances, including significant changes in ownership interests, as defined.

Our income tax expense consists primarily of provisions associated with various state and foreign jurisdictions as well as federal alternative minimum tax. Income tax expense related to our international subsidiaries generally results from taxable income generated by the subsidiary pursuant to intercompany service agreements. We believe the compensation associated with these service agreements is reasonable in light of the level and nature of services performed by our subsidiaries. However, if a foreign tax jurisdiction or the Internal Revenue Service were to challenge these arrangements, we could be subject to additional income tax expense either in the United States or the foreign jurisdiction.

Due to the uncertainty surrounding the realization of our deferred tax assets, based principally on operating losses, we have provided a full valuation allowance against our various tax attributes. We will assess the level of valuation allowance required in future periods. Should more positive than negative evidence regarding the realizability of tax attributes exist at a future point in time, the valuation allowance may be reduced or eliminated altogether. Reduction of the valuation allowance, in whole or in part, would result in a non-cash reduction in income tax expense during the period of reduction.

On January 1, 2007, we adopted the provisions of FASB Interpretation, or FIN, No. 48, *Accounting for Uncertainty in Income Taxes*, an interpretation of SFAS 109. The new standard defines the threshold for recognizing the benefits of tax return positions in the financial statements as more-likely-than-not to be sustained by the taxing authorities based solely on the technical merits of the position. If the recognition threshold is met, the tax benefit is measured and recognized as the largest amount of tax benefit, in our judgment, which is greater than 50% likely to be realized. We did not recognize any change in our reserves for uncertain tax positions as a result of the adoption of this standard. At the adoption date of January 1, 2007, we had approximately $134,000 of unrecognized tax benefits the benefit of which, if recognized, would favorably affect the income tax rate in future periods. At June 30, 2007, we had a liability of approximately $134,000 related to unrecognized tax benefits.

We recognize interest and penalties related to uncertain tax positions in income tax expense. Upon our adoption of FIN 48 and at June 30, 2007, we had an immaterial amount of accrued interest and penalties associated with our uncertain tax positions.

We have accumulated significant losses from our inception in August 2000. Since the net operating losses may potentially be utilized in future years to reduce taxable income, all of our tax years remain open to examination by the major taxing jurisdictions to which we are subject.

Research and Development Expense

Research and development expense includes costs incurred to develop intellectual property. Research and development costs are charged to operations as incurred. The costs to develop new software and substantial enhancements to existing software are expensed as incurred until technological feasibility has been established, at which time any additional costs would be capitalized. We have determined technological feasibility is established at the time a working model of software is completed. The time period during which costs could be capitalized, from the point of reaching technological feasibility until the time of general product release, is short. Consequently, the amounts that could be capitalized are not material to our financial position or results of operations and therefore have been charged to expense as incurred.

Results of Operations

Revenues

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

	Three Months Ended June 30,					
	2007		**2006**		**Period-to-Period Change**	
	Amount	**% of Revenues**	**Amount**	**% of Revenues**	**Amount**	**Percentage**
	(dollars in thousands)					
Revenues:						
Product	$ 25,121	81 %	$ 17,744	87 %	$ 7,377	42 %
Service	5,733	19	2,645	13	3,088	117
Total revenues	$ 30,854	100 %	$ 20,389	100 %	$ 10,465	51 %
Revenues by Type:						
Direct	$ 11,111	36 %	$ 18,286	90 %	$ (7,175)	(39)%
Indirect	19,743	64	2,103	10	17,640	839
Total revenues	$ 30,854	100 %	$ 20,389	100 %	$ 10,465	51 %
Revenues by Geography:						
United States and Canada	$ 16,317	53 %	$ 16,462	81 %	$ (145)	(1)%
Japan	12,828	41	806	4	12,022	1,492
Korea	539	2	162	1	377	233
Rest of world	1,170	4	2,959	14	(1,789)	(60)
Total revenues	$ 30,854	100 %	$ 20,389	100 %	$ 10,465	51 %

Revenues increased $10.5 million, or 51%, in the quarter ended June 30, 2007 as compared to the same quarter in 2006, primarily due to increased product sales to existing customers. Product revenues, which include hardware and software sales, increased $7.4 million in the second quarter of 2007 as compared to the same quarter of 2006 due primarily to increased sales in Japan. The increase in revenues from Japan was due primarily to the recognition of revenue deferred in prior periods since we delivered previously committed software functionality during the quarter ended June 30, 2007.

The $3.1 million increase in service revenues in the second quarter of 2007 was due to an increased amount of our products installed at mobile operators which is generally the basis of maintenance and services fees as compared to the same period in 2006.

	Six Months Ended June 30,					
	2007		2006		Period-to-Period Change	
	Amount	% of Revenues	Amount	% of Revenues	Amount	Percentage
	(dollars in thousands)					
Revenues:						
Product	$ 49,573	85 %	$ 29,466	85 %	$ 20,107	68 %
Service	8,923	15	5,357	15	3,566	67
Total revenues	$ 58,496	100 %	$ 34,823	100 %	$ 23,673	68 %
Revenues by Customer Type:						
Direct	$ 29,094	50 %	$ 29,886	86 %	$ (792)	(3)%
Indirect	29,402	50	4,937	14	24,465	496
Total revenues	$ 58,496	100 %	$ 34,823	100 %	$ 23,673	68 %
Revenues by Geography:						
United States and Canada	$ 36,936	63 %	$ 27,353	79 %	$ 9,583	35 %
Japan	13,524	23	2,144	6	11,380	531
Korea	6,273	11	324	1	5,949	1,836
Rest of world	1,763	3	5,002	14	(3,239)	(65)
Total revenues	$ 58,496	100 %	$ 34,823	100 %	$ 23,673	68 %

Revenues increased $23.7 million, or 68%, in the six months ended June 30, 2007 as compared to the same period in 2006, primarily due to increased product sales to existing customers. Product revenues, which include hardware and software sales, increased $20.1 million in the first half of 2007 as compared to the same period in 2006 due primarily to increased sales to major mobile operators in the United States and Canada and the increase related to Japan discussed above. The increase in revenues from Korea was due primarily to the recognition of approximately $5.5 million that was deferred at December 31, 2006 due to the delivery of specific software functionality during the first quarter of 2007.

Cost of Revenues and Gross Profit

	Three Months Ended June 30,					
	2007		2006		Period-to-Period Change	
	Amount	% of Related Revenues	Amount	% of Related Revenues	Amount	Percentage
	(dollars in thousands)					
Cost of revenues:						
Product	$ 6,316	25 %	$ 3,401	19 %	$ 2,915	86 %
Services	1,942	34	363	14	1,579	435
Total cost of revenues	$ 8,258	27 %	$ 3,764	18 %	$ 4,494	119 %
Gross Profit:						
Product	$ 18,805	75 %	$ 14,343	81 %	$ 4,462	31 %
Services	3,791	66	2,282	86	1,509	66
Total gross profit	$ 22,596	73 %	$ 16,625	82 %	$ 5,971	36 %

Product gross margin decreased six percentage points in the second quarter of 2007 as compared to the same period in 2006 due primarily to the impact of equipment provided to our customers for testing purposes and the second quarter of 2006 included a higher proportion of software license revenue. We anticipate our gross product margin to be somewhat lower during the remainder of 2007 due primarily to our anticipated mix of product shipments.

During the second quarter of 2007, the $1.6 million increase in cost of services was primarily due to higher personnel costs, depreciation expense and overhead costs associated with additional customer support and training personnel that were added during late 2006 and in 2007. We anticipate cost of services will increase in future periods as we continue to expand our customer support testing facilities during the remainder of 2007.

	Six Months Ended June 30,					
	2007		2006		Period-to-Period Change	
	Amount	% of Related Revenues	Amount	% of Related Revenues	Amount	Percentage
	(dollars in thousands)					
Cost of revenues:						