QUALSTAR CORP
Form 10-K
September 21, 2012

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

þ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED JUNE 30, 2012

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 000-30083

QUALSTAR CORPORATION

CALIFORNIA	95-3927330
(STATE OF INCORPORATION)	(I.R.S. ID NO.)

3990-B HERITAGE OAK COURT, SIMI VALLEY, CA 93063
(805) 583-7744

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class:	Name of Each Exchange on Which Registered:
Common Stock	The NASDAQ Stock Market LLC

Securities registered pursuant to Section 12(g) of the Act:
None

Indicate by check mark whether the registrant is well-known seasoned issuer, as defined in Rule 405 of the Securities Act of 1933. Yes o No þ

Indicate by check mark whether the registrant is not required to file reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934. Yes o No þ

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports); and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

Indicate by check mark whether the registrant has submitted electronically and posted on its website, 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 þ No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained

herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

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

Large accelerated filer o Accelerated filer o Non-accelerated filer q smaller reporting company þ

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

As of December 31, 2011 (the last business day of the registrant's most recently completed second fiscal quarter), the aggregate market value of the common equity held by non-affiliates of the registrant was approximately $9,440,000 based on the closing sales price as reported on the NASDAQ Stock Market. As of September 14, 2012, there were 12,253,117 shares of common stock without par value outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of registrant's definitive proxy statement for its annual meeting of shareholders to be held in 2013 are incorporated by reference into Part III of this Form 10-K.

QUALSTAR CORPORATION

FORM 10-K

FOR THE FISCAL YEAR ENDED JUNE 30, 2012

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FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K contains 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. Forward-looking statements inherently are subject to risks and uncertainties, some of which we cannot predict or quantify. Our actual results may differ materially from the results projected in the forward-looking statements. Factors that might cause such a difference include, but are not limited to, those discussed in "ITEM 1A — Risk Factors," and in "ITEM 7 — Management' Discussion and Analysis of Financial Condition and Results of Operations." You generally can identify forward-looking statements by the use of forward-looking terminology such as "believes," "may," "will," "expects," "intend "estimates," "anticipates," "plans," "seeks," or "continues," or the negative thereof or variations thereon or similar terminolo Forward-looking statements also include the assumptions underlying or relating to any such statements. Forward-looking statements contained within this document represent a good-faith assessment of Qualstar's future performance for which management believes there is a reasonable basis. Qualstar disclaims any obligation to update the forward looking statements contained herein, except as may be required by law.

PART I

ITEM 1. BUSINESS

INTRODUCTION

Qualstar is a leading provider of high efficiency and high density power supplies marketed under the N2Power brand, and of data storage systems marketed under the Qualstar brand. Our N2Power power supply products provide compact and efficient power conversion for a wide variety of industries and applications including, but not limited to telecom, networking, broadcast, industrial, lighting, gaming and test equipment. Our Qualstar data storage products are used to provide highly scalable and reliable solutions to store and retrieve very large quantities of electronic data.

In 2002 we acquired N2Power, which we established as a separate division from the Qualstar storage business to better address the distinct market segments that each division serves. (See Note 11 of the Notes to the Consolidated Financial Statements under Part II, item 8 of this Annual Report on Form 10-K.)

The N2Power division provides both high efficiency and high density AC/DC and DC/DC power supplies for a variety of applications; including data center technologies such as switches, routers, data storage, servers and networking communications equipment. We also design and manufacture power solutions for the telecommunications industry employing both conventional AC/DC systems and DC/DC systems. With a wide variety of standard products and the ability to create custom and semi- custom products, we offer a very comprehensive product line to OEMs that require high-value, high-efficiency, power supplies to meet individual needs. The N2 brand is one of the industry leaders in delivering high power density/high efficiency ratios.

The Storage division provides high quality and highly reliable data protection and archive storage systems which are used to record, retrieve and manage electronic data, primarily in networked computing environments. Our storage products integrate with all operating systems including Windows, Linux and UNIX, and are compatible with a wide range of storage management software solutions such as those offered by IBM, EMC, CommVault and Symantec. We offer products spanning the storage needs of the small and medium-size business market to the enterprise market. In addition to storage products the Storage division offers comprehensive worldwide service and support programs that enable customers to keep our products running in environments where the ability to constantly access data is vital.

We design our products at our locations in California and Colorado, and we sell our products globally through authorized resellers and OEMs. Our N2Power division utilizes contract manufacturers in Asia to produce our power supply products, while our Storage division products are manufactured by our own in-house workforce at our factory in California. Our research, development and engineering organization is located in Simi Valley, California and Boulder, Colorado. We employ more than 17 engineers.

Qualstar was incorporated in California in 1984.

POWER SUPPLY INDUSTRY

Background

The power conversion markets are comprised of a few large suppliers and a number of smaller companies that focus on specialized products. The power conversion market, which includes the Servers, Storage and Network (“SSN”),

Industrial and Transportation (“IND”) and Network Power Systems (“NPS”) markets among others are expected to grow at a 5-7% compounded annual growth rate from 2011 to 2014 according to IMS Research. In 2011, power conversion products were negatively influenced by macroeconomic conditions throughout the globe, with industry sales declining versus 2010, according to market studies.

Longer term, we believe the following key trends will continue to drive demand for power conversion products:

- Increasing amounts of power required by the communications infrastructure industry. The proliferation of data centers and their related infrastructures, the internet, wireless communications, broadband applications, server and storage farms and other new technologies, have increased exponentially the amount of information transmitted over the recent past. As a result, the push for higher bandwidth and more efficient and effective systems has been driving a faster replacement cycle for telecommunications equipment as well as strong infrastructure expansion.

- Increasing demand for high conversion efficiencies, high power density and digital power management. Recent efforts in the EU, the United States and Asia to reduce energy consumption are increasing the demand for high conversion efficiencies and digital power control. In addition, groups such as the Climate Savers Computing Initiative, consisting of a consortium of companies including Google and Intel and other eco-conscious businesses and conservation organizations are promoting the development, deployment and adoption of smart technologies that can both improve the efficiency of a computer's power utilization and reduce the energy consumed when the computer is in an inactive state. Because a large portion of electrical energy waste occurs during the power conversion process, power supply companies have an opportunity to improve the conversion efficiency to reduce the operating costs for the end user. Our AC/DC power supplies have led the markets we serve with conversion efficiency ratings up to 93%. Our digital power control technologies allow us to achieve high levels of power conversion efficiency and control that are not possible with analog designs. Higher conversion efficiencies help reduce overall power usage and therefore cut greenhouse gas emissions and total cost of infrastructure ownership.

Strategy

Our primary objective in our power supply business is to be a global leader in high-efficiency, high-density power conversion for the data center, communications equipment, and industrial and telecommunications network power markets. To achieve this objective we plan to:

- Continue to expand our sales channels and geographies. We have begun to promote the N2Power brand on a global basis and are targeting larger OEMs, and distributers who have a presence in markets and geographies that we do not currently serve.

- Continue to drive deeper penetration in our current OEM customers. Our original equipment manufacturer (OEM) customers are constantly changing their products and introducing new products. We are driving to become the supplier of choice within our OEM customer base to leverage our existing relationships and drive volume growth within the same sales channel.

- Continue to expand our footprint in the data center equipment and communications markets. Our products are very well suited for the data center equipment, networking and communications systems markets. We have secured several sizable OEM customers in these markets and are driving deeper penetration within our current customer base as well as adding new customers in these markets.

- Increase our engineering resources to address our OEM customers' custom product requests. Our OEM customers consistently request that our engineering team augment theirs by designing custom power supplies specific to their product requirements. While to date we have had limited resources to apply to these revenue opportunities, we intend to provide our engineering team with additional resources to address these market and customer requirements.

- Expand our standard product offerings while continuing to drive for higher power levels and greater conversion efficiencies in a smaller footprint. Real estate within our customers' products is precious, and as a result there is a continuing need for smaller packaging and space reduction while delivering additional power. Our product roadmap addresses these needs and our objective is to lead the industry with the greatest efficiency in the smallest footprint with the highest power available. In this way, we can deliver advantages to our OEM customers as they leverage our technology in their product designs.

- Organize our technology resources for fast time to market on derivative products. Our customers continually request derivative configurations to our existing products. In order to serve this market effectively, we are organizing our engineering resources for fast turnaround on these designs to shorten our OEM customer's design cycle, leading to

faster time to market.

Our Power Supply Products

We design, develop, manufacture and market our power supply products, which are designed to convert, regulate, purify, manage or distribute electrical power for electronic equipment. Our products generally convert AC current from the grid to DC current for use in computer based products, or modify the voltage being delivered (DC to DC). We specifically target markets where high efficiency and power density are important to our customers.

We sell standard, modified-standard and custom designed products. Standard products are sold unmodified to our customers. Modified-standard products are based on lightly modified versions of standard products. Custom products are designed specifically to the customer's specification and are not generally sold to others. Custom products may require non-recurring engineering and tooling costs to bring the product to production.

Our products can be classified into the following principal groups:

- AC/DC power supplies. Our compact AC/DC power supplies convert AC input voltages ranging from 90VAC to 264VAC into precisely controlled DC output voltages, while achieving efficiencies of up to 93%. The power supplies utilize unique integrated circuits (ICs) to control the operation of the supply and provide operating protections, including over power protection (OPP), over current protection (OCP), over temperature protection (OTP), and over voltage protection (OVP). Constant voltage outputs range from 5VDC to 56VDC, and are available in single and multi-output versions. Constant current versions of the AC/DC power supplies are available with output voltages of 5, 12, 24, 28, 36, 40, 48, or 56VDC, and are typically used in the light emitting diode (LED) lighting industry. Convection-cooled versions of the power supplies provide efficient operation in the absence of forced air cooling. The power supplies may be configured to share current between multiple power supplies, allowing for N and N+1 redundancy installations. An optional PMBusTM digital communications interface is also available to allow up to four model XL275 power supplies to communicate over the same bus for remote control of the main outputs and the 12V fans.

- DC/DC power supplies. The DC/DC power supplies modify 24VDC or 48VDC input voltages into a variety of DC output voltages, while achieving efficiencies greater than 90%. As in our AC/DC power supplies, the DC/DC models utilize unique ICs to control the operation of the supply and provide several methods of protection, including over power protection (OPP), over current protection (OCP), over temperature protection (OTP), and over voltage protection (OVP). Constant voltage outputs range from 5VDC to 56VDC, and are available in single and multi-output versions.

DATA STORAGE INDUSTRY

Background

The data protection and archival storage markets are comprised of a few large suppliers and a number of smaller companies that offer specialized products and capacity ranges. The data protection and archive storage market, which includes disk based and tape library based systems and related software is expected to grow at a 6% compounded annual growth rate from 2012 to 2016 according to IDC. In 2012, the tape portion of the archival storage market was negatively influenced by a shift in IT spending to performance storage in order to keep up with the explosion of data generation, as well as macroeconomic conditions throughout the globe. The emphasis in IT spending on higher end performance storage products contributed to lower sales for archive storage.

Longer term, we believe the increasing amounts of storage required by the IT universe will continue to drive demand for archive storage products. The proliferation of e-commerce, video streaming, digital media, and advanced software applications has driven growth in the production of electronic information to an exponential level from just a few years ago. As a result, the information infrastructure has implemented many solutions addressing access speeds and higher capacity, but a growing need is building for data protection and archival storage. As regulators and companies require the accumulation of and access to archived data, the market to store that data cost-effectively continues to grow. Over the last few years IT spending has been concentrated on the performance aspect of storage, and adding more additional cost effective capacity has lagged in the share of wallet. We believe this performance spending trend is reversing somewhat and the need for additional data protection and archival capacity to house the files that are

currently held on performance storage devices will be moved to make room for new files is fast approaching. We believe this will drive future demand for tape libraries.

As customers constantly add to their ever-growing disk-based storage systems, the operating costs of those systems have become impossible to ignore. Tape libraries use less than 1/20th the power of a comparable sized disk system, making them the ideal storage technology for rarely accessed data. We believe that this operating cost advantage will result in increased interest in tape library-based storage systems.

Strategy

Our primary objective in our storage business is to be a global leader in highly scalable, cost effective data protection and archival storage for the information technology markets. To achieve this objective we plan to:

- Continue to expand our sales channels and geographies. We have begun to accelerate the promotion of Qualstar storage solutions on a global basis and will continue to add resellers outside the US in addition to adding new US resellers. We are also exploring OEM and private label opportunities to market our products.

- Produce expandable storage solutions that deliver scalability within the data center and more effective capital spending for our customers. Expandability is a key requirement for many customers who are dealing with rapidly growing capacity needs on a regular basis. Expandability enables them to easily and quickly add more storage while providing a cost-effective solution that can be readily budgeted during their planning cycles.

- Explore adjacent technologies to expand our functionality and footprint in the IT market. Historically we have been focused on products using magnetic tape as the media in our systems and on automating the loading, unloading and storage of the media. We will explore use of other media such as hard disk drives (HDD) and solid state drives (SSD), alone or in combination, in order to evaluate a wider product offering for the growing data storage market.

- Offer cost effective, service and support programs that enable our customers to keep their products running 24 hours a day, 7 days a week. We have recently expanded our onsite service coverage beyond the US and Western Europe and can now offer this vital service in several Asian countries. We plan to continue this expansion to other markets as we identify appropriate service providers to engage with.

Our Storage Products

We design, develop, manufacture and market storage products which deliver cost effective data protection and archival storage to small and medium businesses (SMB), and to more complex small and medium enterprise environments with stringent performance and data availability requirements. We provide a wide range of storage solutions that span capacities from 75 Terabytes to over 33 Petabytes (1000 Terabytes = 1 Petabyte) which encompass over 125 tape drives and more than 11,700 slots for tape media.

- The RLS-8350 and RLS-8500 Series Expandable Rack Mount Tape Libraries deliver both high density to maximize rack space utilization and easy customer expandability to keep pace with exploding archive storage and data protection requirements. RLS base models house 50, 60, 108 or 114 tape slots and up to 5 LTO format tape drives. Up to three customer installable expansion modules can be installed on every base unit using Qualstar's unique FastPass™ elevator assembly to quickly and transparently move tapes between modules as needed. Each module adds 120 more tape storage slots and 5 additional tape drive slots. RLS configurations can scale capacity to over 1.4 Petabytes in a single 19-inch rack. Advanced features including library-enabled data encryption to protect the data on tapes in transit to remote locations, dual AC input power to allow operation to continue if one power source drops off line and Q-Link, our widely regarded remote library manager.

- Qualstar's XLS Enterprise Library System provides the widest range of capacity and performance available to enterprise-class data protection and archive storage customers. Several Library Resource Modules (LRM) and two Memory Expansion Modules (MEM) can be combined in numerous configurations to cost-effectively deliver capacities from 300 Terabytes to over 33 Petabytes. Over 125 LTO tape drives can be configured in a single system to deliver throughput exceeding 63 Terabytes per hour to meet the performance needs of the most demanding environments. XLS' exclusive Compass Architecture™ design delivers storage density exceeding 180 Terabytes per square foot to minimize costly IT floor space requirements. Tape libraries are the most energy efficient data storage

technology on the market, often using 1/20th the power of a similarly sized disk-based system. Advanced design has reduced the XLS power and cooling requirements to industry-leading levels.

CUSTOMERS

Our solution-focused product offerings are designed specifically for OEM manufacturers, corporate IT departments, and SMBs. We sell all of our storage products through our worldwide authorized distributor and reseller network.

All of our products and services are designed and manufactured to address our customers' stringent requirements and reliability standards. The following provides additional detail on our channels:

- Storage Reseller channel. Our reseller channel includes systems integrators, value added resellers [VARs] and value added distributors (VADs). Our resellers frequently package our products as part of a comprehensive data processing system or with other storage devices to deliver a complete storage subsystem. Our resellers frequently recommend our products as replacement solutions when backup and archive systems are upgraded or bundle our products with storage management software specific to the end user's system. We support the reseller channel through our dedicated field sales representatives and technical support technicians.

- Storage OEM channel. OEM customers incorporate our storage products with their application software and other components to deliver a focused solution. Our products may or may not carry our label.

- N2Power OEM channel. We have supply agreements with our major power supply customers which incorporate our products into their server, telephony, network and industrial product offerings.

We divide our worldwide sales into three geographical regions:

- North America, consisting of Mexico, United States and Canada;

- EMEA, consisting of Europe, the Middle East and Africa; and

- APAC, consisting of Asia Pacific countries.

We support our customers in the Americas primarily from our Simi Valley, California location. We support our EMEA, APAC and other foreign customers through a network of trained resellers and service providers located throughout the region.

Sales to customers outside of the United States represent a significant and growing portion of our sales and international sales are subject to various risks and uncertainties. See "Much of our business is subject to risks associated with operations in foreign countries" under the heading "Risk Factors" in Part I, Item 1A of this report. The following table sets forth foreign revenue by geographic area (in thousands):

	2012	2011
Foreign revenue:		
Europe	$ 3,028	$ 3,201
Asia/Pacific Rim	4,724	3,134
Other foreign revenue	290	260
	$ 8,042	$ 6,595
Foreign revenue as a percentage of total net revenue	47.1%	36.0%

We provide a full range of marketing materials for branded products, including product specifications, sales literature and application notes. We also offer lead generation opportunities and market development funds to key channel partners. Our sales management and engineering personnel provide support to the channel partners and visit potential customer sites to demonstrate the technical advantages of our products. We maintain press relations in the United States and Europe, and we participate in national and regional trade shows worldwide.

CUSTOMER SERVICE AND SUPPORT

Customer service and support are key elements of our storage strategy and critical advantageous components of our commitment to making enterprise-class support and services available to companies of all sizes. Our technical support staff is trained to assist our customers with deployment and compatibility for any combination of hardware platforms, operating systems and backup, data protection and storage management software. Our application engineers assist with complex customer issues. We maintain global toll-free service and support phone lines and we also provide self-service and support through our website and email.

Standard warranties include:

- Three-year advance replacement limited warranty on our RLS and XLS tape library products;
- Optional 24x7 or next business day onsite service on our RLS and XLS products in many countries throughout the world; and
- Three-year return to factory warranty on our N2Power products.

RESEARCH AND DEVELOPMENT

We incurred research and development costs of $2.7 million each of fiscal 2012 and 2011, and $3.2 million in fiscal 2010, representing 15.6%, 15.0% and 20.6% of net revenue, respectively. In fiscal 2012, we continued to augment our product lines by expanding our hardware platforms and feature enhancements to our products. Noteworthy product releases for fiscal 2012 was the Fastpass elevator assembly which adds scalability to the RLS platform and data encryption key management for the XLS Series. Our plans for fiscal 2013 include a number of hardware and software enhancements across all of our storage products, and several new power supplies encompassing derivatives of existing modelsand new power sizes. Particular areas of focus are oriented toward product line streamlining and leveraging common componentry, as well as exploring OEM opportunities in the storage side of the business.

MANUFACTURING AND SUPPLIERS

We perform product assembly, integration and testing for our storage products at our factory in Simi Valley, California. Our N2Power products are manufactured in China at various contract manufacturers. We purchase tape drives, chassis, printed circuit boards, integrated circuits, and all other major components from outside suppliers. We carefully select suppliers based on their ability to provide quality parts and components which meet technical specifications and volume requirements. We actively monitor these suppliers but we are subject to substantial risks associated with the performance of our suppliers. For certain components, we qualify a single source, which magnifies the risk of shortages and decreases our ability to negotiate with that supplier. See "If our suppliers fail to meet our manufacturing needs, it would delay our production and our product shipments to customers and negatively affect our operations" under the heading "Risk Factors" in Part I, Section 1A of this report.

COMPETITION

The worldwide storage market is highly competitive. Competitors vary in size from sma