

STEC, INC.  
Form 10-Q  
November 03, 2009  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

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

For the quarterly period ended 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 000-31623

**STEC, INC.**

(Exact name of Registrant as specified in its charter)

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**CALIFORNIA**  
(State or other jurisdiction of  
incorporation or organization)

**3001 Daimler Street**  
**Santa Ana, CA**  
(Address of principal executive offices)

**33-0399154**  
(I.R.S. Employer  
Identification No.)

**92705-5812**  
(Zip Code)

**(949) 476-1180**  
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  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 definitions of "accelerated filer," "large accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer  Accelerated Filer   
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  No

The number of shares outstanding of the registrant's common stock, par value \$0.001, as of October 16, 2009 was 50,264,383.

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**STEC, INC.**

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**QUARTERLY PERIOD ENDED SEPTEMBER 30, 2009**

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Except as otherwise noted in this report, STEC, the Company, we, us and our collectively refer to STEC, Inc.

**Table of Contents****PART I FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****STEC, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

(in thousands, except share and per share amounts)

	<b>September 30, 2009 unaudited</b>	<b>December 31, 2008</b>
<b>ASSETS:</b>		
Current Assets:		
Cash and cash equivalents	\$ 122,925	\$ 33,379
Short-term investments	10,000	
Accounts receivable, net of allowances of \$2,634 at September 30, 2009 and \$1,196 at December 31, 2008	51,856	43,516
Inventory	35,555	63,985
Deferred income taxes	1,946	1,302
Other current assets	8,206	7,872
<b>Total current assets</b>	<b>230,488</b>	<b>150,054</b>
Leasehold interest in land	2,551	2,587
Property, plant and equipment	39,056	44,406
Intangible assets	349	573
Goodwill	1,682	1,682
Other long-term assets	4,288	2,720
Deferred income taxes	5,669	4,407
<b>Total assets</b>	<b>\$ 284,083</b>	<b>\$ 206,429</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY:</b>		
Current Liabilities:		
Accounts payable	\$ 17,068	\$ 13,097
Accrued and other liabilities	13,529	10,339
<b>Total current liabilities</b>	<b>30,597</b>	<b>23,436</b>
Long-term income taxes payable	2,484	1,430
Commitments and contingencies (Note 9)		
Shareholders' Equity:		
Preferred stock, \$0.001 par value, 20,000,000 shares authorized, no shares outstanding		
Common stock, \$0.001 par value, 100,000,000 shares authorized, 50,256,883 shares issued and outstanding as of September 30, 2009 and 48,429,348 shares issued and outstanding as of December 31, 2008	50	48
Additional paid-in capital	152,287	129,670
Retained earnings	98,665	51,845
<b>Total shareholders' equity</b>	<b>251,002</b>	<b>181,563</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$ 284,083</b>	<b>\$ 206,429</b>

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See accompanying notes to unaudited condensed consolidated financial statements.

**Table of Contents****STEC, INC.****CONDENSED CONSOLIDATED STATEMENTS OF INCOME****(in thousands, except per share amounts)****(unaudited)**

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30, 2009</b>	<b>September 30, 2008</b>	<b>September 30, 2009</b>	<b>September 30, 2008</b>
Net revenues	\$ 98,293	\$ 63,651	\$ 248,179	\$ 170,530
Cost of revenues	49,478	43,233	133,158	115,288
<b>Gross profit</b>	<b>48,815</b>	<b>20,418</b>	<b>115,021</b>	<b>55,242</b>
Sales and marketing	5,162	5,130	14,965	14,242
General and administrative	6,306	7,037	20,386	17,978
Research and development	6,569	5,736	17,512	14,891
Special charges (Note 7)	360		3,533	
Total operating expenses	18,397	17,903	56,396	47,111
Operating income	30,418	2,515	58,625	8,131
Other income	14	119	616	1,314
Income from continuing operations before provision for income taxes	30,432	2,634	59,241	9,445
Provision for income taxes	5,954	1,477	12,206	5,120
Income from continuing operations	24,478	1,157	47,035	4,325
Discontinued operations (Note 8):				
Income (loss) from discontinued operations		80	(356)	229
(Provision) benefit for income taxes		(33)	141	(91)
Income (loss) from discontinued operations		47	(215)	138
Net income	\$ 24,478	\$ 1,204	\$ 46,820	\$ 4,463
Net income per share:				
Basic:				
Continuing operations	\$ 0.49	\$ 0.02	\$ 0.96	\$ 0.09
Discontinued operations			(0.01)	
Total	\$ 0.49	\$ 0.02	\$ 0.95	\$ 0.09
Diluted:				
Continuing operations	\$ 0.47	\$ 0.02	\$ 0.93	\$ 0.09
Discontinued operations			(0.01)	
Total	\$ 0.47	\$ 0.02	\$ 0.92	\$ 0.09
Shares used in net income per share computation:				
Basic	49,851	50,112	49,056	49,905

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Diluted	52,239	51,449	50,672	51,333
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See accompanying notes to unaudited condensed consolidated financial statements.

**Table of Contents****STEC, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(in thousands)****(unaudited)**

	<b>Nine Months Ended September 30,</b>	
	<b>2009</b>	<b>2008</b>
<b>Cash flow from operating activities:</b>		
Net income	\$ 46,820	\$ 4,463
Loss (income) from discontinued operations	215	(138)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	8,926	6,489
Loss (gain) on sale of property, plant and equipment	71	(248)
Non-cash special charges and impairment loss	2,213	138
Accounts receivable provision	1,718	311
Deferred income taxes	(1,906)	(1,466)
Stock-based compensation expense	3,219	1,631
Excess tax benefits from share-based payment arrangements	(9,935)	(2,932)
Change in operating assets and liabilities:		
Accounts receivable	(10,058)	(15,790)
Inventory	28,430	(48,692)
Leasehold interest in land	36	67
Other assets	7,625	(846)
Accounts payable	3,187	5,432
Accrued and other liabilities	4,147	6,583
Net cash flows used in discontinued operations		(138)
Net cash provided by (used in) operating activities	84,708	(45,136)
<b>Cash flows from investing activities:</b>		
Purchases of short-term investments	(15,200)	(47,770)
Sales of short-term investments	5,200	47,770
Purchase of property, plant and equipment	(4,832)	(15,996)
Proceeds from sale of property, plant and equipment	270	311
Net cash used in investing activities	(14,562)	(15,685)
<b>Cash flows from financing activities:</b>		
Proceeds from exercise of stock options	9,465	5,925
Excess tax benefits from share-based payment arrangements	9,935	2,932
Stock buyback		(13,003)
Net cash provided by (used in) financing activities	19,400	(4,146)
Net increase (decrease) in cash and cash equivalents	89,546	(64,967)
Cash and cash equivalents at beginning of period	33,379	94,326
Cash and cash equivalents at end of period	\$ 122,925	\$ 29,359



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### Supplemental schedule of noncash investing activities:

Additions to property, plant and equipment acquired under accounts payable	\$ 499	\$ 495
Additions to other assets acquired under accounts payable	\$ 102	\$

See accompanying notes to unaudited condensed consolidated financial statements.

**Table of Contents****STEC, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)****Note 1 Basis of Presentation**

The accompanying interim condensed consolidated financial statements of STEC, Inc., a California corporation (the Company), are unaudited and have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. In the opinion of management, all adjustments (consisting of normal and recurring adjustments and the special charges discussed in Note 7) considered necessary for a fair statement of the consolidated financial position of the Company at September 30, 2009, the consolidated results of operations for each of the three and nine months ended September 30, 2009 and 2008, and the consolidated results of cash flows for each of the nine months ended September 30, 2009 and 2008 have been included. These interim condensed consolidated financial statements do not include all of the information and footnotes required by GAAP for complete financial statements and, therefore, should be read in conjunction with the consolidated financial statements and related notes contained in the Company's most recent Annual Report on Form 10-K filed with the Securities and Exchange Commission (SEC). The December 31, 2008 balances reported herein are derived from the audited consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2008. The results for the interim periods are not necessarily indicative of results to be expected for the full year. Certain amounts previously reported have been reclassified to conform to the 2009 presentation.

The condensed consolidated financial statements of the Company include the accounts of the Company's subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

The preparation of financial statements in conformity with GAAP requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities (e.g., sales returns, bad debt and inventory reserves and asset impairments), 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. The Company's reported revenues are net of reserves for price protection, sales returns and sales and marketing incentives. Actual results could differ from those estimates.

In June 2009, the Financial Accounting Standards Board (FASB) established the FASB Accounting Standards Codification<sup>TM</sup> (Codification) as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of financial statements in conformity with GAAP. Recognition of the Codification in financial statements is effective for interim and annual periods ending after September 15, 2009. The impact in the Company's financial statements was only to references for accounting guidance.

The Company evaluated subsequent events through November 3, 2009, which is the date these financial statements were issued.

**Note 2 Sales Concentration**

As shown in the table below, customer concentrations of accounts receivable and revenues of greater than 10% were as follows:

	For the Three Months Ended September 30,				For the Nine Months Ended September 30,			
	2009		2008		2009		2008	
	Accounts Receivable	Revenues	Accounts Receivable	Revenues	Accounts Receivable	Revenues	Accounts Receivable	Revenues
Customer A	*	*	38%	37%	*	*	38%	41%
Customer B	*	*	16%	12%	*	*	16%	*
Customer C	61%	54%	*	11%	61%	38%	*	14%

\* Less than 10%

For the three months ended September 30, 2009 and 2008, international sales, which are derived from billings to foreign customers, comprised 51% and 29%, respectively, of the Company's revenues. During the three months ended September 30, 2009, 25% of the Company's revenues

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were derived from billings to customers in the Czech Republic. During the nine months ended September 30, 2009 and 2008, international sales comprised 49% and 22%, respectively, of the Company's revenues. During the nine months ended September 30, 2009, 10%, 10% and 11% of the Company's revenues were derived from billings to customers in the Czech Republic, Singapore and Taiwan, respectively. In 2009, the majority of the Company's international sales are export sales which are shipped primarily from the Company's facility in Malaysia.

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**Table of Contents****STEC, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****Note 3 Financial Instruments**

Financial instruments consist principally of cash equivalents and short-term investments, accounts receivable and accounts payable. Generally, the Company considers all highly liquid investments that are readily convertible into cash and have an original maturity of three months or less at the time of purchase to be cash equivalents. The Company defines short-term investments as income-yielding securities that can be readily converted into cash. As of September 30, 2009, cash equivalents and short-term investments consisted of FDIC-insured certificates of deposits and U.S. treasury bills.

**Note 4 Income Taxes**

The provision for income taxes was \$12.2 million and \$5.1 million for the nine months ended September 30, 2009 and September 30, 2008, respectively. The Company's effective tax rates were 20.6% and 54.2% for the nine months ended September 30, 2009 and September 30, 2008, respectively. The difference between the Company's effective tax rate and the 35% federal statutory rate for the nine months ended September 30, 2009 resulted primarily from earnings in jurisdictions outside of the United States which were taxed at rates lower than U.S. federal statutory rates. The difference between the Company's effective tax rate and the 35% federal statutory rate for the nine months ended September 30, 2008 resulted primarily from foreign losses in tax-free jurisdictions that were not tax-benefited. The foreign losses that were not tax benefited was due to the short-term impact of the global restructuring that the Company was in the process of implementing during the nine months ended September 30, 2008. The decrease in the effective tax rate for the nine months ended September 30, 2009 from the same period in 2008 is due to the transition of certain of the Company's operations to its facility in Penang, Malaysia where the Company has been granted a tax holiday subject to meeting certain conditions.

This tax holiday in Malaysia is effective through September 30, 2022. The impact of the Malaysia tax holiday decreased the provision for income taxes by \$649,000 and \$332,000 in the three months ended September 30, 2009 and 2008, respectively, and \$2.2 million and \$678,000 in the nine months ended September 30, 2009 and 2008, respectively. The benefit of the tax holiday on earnings per share was \$0.01 and \$0.01 for the three months ended September 30, 2009 and 2008, respectively, and \$0.04 and \$0.01 for the nine months ended September 30, 2009 and 2008, respectively.

During the nine months ended September 30, 2009, the Company's gross unrecognized tax benefits increased by \$1.0 million. There was no change in the Company's gross unrecognized tax benefits during the nine months ended September 30, 2008. In the next twelve months, it is reasonably possible that the amount of unrecognized tax benefits will decrease by approximately \$760,000 as a result of the expiration of the statute of limitations for previously filed tax returns.

**Note 5 Net Income Per Share**

Basic earnings per share is computed by dividing net income by the weighted average number of shares outstanding. In computing diluted earnings per share, the weighted average number of shares outstanding is adjusted to reflect potentially dilutive securities. Options to purchase 4,017,124 and 4,695,416 shares of common stock were outstanding at September 30, 2009 and 2008, respectively. In addition, 381,132 and 296,000 restricted stock units payable in shares of common stock were outstanding at September 30, 2009 and 2008, respectively. For each of the three months ended September 30, 2009 and 2008, potentially dilutive securities consisted solely of options and restricted stock units and resulted in an upward adjustment to weighted average number of shares outstanding of 2,388,106 and 1,337,631, respectively. For each of the nine months ended September 30, 2009 and 2008, potentially dilutive securities consisted solely of options and restricted stock units and resulted in an upward adjustment to weighted average number of shares outstanding of 1,615,767 and 1,427,717, respectively. Common stock equivalents of 320,754 and 1,596,500 shares for the three months ended September 30, 2009 and 2008, respectively, and 1,610,246 and 1,338,717 shares for the nine months ended September 30, 2009 and 2008, respectively, were outstanding but were not included in the computation of diluted earnings per share because the effect would have been anti-dilutive.



**Table of Contents****STEC, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****Note 6 Supplemental Balance Sheet Information**

Inventory consists of the following (in thousands):

	<b>September 30, 2009</b>	<b>December 31, 2008</b>
Raw materials	\$ 21,285	\$ 41,554
Work-in-progress	1,640	706
Finished goods	12,630	21,725
Total	\$ 35,555	\$ 63,985

Accrued and other liabilities consisted of the following (in thousands):

	<b>September 30, 2009</b>	<b>December 31, 2008</b>
Accrued expenses - payroll costs	\$ 9,669	\$ 5,703
Accrued expenses - marketing programs	2,466	929
Accrued expenses - other	1,394	3,707
Total	\$ 13,529	\$ 10,339

**Note 7 Special Charges**

Special charges consist of the following (in thousands):

	<b>Three Months Ended September 30, 2009</b>	<b>Nine Months Ended September 30, 2009</b>
Employee severance and termination benefits	\$ 112	\$ 1,738
Asset impairments	248	1,795
Total special charges	\$ 360	\$ 3,533

There were no special charges during the three or nine months ended September 30, 2008.

During the three months ended March 31, 2009, the Company commenced a reduction of its workforce primarily at its Santa Ana, California headquarters as part of the transition of certain of its operations to its facility in Penang, Malaysia. This reduction, which mostly impacted its U.S.-based workforce, is expected to be completed by the end of 2009. The majority of the reduction occurred during the first nine months of 2009 and affected 245 employees, including 200 in manufacturing, 20 in sales and marketing, 20 in research and development, and 5 in administration. In connection with this reduction in workforce, the Company recorded a charge of approximately \$112,000 and \$1.7 million for severance and related costs during the three and nine months ended September 30, 2009, respectively. The Company expects to incur

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approximately \$50,000 to \$150,000 of additional restructuring costs, consisting primarily of workforce reduction and consolidation of facilities expenses related to this restructuring plan, which is expected to be completed by the end of 2009. The Company expects substantially all of the expenses associated with the workforce reduction to result in cash expenditures. Actual amounts and the exact timing of the workforce reductions could differ from these estimates.

In connection with the transition of operations to Malaysia, the Company conducted an assessment for the impairment of certain property, plant and equipment. As the Company finalized its plans for the transition of operations to Malaysia in the second quarter of 2009, the Company determined that certain manufacturing-related property or equipment assets were impaired. Carrying value of the assets was adjusted to reflect estimated fair value, which was based on market prices, prices of similar assets, and other available information. The Company recorded asset impairments totaling \$248,000 and \$1.8 million during the three and nine months ended September 30, 2009, respectively.

The Company recognizes a liability for restructuring costs at fair value only when the liability is incurred. The two main components of the Company's restructuring plan have been related to workforce reductions and asset impairments. Workforce-related charges are accrued when it is determined that a liability has been incurred, which is after individuals have been notified of their termination dates and expected severance benefits.

**Table of Contents****STEC, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

Activity and liability balances related to the 2009 restructuring plan through September 30, 2009 are as follows (in thousands):

	<b>Workforce Reductions</b>
Restructuring balance, December 31, 2008	\$
Charged to costs and expenses	1,738
Cash payments	(1,641)
Restructuring balance, September 30, 2009	\$ 97

The remaining accrued restructuring balance is included in Accrued and Other Liabilities in the Condensed Consolidated Balance Sheet and consists of obligations related to employee severance benefits. These obligations were paid in October 2009.

**Note 8 Discontinued Operations**

On February 9, 2007, the Company entered into an Asset Purchase Agreement ( Purchase Agreement ) with Fabrik, Inc. ( Fabrik ) and Fabrik Acquisition Corp. (together with Fabrik, the Purchasers ) for the sale of assets relating to a portion of the Company's business which was engaged in the designing, final assembling, selling, marketing and distributing consumer-oriented products based on Flash memory, Dynamic Random Access Memory ( DRAM ) technologies and external storage solutions known as the Consumer Division of the Company. The consideration paid to the Company pursuant to the Purchase Agreement consisted of cash in the amount of approximately \$43.0 million. The purchase price was subject to a post-closing adjustment for accrued expenses, reserves on inventory, reserves on accounts receivables and overhead capitalization of the Consumer Division ( Purchase Price Adjustment ). Subsequent to the closing of the sale, the Purchasers disputed certain amounts calculated by the Company in regards to the Purchase Price Adjustment. The original claim amount was approximately \$6.7 million. In accordance with the Purchase Agreement, both parties agreed to resolve their Purchase Price Adjustment disputes through a third-party arbitrator. During the arbitration proceeding, the Purchasers conceded approximately \$4.0 million of their original disputed amounts. In January 2008, the arbitrator rejected substantially all of the Purchasers' claims. Since the Company has been unable to resolve the remaining open issues with Fabrik related to the sale of the Consumer Division and as a result of the indemnification period for claims as specified in the Purchase Agreement having expired in February 2009, the Company recorded \$215,000, net of taxes, related to the write off of amounts owed to the Company under the original purchase as loss from discontinued operations in the first quarter of 2009.

Operating results of the Consumer Division which are accounted as discontinued operations for the three and nine months ended September 30, 2009 and 2008 are summarized as follows (in thousands):

	<b>For the Three Months Ended September 30,</b>		<b>For the Nine Months Ended September 30,</b>	
	<b>2009</b>	<b>2008</b>	<b>2009</b>	<b>2008</b>
Net revenues	\$	\$	\$	\$
Income (loss) from discontinued operations	\$	\$ 80	\$ (356)	\$ 229
(Provision) benefit for income taxes		(33)	141	(91)
Income (loss) from discontinued operations, net of taxes	\$	\$ 47	\$ (215)	\$ 138



**Note 9 Commitments and Contingencies**

The Company is currently not a party to any material legal proceedings; however, the Company is involved in other suits and claims in the ordinary course of business, and the Company may from time to time become a party to additional legal proceedings arising in the ordinary course of business.

As is common in the industry in which the Company competes, the Company is bound by a number of agreements in which the Company has agreed to defend, indemnify and hold harmless certain of its suppliers and customers from damages and costs which may arise from the infringement by the Company's products of third-party patents, trademarks or other proprietary rights. The scope of such indemnity varies, but may, in some instances, include indemnification for damages and expenses, including attorneys' fees. The Company's insurance does not cover intellectual property infringement. The term of these indemnification agreements is generally perpetual any time after execution of the agreement. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited. The Company has never incurred significant costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, the Company believes the estimated fair value of these agreements is minimal. Accordingly, the Company has no liabilities recorded for these agreements as of September 30, 2009.

**Table of Contents****STEC, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****Note 10 Credit Facility**

On July 30, 2008, the Company entered into an agreement for a \$35 million two-year senior unsecured revolving credit facility (the Credit Facility) with Wachovia Bank, National Association (Wachovia). Borrowings under the Credit Facility will bear interest at a floating rate equivalent to, at the option of the Company, either (i) LIBOR plus 0.70% - 1.20% depending on the Company's leverage ratio at each quarter end or (ii) Wachovia's prime rate, announced from time to time, less 1.00% - 1.50% depending on the Company's leverage ratio at each quarter end. The Credit Facility is guaranteed by certain domestic subsidiaries of the Company. In addition, if the Company makes a loan to any of its foreign subsidiaries, the Company has agreed to pledge to Wachovia the Company's intercompany note from such foreign subsidiary. The Credit Facility agreement contains customary affirmative and negative covenants, some of which require the maintenance of specified leverage and minimum liquidity ratios. The Company was subject to a maximum leverage ratio of 2.0 to 1.0 for the nine months ended September 30, 2009 and a minimum liquidity ratio of 1.0 to 5.0 through September 30, 2009. The Credit Facility matures on July 30, 2010.

As of September 30, 2009, there were no borrowings outstanding under the Credit Facility and the Company was in compliance with all covenants under the Credit Facility. The Credit Facility will be used to maintain liquidity and fund working capital requirements, on an as needed basis.

**Note 11 Cash and Cash Equivalents and Short-term Investments**

At September 30, 2009, cash and cash equivalents and short-term investments were invested in certificates of deposit, U.S. treasury bills, money market funds and other interest bearing accounts. The Company determined the fair value of its cash equivalents and short-term investments based on Level 1 inputs, which consist of quoted prices in active markets for identical assets.

Cash and cash equivalents and short-term investments consist of the following (in thousands):

	September 30, 2009	December 31, 2008
Cash and cash equivalents:		
Money market funds	\$ 92,929	\$ 33,379
Certificates of deposit	15,000	
U.S. treasury bills	14,996	
	122,925	33,379
Short-term investments:		
Certificates of deposit	10,000	
Total cash and cash equivalents and short-term investments	\$ 132,925	\$ 33,379

**Note 12 Intangible Assets and Goodwill**

The following table presents detail of the Company's intangible assets, related accumulated amortization and goodwill (in thousands):

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	As of September 30, 2009			As of December 31, 2008		
	Gross	Accumulated Amortization	Net	Gross	Accumulated Amortization	Net
Developed technology (five years)	\$ 1,070	\$ 791	\$ 279	\$ 1,070	\$ 637	\$ 433
Customer relationships (five years)	792	722	70	792	652	140
<b>Total intangible assets</b>	<b>\$ 1,862</b>	<b>\$ 1,513</b>	<b>\$ 349</b>	<b>\$ 1,862</b>	<b>\$ 1,289</b>	<b>\$ 573</b>
Goodwill	\$ 1,682	\$	\$ 1,682	\$ 1,682	\$	\$ 1,682

Goodwill and other intangible assets with indeterminate lives are not subject to amortization but are tested for impairment annually or whenever events or changes in circumstances indicate that the asset might be impaired. Intangible assets with finite lives continue to be subject to amortization, and any impairment is determined in accordance with the authoritative guidance for intangible assets. The Company recorded amortization expense of \$70,000 and \$95,000 for the three months ended September 30, 2009 and 2008, respectively, and \$224,000 and \$285,000 for the nine months ended September 30, 2009 and 2008, respectively. Estimated intangible asset amortization expense (based on existing intangible assets) for the remainder of the year ending December 31, 2009 and the years ending December 31, 2010, and 2011 is \$57,000, \$180,000, and \$112,000, respectively. Amortization will be completed as of the end of 2011.

**Table of Contents****STEC, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****Note 13 Shareholders Equity*****Stock Incentive Plan***

The 2000 Stock Incentive Plan (the Plan) was adopted by the Company's board of directors and approved by its shareholders in June 2000. On April 17, 2006, the Plan was amended and restated by the board of directors and approved by the Company's shareholders on May 25, 2006. The Plan provides for the direct issuance or sale of shares and the grant of options to purchase shares of the Company's common stock to officers and other employees, non-employee board members and consultants. The Company issues new shares to satisfy stock option exercises and stock purchases under the Company's share-based plans. Under the Plan, eligible participants may be granted options to purchase shares of common stock at an exercise price not less than 100% of the fair market value of those shares on the grant date. In addition, the Plan as amended and restated, allows for the issuance of restricted stock units to officers and other employees, non-employee board members and consultants. Restricted stock units are share awards that entitle the holder to receive shares of the Company's common stock upon vesting. The Company's board of directors, its compensation committee or its equity awards committee determines eligibility and vesting schedules for options and restricted stock units granted under the Plan. Options expire within a period of not more than ten years from the date of grant.

At September 30, 2009, the Plan provided for the issuance of up to 23,128,277 shares of common stock. The number of shares of common stock reserved for issuance under the Plan will automatically increase on the first trading day in January in each calendar year by an amount equal to 4% of the total number of shares of common stock outstanding on the last trading day in December of the prior calendar year, but in no event will exceed 2,500,000 shares.

During the nine months ended September 30, 2009, options for the purchase of 1,282,000 shares at a weighted-average option price of \$21.00 per share, with annual vesting of 20% or 25%, were awarded. The contractual lives of 2009 awards are consistent with those of prior years. The per share fair values of the options granted in the nine months ended September 30, 2009 were estimated with the following weighted average assumptions:

Expected term (years)	5.8
Risk-free interest rate	2.6%
Volatility	64%
Dividend rate	0.0%

At September 30, 2009, there were 6,300,350 shares of common stock available for grant under the Plan.

From time to time the Company's board of directors has authorized various programs to repurchase shares of its common stock depending on market conditions and other factors. In November 2008, the board of directors authorized a share repurchase program effective November 19, 2008, enabling the Company to repurchase up to \$10 million of its common stock over an 18-month period expiring on May 18, 2010. At September 30, 2009, \$5.0 million was still authorized for the repurchase of shares under this plan. The Company did not make any share repurchases in the three months ended September 30, 2009.

During the nine months ended September 30, 2009, the Company received \$9.5 million in cash proceeds for the exercise of 1,780,288 options with a \$9.9 million tax benefit for disqualifying dispositions of incentive stock options and vesting of restricted stock units.

On August 3, 2009, the Company filed a registration statement (including a base prospectus) and filed a prospectus supplement on August 7, 2009 with the Securities and Exchange Commission in connection with the offering by certain stockholders of the Company of an aggregate of 9,000,000 shares of the Company's common stock. The offering closed on August 11, 2009, and 9,000,000 shares were sold to the public at a price per share of \$31.00 including a \$1.24 per share discount to the underwriters. The Company did not receive any proceeds from the sale of shares sold in the offering.

**Note 14 New Accounting Pronouncements**

The Company has implemented all new accounting pronouncements that are in effect and that may impact its consolidated financial statements and does not believe that there are any other new accounting pronouncements that have been issued that might have a material impact on its consolidated financial statements.

**Table of Contents****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS*****Cautionary Statement***

Certain information in this report contain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, or the Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act. These forward-looking statements often can be, but are not always, identified by the use of words such as assume, expect, intend, plan, project, believe, estimate, predict, anticipate, may, might, should, could, goal, potential and similar expressions. They include, but are not limited to, our expectations regarding our revenue growth initiatives; continued growth in the sales of our Flash product line; changes in the average selling prices of our products; the loss of, or reduction in sales to, any of our key customers; our ability to deliver new and enhanced products on a timely basis; our sales, operating results and anticipated cash flows; our ability to forecast customer demand; the availability of certain components in our products which we obtain from a limited number of suppliers; competition from other companies in our industry; changes in political and economic conditions and local regulations, particularly outside of the United States; and our ability to protect our intellectual property rights. We base these forward-looking statements on our current expectations and projections about future events, our assumptions regarding these events and our knowledge of facts at the time the statements are made. These forward-looking statements are subject to various risks and uncertainties that may be outside our control and our actual results could differ materially from our projected results. Please see our most recent Annual Report on Form 10-K and our subsequent Quarterly Reports on Form 10-Q and the other information contained in our other SEC filings for a further discussion of these and other risk and uncertainties applicable to our business. We are not able to predict all the factors that may affect future results. Forward-looking statements speak only as of the date of this Quarterly Report on Form 10-Q. Except as required by applicable laws or regulations, we do not undertake any obligation to update or revise any forward-looking statement, whether as a result of new information, future events or otherwise.

The following discussion should be read in conjunction with our consolidated financial statements and notes thereto included elsewhere in this Quarterly Report on Form 10-Q.

***Overview***

STEC, Inc. is a leading global provider of enterprise-class Flash solid-state drives ( SSDs ) that are designed to increase the performance of storage systems and servers enterprises use to retain and access their critical data. Our products are designed specifically for storage systems and servers that run applications requiring a high level of input/output operations per second, or IOPS, performance, capacity, reliability and a low amount of latency, with the added benefits of lower power consumption and a smaller footprint.

We design and develop our SSD controllers, enhance them with proprietary firmware and combine them with third-party Flash memory to form high-performance SSDs which provide a level of IOPS performance not currently possible with traditional hard disk drives ( HDDs ). We sell our SSDs to the leading global storage and server original equipment manufacturers ( OEMs ) which integrate them into storage systems and servers used by enterprises in a variety of industries including financial services, government, transportation, defense and aerospace, and transaction processing. We also manufacture small form factor Flash SSDs, cards and modules, as well as custom high density dynamic random access memory ( DRAM ) modules for networking, communications and industrial applications. We are headquartered in Santa Ana, California and have operations in Penang, Malaysia.

We market our products to OEMs, leveraging our comprehensive design capabilities to offer custom storage solutions to address their specific needs.

We are focusing on several revenue growth initiatives, including:

continuing to develop and qualify customized Flash-based SSDs, including our Zeus<sup>IOPS</sup> and MACH8<sup>IOPS</sup> product lines, for enterprise-storage and enterprise-server applications, respectively; and

expanding our international business in Asia and Europe.

Over the past several years we have expanded our custom design capabilities of Flash products for OEM applications. We have invested significantly in the design and development of customized Flash controllers, firmware and hardware and made strategic acquisitions that have expanded our Flash controller design capabilities. Flash product revenue increased 102% from \$40.5 million in the third quarter of 2008 to \$81.7 million in the third quarter of 2009. We expect our continued investments in Flash custom design capabilities and controller development to result in sustained revenue growth from our Flash product line in the remaining fiscal year 2009.



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A major area of our Flash-based product investment has been focused on SSD technology. We believe the advantages of SSD technology are currently being defined in several distinct market segments; a) enterprise-storage applications, b) enterprise-server applications, c) military and industrial applications, and d) video-on-demand ( VoD ) applications. We see opportunities to leverage our SSD expertise across each of these markets where we believe our technology can outperform existing solutions. In addition, we believe the SSD market will continue to expand over the next several years as overall unit volume growth is expected. In the long term, we expect Flash component pricing to decline, which will serve to improve the comparative economics of Flash-based SSDs versus HDDs in both new and existing storage applications. On July 16, 2009 we announced a firm and non-cancellable supply agreement with one of our largest enterprise storage customers for sales of \$120 million of Zeus<sup>IOPS</sup> SSDs in the second half of 2009. Our shipments related to this agreement were approximately \$54 million during the third quarter of 2009. In addition, we have received recent indications from this customer that they may have inventory of our Zeus<sup>IOPS</sup> SSDs at the end of 2009 which might carry over into 2010. As a result, our sales to this customer may be negatively affected in early 2010; however, the actual impact cannot be quantified at this time.

Although the enterprise Flash-based SSD market is new, rapidly evolving and difficult to predict, we are encouraged by the increasing variety of applications that our SSDs are able to support. As more of our customers and end-users experience the benefits of SSD technology, including performance increases and cost reductions, we believe that adoption will continue to expand. Accordingly, we are planning to implement certain marketing programs and sales initiatives with several of our customers, including our largest enterprise-storage customer, in order to speed the mass adoption of our SSD products.

In 2008 we entered the mobile computer market with our ultra-mobile SSDs. While we have qualified and sold this product into a leading personal computer ( PC ) OEM in this market segment, we believe that our technology and SSD product offerings will be primarily focused on the other market segments for SSD technology enterprise-storage and enterprise-server and we expect our revenues in this segment to decline significantly.

We also offer both monolithic DRAM modules and DRAM modules based on our proprietary stacking technology. DRAM product revenue decreased 50% from \$21.8 million in the third quarter of 2008 to \$10.8 million in the third quarter of 2009. We expect sales of DRAM modules to decline as a percentage of our total revenues over time as we continue to focus on growing our Flash-based product lines.

A limited number of customers account for a significant percentage of our revenue and our level of customer concentration has increased. Our ten largest customers accounted for an aggregate of 83.9% of our revenues in the first nine months of 2009, compared to 78.4% of our total revenues in the first nine months of 2008, and 86.1% of our revenues in the third quarter of 2009, compared to 82.2% of our total revenues in the third quarter of 2008. We had one customer account for more than 10% of our revenues, at 37.9%, for the nine months ended September 30, 2009, compared to two customers, which accounted for more than 10% of our revenues, at 40.9% and 13.7%, for the same period in 2008. We had one customer account for more than 10% of our revenues, at 53.7% in the third quarter of 2009, compared to three customers, which accounted for more than 10% of our revenues, at 36.5%, 12.3%, and 10.7%, for the same period in 2008.

The composition of our major customer base changes from quarter to quarter as the market demand for our products changes, and we expect this variability will continue in the future. We expect that sales of our products to a limited number of customers will continue to account for a majority of our revenues in the foreseeable future. The loss of, or a significant reduction in purchases by any of our major customers, would harm our business, financial condition and results of operations. See Risk Factors Sales to a limited number of customers represent a significant portion of our revenues and the loss of any key customer would materially reduce our revenues.

International sales, which are derived from billings to foreign customers, accounted for 49.4% of our revenues in the first nine months of 2009, compared to 21.8% of our revenues in the first nine months of 2008 and 50.9% in the third quarter of 2009, compared to 29.3% of our revenues in the third quarter of 2008. During the nine months ended September 30, 2009, 9.8%, 10.0% and 10.7% of our revenues were derived from billings to customers in the Czech Republic, Singapore and Taiwan, respectively. During the third quarter of 2009, 25.0% of our revenues were derived from billings to customers in the Czech Republic. The increase in international sales as a percentage of our revenues in the third quarter of 2009, compared to the same period in 2008, and the first nine months of 2009, compared to the same period in 2008, is due to the increase in sales of our Zeus<sup>IOPS</sup> products to new customers in 2009. No foreign geographic area or single foreign country accounted for more than 10% of revenues during the nine months ended September 30, 2008. For the nine months ended September 30, 2009 and 2008, more than 95% of our international sales were denominated in U.S. dollars. In addition, our purchases of DRAM and Flash components are currently denominated in U.S. dollars. However, we do face risks associated with doing business in foreign countries.

See Risk Factors We face risks associated with doing business in foreign countries, including foreign currency fluctuations and trade barriers, that could lead to a decrease in demand for our products or an increase in the cost of the components used in our products.





**Table of Contents****Results of Operations**

The following table sets forth, for the periods indicated, certain consolidated statement of operations data reflected as a percentage of revenues.

	Three Months Ended		Nine Months Ended	
	September 30, 2009	September 30, 2008	September 30, 2009	September 30, 2008
Net revenues	100.0%	100.0%	100.0%	100.0%
Cost of revenues	50.3	67.9	53.7	67.6
Gross profit	49.7	32.1	46.3	32.4
Operating expenses:				
Sales and marketing	5.3	8.1	6.0	8.4
General and administrative	6.4	11.1	8.2	10.6
Research and development	6.6	9.0	7.1	8.7
Special charges	0.4	0.0	1.4	0.0
Total operating expenses	18.7	28.2	22.7	27.7
Operating income	31.0	3.9	23.6	4.7
Other income	0.0	0.2	0.3	0.8
Income from continuing operations before provision for income taxes	31.0	4.1	23.9	5.5

**Comparison of Three Months Ended September 30, 2009 to Three Months Ended September 30, 2008**

**Net Revenues.** Our revenues were \$98.3 million in the third quarter of 2009, compared to \$63.7 million in the same period in 2008. Revenues increased 54% in the third quarter of 2009 due primarily to a 211% increase in average sales price ( ASP ) of our products from \$36 in the third quarter of 2008 to \$112 in the third quarter of 2009, partially offset by a 53% decrease in unit shipments. The increase in revenues and ASP was due primarily to a 102% increase in Flash memory sales and a 324% increase in ASP for Flash products, partially offset by a 50% decrease in sales of DRAM products. Within Flash memory sales, shipments of our Zeus<sup>IOPS</sup> SSDs into the enterprise-storage market grew to \$60.7 million for the third quarter of 2009, an increase of 343% from \$13.7 million for the third quarter of 2008. The increase in our Flash ASP resulted from increased sales of higher ASP Zeus<sup>IOPS</sup> and MACH8<sup>IOPS</sup> products in the third quarter of 2009, compared to the same period in 2008. Unit shipments decreased due primarily to declines in sales of our DRAM modules, ultra-mobile SSDs and CompactFlash products. We expect sales of our ultra-mobile SSD products to decline as we continue to focus on growing our higher ASP Zeus<sup>IOPS</sup> and MACH8<sup>IOPS</sup> products.

Sales of our products are made through individual purchase orders and, in certain cases, we have master agreements in place governing the terms and conditions of the relationships. Customers may change, cancel or delay orders with limited or no penalties. Our ability to predict future sales is limited because a majority of our quarterly product revenues come from orders that are received and fulfilled in the same quarter. Our reported revenues are net of reserves for price protection, sales returns and sales and marketing incentives.

**Gross Profit.** Our gross profit was \$48.8 million in the third quarter of 2009, compared to \$20.4 million in the same period in 2008. Gross profit as a percentage of revenues was 49.7% in the third quarter of 2009, compared to 32.1% in the third quarter of 2008. The increase in gross profit in absolute dollars was due primarily to increased revenues and ASP for Flash products. Gross profit as a percentage of revenue in the third quarter of 2009 increased due primarily to a shift in product mix toward higher gross profit margin Flash SSD-based products.

**Sales and Marketing.** Sales and marketing expenses are primarily comprised of personnel costs and travel expenses for our domestic and international sales and marketing employees, commissions paid to internal salespersons and independent manufacturers' representatives, shipping costs and marketing programs. Sales and marketing expenses were \$5.2 million in the third quarter of 2009, compared to \$5.1 million in the third quarter of 2008. Sales and marketing expenses as a percentage of revenue were 5.3% in the third quarter of 2009, compared to 8.1% in the third quarter of 2008. The increase in sales and marketing expenses in absolute dollars was due to increased commissions related to higher revenues. The decrease in sales and marketing expenses as a percentage of revenues was due primarily to the termination of certain outside manufacturing representative firm commission agreements in the second half of 2008 and the first quarter of 2009. We expect our sales and marketing expenses to increase in absolute dollars as our revenues grow.

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*General and Administrative.* General and administrative expenses are primarily comprised of personnel costs for our executive and administrative employees, professional fees and facilities overhead. General and administrative expenses were \$6.3 million in the third quarter of 2009, compared to \$7.0 million in the third quarter of 2008. General and administrative expenses as a percentage of revenues were 6.4% and 11.1% in the third quarters of 2009 and 2008, respectively. The decrease in general and administrative expenses in absolute dollars and as a percentage of revenues was due primarily to a \$750,000 decrease in legal costs and a \$200,000 decrease in supplies expense, partially offset by a \$350,000 increase in stock-based compensation. Legal expenses have decreased as the result of an IP-litigation matter which was settled in the first quarter of 2009.

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*Research and Development.* Research and development expenses are comprised primarily of personnel costs for our engineering and design staff and the cost of prototype supplies. Research and development expenses were \$6.6 million in the third quarter of 2009, compared to \$5.7 million in the third quarter of 2008. Research and development expenses as a percentage of revenues were 6.6% in the third quarter of 2009 compared to 9.0% in the third quarter of 2008. Research and development expenses increased due primarily to an increase in payroll and payroll-related costs from our expanding global research and development efforts from our facilities in the United States, United Kingdom, Taiwan and Malaysia predominantly related to our Flash product line which includes the advancement of high-performance SSDs.

*Special Charges.* Special charges consist of approximately \$112,000 in employee severance and termination benefits and approximately \$248,000 of asset impairment charges in the third quarter of 2009. There were no special charges during the three months ended September 30, 2008.

During the first quarter of 2009, we commenced a reduction of our workforce primarily at our Santa Ana, California headquarters as part of the transition of certain of our operations to our facility in Penang, Malaysia. This reduction, which mostly impacted our U.S.-based workforce, is expected to be completed by the end of 2009. The majority of the reduction occurred during the first nine months of 2009 and affected 245 employees, including 200 in manufacturing, 20 in sales and marketing, 20 in research and development and 5 in administration. In connection with this reduction in workforce, we recorded a charge of approximately \$112,000 for severance and related costs during the three months ended September 30, 2009. We expect to incur approximately \$50,000 to \$150,000 of additional restructuring costs, consisting primarily of workforce reduction and consolidation of facilities expenses, related to this restructuring plan, which is expected to be completed by the end of 2009. We expect substantially all of the expenses associated with the workforce reduction to result in cash expenditures. Actual amounts and the exact timing of the workforce reductions could differ from these estimates. Future cash payments related to the restructuring plan are not expected to significantly impact our liquidity.

We expect that this restructuring action will reduce annual operating expenses by approximately \$14.4 million, including approximately \$11.4 million in cost of sales, approximately \$1.5 million in sales and marketing expenses, approximately \$850,000 in general and administrative expenses and approximately \$600,000 in research and development expenses. We began to realize cost savings in the second quarter of fiscal year 2009. We expect the cost savings from the restructuring plan to be partially offset by approximately \$7.1 million in incremental cost increases at our foreign subsidiaries, related primarily to manufacturing headcount increases for our Malaysia facility as our operations in Malaysia continue to advance.

In connection with the transition of operations to Malaysia, we conducted an assessment for the impairment of certain property, plant and equipment. During this assessment, certain manufacturing-related property or equipment assets were deemed to be impaired. Carrying values of the assets were adjusted to reflect estimated fair value, which was based on market prices, prices of similar assets, and other available information. We recorded asset impairments totaling \$248,000 during the three months ended September 30, 2009.

*Other Income.* Other income is comprised of interest earned on our cash, cash equivalents and short-term investments. Other income was \$14,000 in the third quarter of 2009 and \$119,000 in the third quarter of 2008. This decrease in other income resulted primarily from a decrease in interest income as a result of lower interest rates in the third quarter of 2009 compared to the third quarter of 2008.

*Provision for Income Taxes.* The provision for income taxes was \$6.0 million and \$1.5 million in the third quarters of 2009 and 2008, respectively. As a percentage of income before provision for income taxes, provision for income taxes decreased from 56.1% in the third quarter of 2008 to 19.6% in the third quarter of 2009 due primarily to the transition of substantially all of our manufacturing operations and our foreign sales to international subsidiaries in lower tax rate jurisdictions. We operate under a tax holiday in Malaysia, which is effective through September 30, 2022. The impact of the Malaysia tax holiday decreased our provision for income taxes by \$649,000 and \$332,000 in the three months ended September 30, 2009 and 2008, respectively. The benefit of the tax holiday on earnings per share was \$0.01 and \$0.01 for the three months ended September 30, 2009 and 2008, respectively.

During the three months ended September 30, 2009, our gross unrecognized tax benefits increased by \$900,000. There was no change in our gross unrecognized tax benefits during the three months ended September 30, 2008.

*Income from Continuing Operations.* Income from continuing operations was \$24.5 million and \$1.2 million in the third quarters of 2009 and 2008, respectively. The increase in income from continuing operations was due primarily to a \$28.4 million increase in gross profit offset by a \$494,000 increase in operating expenses, a \$105,000 decrease in other income and a \$4.5 million increase in the provision for income taxes in the third quarter of 2009 compared to the third quarter of 2008.



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The increase in operating expenses is due primarily to special charges incurred in the third quarter of 2009 related to our restructuring plan, expansion efforts in Asia and Europe, an increase in employee compensation costs, and increased investments in research and development for new Flash products, partially offset by a decrease in legal expenses.

*Income from Discontinued Operations.* As the result of the sale of the assets of our Consumer Division on February 9, 2007, the Consumer Division is reflected as discontinued operations. Income from discontinued operations was \$47,000 in the third quarter of 2008. The income in the third quarter of 2008 is due primarily to a cash settlement on a lawsuit received from a former supplier of hard drive products to our former Consumer Division.

***Comparison of Nine Months Ended September 30, 2009 to Nine Months Ended September 30, 2008***

*Net Revenues.* Our revenues were \$248.2 million in the first nine months of 2009, compared to \$170.5 million in the same period in 2008. Revenues increased 46% in the first nine months of 2009 due primarily to a 110% increase in Flash memory sales and a 222% increase in ASP for Flash products, partially offset by a 57% decrease in sales of DRAM products and a 14% decline in our DRAM ASP. Within Flash memory sales, shipments of our Zeus<sup>IOPS</sup> SSDs into the enterprise-storage market grew to \$144.0 million for the first nine months of 2009, an increase of 339% from \$32.8 million for the first nine months of 2008. The increase in our Flash ASP resulted from increased sales of higher ASP Zeus<sup>IOPS</sup> and MACH8<sup>IOPS</sup> products in the first nine months of 2009, compared to the same period in 2008. The decrease in our DRAM ASP resulted primarily from a decrease in selling prices for DRAM modules. Unit shipments decreased due primarily to declines in sales of our DRAM modules and CompactFlash products, partially offset by sales of our ultra-mobile SSDs. However, going forward, we expect sales of our ultra-mobile SSD products to decline as we continue to focus on growing our higher ASP Zeus<sup>IOPS</sup> and MACH8<sup>IOPS</sup> products.

*Gross Profit.* Our gross profit was \$115.0 million in the first nine months of 2009, compared to \$55.2 million in the same period in 2008. Gross profit as a percentage of revenues was 46.3% in the first nine months of 2009, compared to 32.4% in the first nine months of 2008. Gross profit as a percentage of revenue increased in the first nine months of 2009 due primarily to a shift in product mix toward higher gross profit margin Flash products, partially offset by a \$2.3 million increase in write-downs of our inventory related to obsolescence, excess quantities and declines in market value below our costs.

*Sales and Marketing.* Sales and marketing expenses are primarily comprised of personnel costs and travel expenses for our domestic and international sales and marketing employees, commissions paid to internal salespersons and independent manufacturers' representatives, shipping costs and marketing programs. Sales and marketing expenses were \$15.0 million in the first nine months of 2009, compared to \$14.2 million in the first nine months of 2008. Sales and marketing expenses as a percentage of revenue were 6.0% in the first nine months of 2009, compared to 8.4% in the first nine months of 2008. The increase in sales and marketing expenses in absolute dollars was due to increased commissions related to higher revenues. The decrease in sales and marketing expenses as a percentage of revenues was due primarily to the termination of certain outside manufacturing representative firm commission agreements in the second half of 2008 and the first quarter of 2009. We expect our sales and marketing expenses to increase in absolute dollars as our revenues grow.

*General and Administrative.* General and administrative expenses are primarily comprised of personnel costs for our executive and administrative employees, professional fees and facilities overhead. General and administrative expenses were \$20.4 million in the first nine months of 2009, compared to \$18.0 million in the first nine months of 2008. General and administrative expenses as a percentage of revenues were 8.2% in the first nine months of 2009, compared to 10.6% in the first nine months of 2008. The increase in general and administrative expenses in absolute dollars was due primarily to a \$1.4 million increase in payroll and payroll-related costs, a \$460,000 increase in legal expenses and a \$500,000 loss on impairment of fixed assets. Legal expenses increased primarily as the result of an IP-litigation matter which began in the second quarter of 2008 and was settled in the first quarter of 2009. Payroll and payroll-related costs increased due to higher stock-based compensation and an increase in employee headcount at our Malaysia facility. In the second quarter of 2009, we recorded an asset impairment charge to adjust the carrying value of certain production equipment related to a discontinued product line. The estimated fair value of the assets was based on market prices, prices of similar assets, and other available information.

*Research and Development.* Research and development expenses are comprised primarily of personnel costs for our engineering and design staff and the cost of prototype supplies. Research and development expenses were \$17.5 million in the first nine months of 2009, compared to \$14.9 million in the first nine months of 2008. Research and development expenses as a percentage of revenues were 7.1% in the first nine months of 2009 compared to 8.7% in the first nine months of 2008. Research and development expenses increased due primarily to an increase in payroll and payroll-related costs from our expanding global research and development efforts from our facilities in the United States, United Kingdom, Taiwan and Malaysia predominantly related to our Flash product line which includes the advancement of high-performance SSDs.



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*Special Charges.* Special charges consist of approximately \$1.7 million in employee severance and termination benefits and approximately \$1.8 million of asset impairment charges in the first nine months of 2009. There were no special charges in the first nine months of 2008.

During the first quarter of 2009, we commenced a reduction of our workforce primarily at our Santa Ana, California headquarters as part of the transition of certain of our operations to our facility in Penang, Malaysia as described above. In connection with this reduction in workforce, we recorded a charge of approximately \$1.7 million for severance and related costs during the first nine months of 2009. We expect to incur approximately \$50,000 to \$150,000 of additional restructuring costs as described above.

In connection with the transition of operations to Malaysia, we conducted an assessment for the impairment of certain property, plant and equipment and recorded asset impairments totaling \$1.8 million during the nine months ended September 30, 2009.

*Other Income.* Other income was \$616,000 in the first nine months of 2009 and \$1.3 million in the first nine months of 2008. Other income is comprised of government grant income received from the Malaysian government authority for qualified research and development expenses and interest earned on our cash, cash equivalents and short-term investments. This decrease in other income resulted primarily from by a decrease in interest income as a result of lower interest rates in the first nine months of 2009 compared to the first nine months of 2008, which was partially offset by \$560,000 of government grant income received in the second quarter of 2009.

*Provision for Income Taxes.* The provision for income taxes increased from \$5.1 million in the first nine months of 2008 to \$12.2 million in the first nine months of 2009. As a percentage of income before provision for income taxes, provision for income taxes decreased from 54.2% in the first nine months of 2008 to 20.6% in the first nine months of 2009. The decrease in the effective tax rate for the first nine months of 2009 from the first nine months in 2008 is due primarily to the transition of substantially all of our manufacturing operations and our foreign sales to international subsidiaries in lower tax rate jurisdictions. We operate under a tax holiday in Malaysia, which is effective through September 30, 2022. The impact of the Malaysia tax holiday decreased our provision for income taxes by \$2.2 million and \$678,000 in the nine months ended September 30, 2009 and 2008, respectively. The benefit of the tax holiday on earnings per share was \$0.04 and \$0.01 for the nine months ended September 30, 2009 and 2008, respectively.

During the nine months ended September 30, 2009, our gross unrecognized tax benefits increased by \$1.0 million. There was no change in our gross unrecognized tax benefits during the nine months ended September 30, 2008.

*Income from Continuing Operations.* Income from continuing operations increased from \$4.3 million in the first nine months of 2008 to \$47.0 million in the first nine months of 2009. The increase in income from continuing operations was due primarily to a \$59.8 million increase in gross profit, offset by a \$9.3 million increase in operating expenses, a \$7.1 million increase in the provision for income taxes and a \$698,000 decrease in other income in the first nine months of 2009. The increase in operating expenses was due primarily to special charges incurred in the first nine months of 2009 related to our restructuring plan, expansion efforts in Asia and Europe, an increase in employee compensation costs, higher legal fees, and increased investments in research and development for new Flash products.

*Income from Discontinued Operations.* As the result of the sale of the assets of our Consumer Division on February 9, 2007, the Consumer Division is reflected as discontinued operations. Income (loss) on discontinued operations decreased from income of \$138,000 in the first nine months of 2008 to a loss of \$215,000 in the first nine months of 2009 due primarily to the write off of amounts owed to us under the original purchase as loss from discontinued operations in the first quarter of 2009, partially offset by a cash settlement on a lawsuit received in 2008 from a former supplier of hard drive products to our former Consumer Division.

## ***Liquidity and Capital Resources***

### ***Working Capital, Cash and Short-term Investments***

As of September 30, 2009, we had working capital of \$199.9 million, including \$122.9 million of cash and cash equivalents, compared to working capital of \$126.6 million, including \$33.4 million of cash and cash equivalents as of December 31, 2008 and working capital of \$133.0 million, including \$29.4 million of cash and cash equivalents as of September 30, 2008. Current assets were 7.5 times current liabilities at September 30, 2009, compared to 6.4 times current liabilities at December 31, 2008, and 5.1 times current liabilities at September 30, 2008.



**Table of Contents***Cash Provided by Operating Activities in the Nine Months Ended September 30, 2009*

Net cash provided by operating activities was \$84.7 million for the nine months ended September 30, 2009 and resulted primarily from a \$28.4 million decrease in inventory, a \$7.6 million decrease in other assets, a \$4.1 million increase in accrued and other liabilities, a \$3.2 million increase in accounts payable, net income of \$46.8 million, non-cash stock-based compensation expense of \$3.2 million, non-cash depreciation and amortization of \$8.9 million, and non-cash special charges and impairment loss of \$2.2 million, which were partially offset by \$9.9 million of excess tax benefits from share-based payment arrangements and a \$8.3 million increase in accounts receivable, net of reserves. Inventory decreased primarily due to an increase in sales in the first nine months of 2009, compared to the same period in 2008. In 2008 we had increased our purchases of Flash inventory in anticipation of increased production volumes for SSD products based on customer forecast and orders related to new product launches set for 2009. Accounts payable increased as a result of higher inventory purchases in the three months ended September 30, 2009 compared to the three months ended December 31, 2008. Other assets decreased due primarily to a decrease in income taxes receivable. Accrued and other liabilities increased due primarily to increases in accrued commissions and sales incentives as a result of higher sales in the third quarter of 2009, compared to the fourth quarter of 2008. Accounts receivable, net of reserves, increased due primarily to an increase in sales in the third quarter of 2009, compared to the fourth quarter of 2008. Other assets increased due primarily to an increase in prepaid expenses.

*Cash Used in Investing Activities for the Nine Months Ended September 30, 2009*

Net cash used in investing activities was \$14.6 million for the nine months ended September 30, 2009 resulting primarily from a \$10.0 million net increase in short-term investments and \$4.8 million in purchases of property, plant and equipment primarily related to production equipment for manufacturing.

As of September 30, 2009, we have made capital expenditures of approximately \$36 million for our Malaysia facility primarily related to building construction costs, acquisition of land and purchases of production equipment. We estimate that total investments in land, facilities and capital equipment will be approximately \$17 million over the next five years ending September 30, 2014. We expect that the substantial majority of these estimated investments will relate to our Malaysia facility.

*Cash Provided by Financing Activities for the Nine Months Ended September 30, 2009*

Net cash provided by financing activities was \$19.4 million for the nine months ended September 30, 2009 and resulted from \$9.5 million in proceeds realized from the exercise of stock options and a \$9.9 million tax benefit from employee stock option exercises and vestings of restricted stock units.

From time to time our board of directors has authorized various programs to repurchase shares of our common stock depending on market conditions and other factors. In November 2008, our board of directors authorized a share repurchase program effective November 19, 2008 enabling us to repurchase up to \$10 million of our common stock over an 18-month period expiring on May 18, 2010. At September 30, 2009, \$5.0 million was still authorized for the repurchase of shares under this plan. We did not make any share repurchases in the nine months ended September 30, 2009.

On July 30, 2008, we entered into an agreement for a \$35 million two-year senior unsecured revolving credit facility (the Credit Facility) with Wachovia Bank, National Association (Wachovia). Borrowings under the Credit Facility will bear interest at a floating rate equivalent to, at our option, either (i) LIBOR plus 0.70% 1.20% depending on our leverage ratio at each quarter end or (ii) Wachovia's prime rate, announced from time to time, less 1.00% 1.50% depending on our leverage ratio at each quarter end. The Credit Facility is guaranteed by certain of our domestic subsidiaries. In addition, if we make a loan to any of our foreign subsidiaries, we have agreed to pledge to Wachovia our intercompany note from such foreign subsidiary. The Credit Facility agreement contains customary affirmative and negative covenants, some of which require the maintenance of specified leverage and minimum liquidity ratios. We were subject to a maximum leverage ratio of 2.0 to 1.0 for the quarter ended September 30, 2009, and a minimum liquidity ratio of 1.0 to 5.0 through September 30, 2009. The Credit Facility matures on July 30, 2010. As of September 30, 2009, there were no borrowings outstanding under our Credit Facility with Wachovia. As of September 30, 2009, we were in compliance with all required covenants. Our leverage and minimum liquidity ratios for the three months ended September 30, 2009 were 0.0 and 4.02, respectively. The Credit Facility will be used to maintain liquidity and fund working capital requirements, on an as needed basis.

We believe that our existing assets, cash and cash equivalents and investments on hand, together with amounts available under our \$35 million credit facility and cash that we expect to generate from our operations, will be sufficient to meet our capital needs for at least the next 12 months; however, it is possible that we may need or elect to raise additional funds to fund our activities beyond the next year to provide additional working capital if our revenues increase substantially, to expand our international operations or to consummate acquisitions of other businesses, products or technologies. We could raise such funds by selling more stock to the public or to selected investors, or by borrowing

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money. In addition, even though we may not need additional funds, we may still elect to sell additional equity securities or obtain credit facilities for other reasons. There can be no assurance that we will be able to obtain additional funds on commercially favorable terms, or at all. If we raise additional funds by issuing additional equity or convertible debt securities, the holdings of existing shareholders would be diluted. In addition, the equity or debt securities that we issue may have rights, preferences or privileges senior to those of the holders of our common stock.

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On August 3, 2009, we filed a universal shelf registration statement with the SEC that became effective upon filing. The shelf registration statement permits us, from time to time, to sell, in one or more public offerings, shares of common stock, shares of preferred stock, debt securities, depositary shares, warrants, stock purchase contracts, stock purchase units, or any combination of such securities. The terms of any such future offerings by us would be established at the time of the offering.

We determine our future capital and operating requirements and liquidity based, in large part, upon our projected financial performance, and we regularly review and update these projections due to changes in general economic conditions, our current and projected operating and financial results, the competitive landscape and other factors. Although we believe we have sufficient capital to fund our activities for at least the next twelve months, our future capital requirements may vary materially from those now planned. The amount of capital that we will need in the future will depend on many factors, including:

general economic and political conditions and specific conditions in the markets we address, including the continuing volatility in the technology sector and semiconductor industry, and the current global economic recession;

the inability of certain of our customers who depend on credit to have access to their traditional sources of credit to finance the purchase of products from us, particularly in the current global economic environment, which may lead them to reduce their level of purchases or to seek credit or other accommodations from us;

whether our revenues increase substantially;

our relationships with suppliers and customers;

the market acceptance of our products;

expansion of our international business, including the opening of offices and facilities in foreign countries;

price discounts on our products to our customers;

our pursuit of strategic transactions, including acquisitions, joint ventures and capital investments;

our business, product, capital expenditure and research and development plans and product and technology roadmaps;

the levels of inventory and accounts receivable that we maintain;

our entrance into new markets;

capital improvements to new and existing facilities;

technological advances; and

competitors' responses to our products.

***Contractual Obligations and Off Balance Sheet Arrangements***

Other than lease commitments incurred in the normal course of business (see Contractual Obligation table below), we do not have any material off-balance sheet financing arrangements or liabilities, guarantee contracts, retained or contingent interests in transferred assets, or any obligation arising out of a material variable interest in an unconsolidated entity. We do not have any majority-owned subsidiaries that are not included in the consolidated financial statements. Additionally, we do not have any interest in, or relationship with, any special purpose entities.

In the ordinary course of business, we may provide indemnifications of varying scope and terms to customers, vendors, lessors, business partners and other parties with respect to certain matters, including, but not limited to, losses arising out of our breach of such agreements, services to be provided by us, or from intellectual property infringement claims made by third parties. In addition, we have entered into indemnification agreements with our directors and certain of our officers that will require us, among other things, to indemnify them against certain liabilities that may arise by reason of their status or service as directors or officers. We maintain director and officer insurance, which may cover certain liabilities arising from our obligation to indemnify our directors and officers in certain circumstances. It is not possible to determine the maximum potential amount under these indemnification agreements due to the limited history of prior indemnification claims and the unique facts and circumstances involved in each particular agreement. Such indemnification agreements may not be subject to maximum loss clauses. Historically, we have not incurred material costs as a result of obligations under these agreements. Set forth in the table below is our estimate of our significant contractual obligations at September 30, 2009 (in thousands).

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Contractual Obligations	Total	Payment due by period			
		Less than 1 year	1-3 years	3-5 years	More than 5 years
Operating lease obligations	\$ 5,330	\$ 789	\$ 1,433	\$ 1,289	\$ 1,819
Non-cancelable capital equipment purchase commitments	1,261	1,261			
Non-cancelable inventory purchase commitments	6,859	6,859			
Other non-cancelable purchase commitments	1,093	1,093			
<b>Total</b>	<b>\$ 14,543</b>	<b>\$ 10,002</b>	<b>\$ 1,433</b>	<b>\$ 1,289</b>	<b>\$ 1,819</b>

**Inflation**

Inflation was not a material factor in either revenue or operating expenses during each of the first nine months ended September 30, 2009 and 2008.

**Critical Accounting Policies and Estimates**

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America ( GAAP ). The preparation of these financial statements requires us to make estimates and judgments that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses for each period. Information with respect to our critical accounting policies which we believe could have the most significant effect on our reported results and require subjective or complex judgments is contained in the notes to the consolidated financial statements in the Annual Report on Form 10-K for the fiscal year ended December 31, 2008. There have been no significant changes in our critical accounting policies and estimates during the nine months ended September 30, 2009 as compared to what was previously disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2008.

**New Accounting Pronouncements**

In June 2009, the Financial Accounting Standards Board ( FASB ) established the FASB Accounting Standards Codification<sup>TM</sup> ( Codification ) as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of financial statements in conformity with GAAP. Recognition of the Codification in financial statements is effective for interim and annual periods ending after September 15, 2009. The impact in our financial statements was only to references for accounting guidance.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK****Interest Rate Risk**

At September 30, 2009, our cash and cash equivalents and short-term investments were \$132.9 million invested in certificates of deposit, U.S. treasury bills, money market funds and other interest bearing accounts. Our main investment objectives are the preservation of investment capital and the maximization of after-tax returns on our investment portfolio. Consequently, we invest in the securities that meet high credit quality standards and we limit the amount of our credit exposure to any one issuer. We do not use derivative instruments for speculative or investment purposes.

At any time, fluctuations in interest rates could affect interest earnings on our cash and cash equivalents and short-term investments. We believe that the effect, if any, of reasonably possible near-term changes in interest rates on our financial position, results of operations and cash flows would not be material. Currently, we do not hedge these interest rate exposures. The primary objective of our investment activities is to preserve capital.

In a declining interest rate environment, as short-term investments mature, reinvestment occurs at less favorable market rates. Given the short-term nature of certain investments, the current interest rate environment may negatively impact our investment income.

Current economic conditions have had widespread negative effects on the financial markets. Due to credit concerns and lack of liquidity in the short-term funding markets, we have shifted a larger percentage of our portfolio to U.S. Treasury and other government securities and

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FDIC-insured time deposits, which may negatively impact our investment income, particularly in the form of declining yields.

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The carrying amount, principal maturity and estimated fair value of our cash and cash equivalents and short-term investments as of September 30, 2009 were as follows (in thousands, except percentages):

	Expected Maturity Date		Total	Fair Value 9/30/2009
	Before 10/1/2010	Thereafter		
<b>Cash and cash equivalents:</b>				
Money market funds	\$ 92,929	\$	\$ 92,929	\$ 92,929
Certificates of deposit	15,000		15,000	15,000
U.S. treasury bills	14,996		14,996	14,996
	122,925		122,925	122,925
<b>Short-term investments:</b>				
Certificates of deposit	10,000		10,000	10,000
Total cash and cash equivalents and short-term investments	\$ 132,925	\$	\$ 132,925	\$ 132,925
Weighted average interest rate	0.15%		0.15%	0.15%

We are also exposed to interest rate risks due to the possibility of changing interest rates under our Credit Facility. Borrowings under the Credit Facility will bear interest at a floating rate equivalent to, at our option, either (i) LIBOR plus 0.70% - 1.20% depending on our leverage ratio at each quarter end or (ii) Wachovia's prime rate, announced from time to time, less 1.00% - 1.50% depending on our leverage ratio at each quarter end. The credit facility matures on July 30, 2010. As of September 30, 2009, there were no borrowings outstanding under our credit facility.

**Foreign Currency Exchange Rate Risk**

More than 95% of our international sales are denominated in U.S. dollars. Consequently, if the value of the U.S. dollar increases relative to a particular foreign currency, our products could become relatively more expensive. In addition, we purchase substantially all of our integrated circuit ( IC ) components from local distributors of Japanese, Korean and Taiwanese suppliers. Fluctuations in the currencies of Japan, Korea or Taiwan could have an adverse impact on the cost of our raw materials. To date, we have not entered any derivative instruments to manage risks related to interest rate or foreign currency exchange rates.

**ITEM 4. CONTROLS AND PROCEDURES****Evaluation of Disclosure Controls and Procedures**

An evaluation as of the end of the period covered by this report was carried out under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, of the effectiveness of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) and Rule 15d-15(e) promulgated under the Securities Exchange Act of 1934, as amended (the Exchange Act ). Based on their evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures were effective as of the end of the period.

**Changes in Internal Control Over Financial Reporting**

During the three months ended September 30, 2009, there have not been any changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that have materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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**PART II OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

***Seagate Patent Infringement Lawsuit***

On April 14, 2008, a patent infringement lawsuit was filed in the U.S. District Court, Northern District of California by Seagate Technology LLC, Seagate Technology International, Seagate Singapore International Headquarters Pte. Ltd. and Maxtor Corporation (collectively, "Seagate") alleging that we infringe four of Seagate's patents U.S. Patent Nos. 6,404,647, 6,849,480, 6,336,174 and 7,042,664. On May 1, 2008, Seagate filed an amended complaint asserting that we infringe an additional Seagate patent U.S. Patent No. 5,261,058. The lawsuit sought injunctive relief and unspecified compensatory and treble damages and attorneys' fees for the alleged patent infringement. On February 18, 2009, we, Seagate, and William D. Watkins entered into a Settlement Agreement (the "Settlement Agreement") to dismiss with prejudice their respective claims in the lawsuit. Pursuant to the Settlement Agreement, the parties jointly filed a stipulated order of dismissal with prejudice with the court on February 18, 2009. Under the terms of the Settlement Agreement, the parties also agreed to release each other from liability for all claims asserted by the other in the lawsuit, with each party bearing its own fees and costs incurred in connection with the lawsuit. As part of the dismissal, no money was exchanged and neither party licensed its technology to the other.

**ITEM 1A. RISK FACTORS**

*Our business, operating results and cash flows can be impacted by a number of factors, any one of which could cause our actual results to vary materially from recent results or from our anticipated future results. The descriptions below include any material changes to and supersede the description of the risk factors affecting our business previously disclosed in Part I, Item 1A. Risk Factors of our Annual Report on Form 10-K for the fiscal year ended December 31, 2008. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also impair our business operations.*

***Risks related to our business***

**Sales to a limited number of customers, particularly EMC Corporation, represent a significant portion of our revenues and the loss of any key customer could materially reduce our revenues.**

Historically, sales to a relatively limited number of customers have accounted for a significant percentage of our revenues. In 2008 and the nine months ended September 30, 2009, sales to our ten largest customers accounted for an aggregate of 77.2% and 83.9%, respectively, of our total revenues. Of these amounts, EMC Corporation, which is currently our largest customer, accounted for 15.2% and 37.9%, respectively, of our total revenues. Sales to EMC as a percentage of our total revenues increased to 53.7% in the third quarter of 2009. In future periods, our revenues derived from EMC as a percentage of total revenues may increase and, in any event, we expect sales to EMC will represent a significant percentage of our total revenues for the fiscal year ending December 31, 2009.

In addition, we have received recent indications from this customer that they may have inventory of our Zeus<sup>IOPS</sup> SSDs at the end of 2009 which might carry over into 2010. In an effort to increase the rate of adoption and sales of SSDs, we are planning to implement various marketing and sales incentive programs with several of our customers, including EMC, but there is no guarantee that these programs will be successful.

The industries in which many of our customers compete have experienced, and may continue to experience, consolidation which may result in increased customer concentration and/or the loss of customers. In addition, the composition of our major customer base changes from quarter to quarter as the market demand for our customers' products changes, and we expect this variability to continue in the future. We expect that sales of our products to a limited number of customers will continue to contribute materially to our revenues in the foreseeable future. The loss of, or a significant reduction in purchases by, any of our major customers could materially harm our business, financial condition and results of operations.

**The market for enterprise Flash-based SSD products is relatively new and evolving, which makes it difficult to forecast end user adoption rates, and customer demand, for our products.**

The enterprise Flash-based SSD market is new and rapidly evolving. As a result, we may encounter risks and uncertainties related to our business and future prospects. It is difficult to predict with any precision end user adoption rates or customer demand for our products or the



future growth rate and size of this market. The rapidly evolving nature of the markets in which we sell our products and services, as well as other factors that are beyond our control, reduce our ability to accurately evaluate our future outlook and forecast quarterly or annual performance.

**Current economic conditions and the global financial crisis may have an impact on our business and financial condition in ways that we currently cannot predict.**

Our operations and performance depend in part on worldwide economic conditions and their impact on levels of spending on information technology. As a result in the recent downturn in global economic activity, spending on information technology has deteriorated significantly in the United States and many other countries and regions, and may remain depressed for the foreseeable future. Uncertainty in the financial and credit markets have caused many of our customers to postpone or cancel purchases, and continued uncertainty may reduce future sales of our products and services. For example, during the fourth quarter of 2008 we experienced the cancellation of previously anticipated orders that negatively affected our revenues and operating results. These worldwide economic conditions make it extremely difficult for our customers, our vendors and us to accurately forecast and plan future business activities, and they could cause our customers to further reduce or slow spending on our products, which would delay and lengthen sales cycles. Furthermore, during challenging economic times our customers may face issues gaining timely access to sufficient credit, which could result in an impairment of their ability to make timely payments to us. If that were to occur, we may

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experience increased collection times or write-offs, which could have a material adverse effect on our revenues and cash flow. Similarly, our vendors may face issues gaining timely access to sufficient credit, which could result in an impairment of their ability to supply us with components that are needed in the manufacture of our products. If that were to occur, we may experience delays in our production and increased costs associated with our qualification of additional new vendors and replacement of their components, which could have a material adverse effect on our revenues and cash flow. Finally, our ability to access the capital markets may be restricted at a time when we would like, or need, to do so, which could have an impact on our flexibility to pursue additional expansion opportunities and maintain our desired level of revenue growth in the future. These and other economic factors could have a material adverse effect on demand for our products and services and on our financial condition and operating results.

**Disruption of operations at our manufacturing facilities in Penang, Malaysia would substantially harm our business.**

Substantially all of our manufacturing operations are located in Penang, Malaysia. Due to this geographic concentration, a disruption of our manufacturing operations, whether as a result of sustained process abnormalities, human error, government intervention or natural disasters, including earthquakes, power failures, fires or floods, or otherwise, could cause us to cease or limit our manufacturing operations which would harm our business, financial condition and results of operations.

**Our dependence on a small number of suppliers for components, including integrated circuit devices, and inability to obtain a sufficient supply of these components on a timely basis could harm our ability to fulfill orders.**

Typically, integrated circuit, or IC, devices represent more than 80% of the component costs of our products. We are dependent on a small number of suppliers that supply key components used in the manufacture of our products. Since we have no long-term supply contracts, there is no assurance that our suppliers will agree to supply the quantities of components we may need to meet our production goals. Samsung currently supplies substantially all of the IC devices used in our Flash memory products. Micron and Samsung currently supply substantially all of the DRAM IC devices used in our DRAM products.

Our customers qualify specific controller, Flash and DRAM ICs that are components in our products as part of the product qualification process. If any of our suppliers experience quality control problems, our products that utilize that supplier's ICs may be disqualified by one or more of our customers. This would disrupt our supply of ICs, reduce the number of suppliers available to us and adversely affect our ability to fulfill our customers' product orders. Further, we may be required to qualify a new supplier's ICs, which could negatively impact our revenues during the new qualification process. There can be no assurance that we would be able to find and successfully qualify new suppliers in a timely manner or obtain ICs from new suppliers on commercially reasonable terms.

Moreover, from time to time, our industry experiences shortages in IC devices and foundry services which have resulted in placing their customers, ourselves included, on component allocation. This means that while we may have customer orders, we may not be able to obtain the materials that we need to fill those orders in a timely manner or at competitive prices. As a result, our reputation could be harmed, we may lose business from our customers, our revenues may decline, and we may lose market share to our competitors.

In addition to Flash and DRAM ICs, a number of other components that we use in our products are available from only a single or limited number of suppliers. In the development of our own application specific ICs, or ASICs, we also depend on certain foundry subcontractors to manufacture these ASICs as well as on certain third-party subcontractors to assemble, obtain packaging materials for, and test these ASICs. Our dependence on a small number of suppliers and the lack of any guaranteed sources of supply expose us to several risks, including:

the inability to obtain an adequate supply of components;

price increases, late deliveries and poor component quality;

an unwillingness of a supplier to supply such components to us;

a key supplier's or sub-supplier's inability to access credit necessary to operate its business;

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failure of a key supplier to remain in business or adjust to market conditions;

consolidation among suppliers may result in some suppliers exiting the industry or discontinuing the manufacture of components; or

failure of a supplier to meet our quality, yield or production requirements.

A disruption in or termination of our supply relationship with any of our significant suppliers or our inability to develop relationships with new suppliers, if required, would cause delays, disruptions or reductions in product shipments or require product redesigns which could damage relationships with our customers, could increase our costs or the prices of our products and adversely affect our revenues and business.

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**Ineffective management of inventory levels or product mix, order cancellations, product returns and inventory write-downs could adversely affect our results of operations.**

With certain exceptions, sales of our products are generally made through individual purchase orders and, in certain cases, are made under master agreements governing the terms and conditions of the relationships. Customers may change, cancel or delay orders with limited or no penalties. It is difficult to accurately predict what or how many products our customers will need in the future. Anticipating demand is challenging because our customers face volatile pricing and unpredictable demand for their products and are increasingly focused on cash preservation and tighter inventory management. We have experienced cancellations of orders and fluctuations in order levels from period-to-period, and we expect to continue to experience similar cancellations and fluctuations in the future, which could result in fluctuations in our revenues.

If we are unable to properly monitor, control and manage our inventory and maintain an appropriate level and mix of products to support our customers' needs, we may incur increased and unexpected costs associated with this inventory. If we manufacture products in anticipation of future demand that does not materialize, or if a customer cancels outstanding orders, we could experience an unanticipated increase in our inventory that we may be unable to sell in a timely manner, if at all. For example, in the first six months of 2009, we significantly increased our non-cancelable inventory purchase commitments as a result of the actual and anticipated growth in orders for our Zeus<sup>IOPS</sup> products. If demand does not meet our expectations, we could incur increased expenses associated with writing off excess or obsolete inventory. We also maintain inventory, or hubbing, arrangements with certain of our customers. Pursuant to these arrangements, we deliver products to a customer or a designated third party warehouse based upon the customer's projected needs but do not recognize product revenue unless and until the customer has removed our product from the warehouse to incorporate into its end products. If a customer does not take our products under a hubbing arrangement in accordance with the schedule it originally provided us, our predicted future revenue stream could vary substantially from our forecasts and our results of operations could be materially and adversely affected. Additionally, since we own inventory that is physically located in a third party's warehouse, our ability to effectively manage inventory levels may be impaired, causing our total inventory turns to decrease, which could increase expenses associated with excess and obsolete inventory and negatively impact our cash flow. In addition, while we may not be contractually obligated to accept returned products, we may determine that it is in our best interest to accept returns in order to maintain good relations with our customers. Product returns would increase our inventory and reduce our revenues. Alternatively, we could end up with too little inventory and we may not be able to satisfy demand, which could have a material adverse effect on our customer relationships. Our risks related to inventory management are exacerbated by our strategy of closely matching inventory levels with product demand, leaving limited margin for error. We have had to write-down inventory in the past for reasons such as obsolescence, excess quantities and declines in market value below our costs. These inventory write-downs were \$3.8 million during the fiscal year ended 2008 and \$4.9 million during the nine months ended September 30, 2009.

**Declines in our average sales prices may result in declines in our revenues and gross profit.**

Our industry is competitive and historically has been characterized by declines in average sales prices. Our average sales prices may decline due to several factors, including overcapacity in the worldwide supply of DRAM and Flash memory components as a result of worldwide economic conditions, increased manufacturing efficiencies, implementation of new manufacturing processes and expansion of manufacturing capacity by component suppliers. In the past, overcapacity has resulted in significant declines in component prices, which in turn has negatively impacted our average sales prices, revenues and gross profit. In addition, since a large percentage of our sales are to a small number of customers that are primarily distributors and large OEMs, these customers have exerted, and we expect they will continue to exert, pressure on us to make price concessions. If not offset by increases in volume of sales or the sales of newly-developed products with higher margins, decreases in average sales prices would likely have a material adverse effect on our business and operating results.

**The semiconductor industry is cyclical which could adversely affect our business.**

The semiconductor industry, including the memory markets in which we compete, is highly cyclical and characterized by constant and rapid technological change, rapid product obsolescence and price erosion, evolving standards, and wide fluctuations in product supply and demand. The industry has experienced significant downturns often connected with, or in anticipation of, maturing product cycles of both semiconductor companies and their customers' products and declines in general economic conditions.

These downturns have been characterized by diminished product demand, production overcapacity, high inventory levels and accelerated erosion of average sales prices which have negatively impacted our average sales prices, revenues and earnings. Any future downturns could have a material adverse effect on our business and results of operations.

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In addition, from time to time, our industry experiences shortages in integrated circuit, or IC, devices and foundry services which have resulted in customers for such products and services, including ourselves, on component allocation. This means that while we may have customer orders, we may not be able to obtain the materials that we need to fill those orders in a timely manner or at competitive prices. As a result, our reputation could be harmed, we may lose business from our customers, our revenues may decline, and we may lose market share to our competitors who are not similarly affected.

**We may not be able to maintain or improve our competitive position because of the intense competition in the memory and storage industry.**

We conduct business in an industry characterized by intense competition. We primarily compete with Intel, Samsung, SanDisk, Seagate, Toshiba, Hitachi and Western Digital in connection with the sale of storage products, and Micron, Samsung and SMART Modular in connection with the sale of DRAM products. Our competitors include many large U.S. and international companies that have substantially greater financial, technical, marketing, distribution and other resources, broader product lines, lower cost structures, greater brand recognition and longer-standing relationships with customers and suppliers. As a result, our competitors may be in a better position to influence or respond to new or emerging technologies or standards and to changes in customer requirements than us. Our competitors may also be able to devote greater resources to the development, promotion and sale of products, and may be able to deliver competitive products at a lower price.

In addition, some of our significant suppliers, including Micron and Samsung, are also our competitors, and have the ability to manufacture competitive products at lower costs as a result of their higher levels of integration. We also face competition from current and prospective customers that evaluate our capabilities against the merits of manufacturing products internally. Competition may arise from new and emerging companies or due to the development of cooperative relationships among our current and potential competitors or third parties to increase the ability of their products to address the needs of our prospective customers. We expect our competitors will continue to improve the performance of their current products, reduce their prices and introduce new products that may offer greater performance, or otherwise render our technology or products obsolete or uncompetitive, any of which could cause a decline in sales or loss of market acceptance of our products.

**We may be less competitive if we fail to develop new and enhanced products and introduce them in a timely manner.**

The enterprise-storage, enterprise-server, networking, video-on-demand and military and industrial applications markets are subject to rapid technological change, product obsolescence, frequent new product introductions and enhancements, changes in end-user requirements and evolving industry standards. Our ability to compete in these markets will depend in significant part upon our ability to successfully develop, introduce and sell new and enhanced products on a timely and cost-effective basis, and to respond to changing customer requirements.

We have experienced, and may in the future experience, delays in the development and introduction of new products. These delays would provide a competitor a first-to-market opportunity and allow a competitor to achieve greater market share. Once a customer designs a competitor's product into its product offering, it becomes significantly more difficult for us to sell our products to that customer because changing suppliers involves significant cost, time, effort and risk for the customer. Our product development is inherently risky because it is difficult to foresee developments in technology, anticipate the adoption of new standards, coordinate our technical personnel, and identify and eliminate design flaws. Defects or errors found in our products after commencement of commercial shipments could result in delays in market acceptance of these products. New products, even if first introduced by us, may not gain market acceptance or result in future profitability. Lack of market acceptance for our new products will jeopardize our ability to recoup research and development expenditures, hurt our reputation and harm our business, financial condition and results of operations. In addition, after we have developed a new product, our customers will usually test and evaluate our products. Our customers may need three or more months to test, evaluate and adopt our products and an additional three or more months to begin volume production of equipment that incorporates our products. Even if a customer selects our product to incorporate into its equipment, we have no assurance that the customer will ultimately bring its product to market or that such effort by our customer will be successful.

We may also seek to develop products with new standards for our industry; however, it will take time for these new standards and products to be adopted, for customers to accept and transition to these new products and for significant sales to be generated from them, if this happens at all. Moreover, broad acceptance of new standards or products by customers may reduce demand for our older products. If this decreased demand is not offset by increased demand for our new products, our results of operations could be harmed. We cannot assure you that any new products or standards we develop will be commercially successful.

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**The manufacturing of our products is complex and subject to yield problems, which could decrease available supply and increase costs.**

The manufacture of our Flash controllers, Flash memory products and stacked DRAM products is a complex process, and it is often difficult for companies such as ours to achieve acceptable product yields. Reduced yields could decrease available supply and increase costs. Flash controller yields depend on both our product design and the manufacturing process technology unique to our semiconductor foundry partners. Because low yields may result from either design defects or process difficulties, we may not identify yield problems until well into the production cycle, when an actual product defect exists and can be analyzed and tested. In addition, many of these yield problems are difficult to diagnose and time consuming or expensive to remedy.

**The execution of our growth strategy depends on our ability to retain key personnel, including our executive officers, and to attract qualified personnel.**

Competition for employees in our industry is intense. We have had and may continue to have difficulty hiring the necessary engineering, sales and marketing and management personnel to support our growth. The successful implementation of our business model and growth strategy depends on the continued contributions of our senior management and other key research and development, sales and marketing and operations personnel, including Manouch Moshayedi, our Chief Executive Officer and Chairman of the Board of Directors, Mark Moshayedi, our President, Chief Operating Officer, Chief Technical Officer, Secretary and a Director, and Raymond Cook, our Chief Financial Officer. The loss of any key employee, the failure of any key employee to perform in his or her current position, or the inability of our officers and key employees to expand, train and manage our employee base would prevent us from executing our growth strategy.

During the first quarter of 2009, we commenced a reduction of our workforce primarily at our Santa Ana, California headquarters as part of the transition of certain of our operations to our facility in Penang, Malaysia. This initiative may negatively impact employee morale and our ability to attract, retain and motivate employees. Our inability to attract and retain additional key employees could have an adverse effect on our business, financial condition and results of operations.

**Our efforts to expand our business internationally may not be successful and may expose us to additional risks that may not exist in the United States, which in turn could cause our business and operating results to suffer.**

We sell our products to customers in foreign countries and seek to increase our level of international business activity through the expansion of our operations into select markets, including Asia and Europe. Such strategy may include opening sales offices in foreign countries, the outsourcing of manufacturing operations to third party contract manufacturers, establishing joint ventures with foreign partners, and the establishment of manufacturing operations in foreign countries.

A failure to successfully and timely integrate these operations into our global infrastructure will have a negative impact on our overall operations, cause us to delay or forego some of the original perceived benefits of operating internationally such as lower average production and engineering labor costs, better access to growing markets in Asia, improved supply chain efficiency, reduced lead times, increased manufacturing efficiency through investments in new state-of-the-art equipment and a lower overall long-term effective tax rate.

Establishing operations in a foreign country or region presents numerous risks, including:

difficulties and costs of staffing and managing operations in certain foreign countries;

foreign laws and regulations, which may vary country by country, and may impact how we conduct our business;

higher costs of doing business in certain foreign countries, including different employment laws;

difficulty protecting our intellectual property rights from misappropriation or infringement;

political or economic instability;

changes in import/export duties;

necessity of obtaining government approvals;

trade restrictions;

work stoppages or other changes in labor conditions;

difficulties in collecting of accounts receivables on a timely basis or at all;

taxes;

longer payment cycles and foreign currency fluctuations; and

seasonal reductions in business activity in some parts of the world, such as Europe.

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In addition, changes in policies and/or laws of the United States or foreign governments resulting in, among other things, higher taxation, currency conversion limitations, restrictions on fund transfers or the expropriation of private enterprises, could reduce the anticipated benefits of our international expansion. Moreover, as a result of our international operations, we are subject to tax in multiple jurisdictions. If any taxing authority (in the United States or otherwise) were to successfully challenge our interpretation of the applicable tax laws or our determination of the income and expenses attributable to operations in a specific jurisdiction, we could be required to pay additional taxes, interest and penalties. Furthermore, any actions by countries in which we conduct business to reverse policies that encourage foreign trade or investment could adversely affect our business. If we fail to realize the anticipated revenue growth of our future international operations, our business and operating results could suffer.

We expect that our strategy to expand our international operations will require the expenditure of significant resources and involve the efforts and attention of our management. Unlike some of our competitors, we have limited experience operating our business in foreign countries. Some of our competitors may have substantial advantage over us in attracting customers in certain foreign countries due to earlier established operations in that country, greater knowledge with respect to cultural differences of customers residing in that country and greater brand recognition and longer-standing relationships with customers in that country. If our international expansion efforts in any foreign country are unsuccessful, we may decide to cease these foreign operations, which would likely harm our reputation and cause us to incur expenses and losses.

### **We face risks associated with doing business in foreign countries, including foreign currency fluctuations and trade barriers, that could lead to a decrease in demand for our products or an increase in the cost of the components used in our products.**

The volatility of general economic conditions and fluctuations in currency exchange rates affect the prices of our products and the prices of the components used in our products. International sales, which are derived from billings to foreign customers, accounted for 26.3%, 50.9% and 49.4% of our revenues for 2008 and the three and nine months ended September 30, 2009, respectively. During the three months ended September 30, 2009, 25.0% of our revenues were derived from billings to customers in the Czech Republic. During the nine months ended September 30, 2009, 9.8%, 10.0% and 10.7% of our revenues were derived from billings to customers in the Czech Republic, Singapore and Taiwan, respectively. For 2008 and the three and nine months ended September 30, 2009, more than 95% of our international sales were denominated in U.S. dollars, and if the U.S. dollar experiences significant appreciation relative to the currency of a specific country, the prices of our products will rise in such country and our products may be less competitive. In addition, we cannot be sure that our international customers will continue to be willing to place orders denominated in U.S. dollars. If they do not, our revenues and results of operations will be subject to foreign exchange fluctuations, which could harm our business. We do not hedge against foreign currency exchange rate risks.

In addition, we purchase a majority of the Flash and DRAM components used in our products from local distributors of foreign suppliers. Although our purchases of Flash and DRAM components are currently denominated in U.S. dollars, devaluation of the U.S. dollar relative to the currency of a foreign supplier would likely result in an increase in our cost of Flash and DRAM components.

Our international sales are subject to other risks, including regulatory risks, tariffs and other trade barriers, timing and availability of export licenses, political and economic instability, difficulties in accounts receivable collections, difficulties in managing distributors, lack of a significant local sales presence, difficulties in obtaining governmental approvals, compliance with a wide variety of complex foreign laws and treaties and potentially adverse tax consequences. In addition, the United States or foreign countries may implement quotas, duties, taxes or other charges or restrictions upon the importation or exportation of our products, leading to a reduction in sales and profitability in that country.

### **We are involved from time to time in claims and litigation over intellectual property rights, which may adversely affect our ability to manufacture and sell our products.**

The semiconductor industry is characterized by vigorous protection and pursuit of intellectual property rights. We believe that it may be necessary, from time to time, to initiate litigation against one or more third parties to preserve our intellectual property rights. Some of our suppliers and licensors have generally agreed to provide us with various levels of intellectual property indemnification for products and technology we purchase or license from them. A third party could claim that our products infringe or contribute to the infringement of a patent or other proprietary right. In addition, from time to time, we have received, and may continue to receive in the future, notices that claim we have infringed upon, misappropriated or misused other parties' proprietary rights. Any of the foregoing events or claims could result in litigation. Such litigation, whether as plaintiff or defendant, would likely result in significant expense to us and divert the efforts of our technical and management personnel, whether or not such litigation is ultimately determined in our favor. In the event of an adverse result in such litigation, we could be required to pay substantial damages, cease the manufacture, use and sale of certain products, expend significant resources to develop, license or acquire non-infringing technology, discontinue the use of certain processes or obtain licenses to use the infringed technology. In addition, our suppliers and licensors





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obligation to indemnify us for intellectual property infringement may be insufficient or inapplicable to any such litigation or other claims of intellectual property infringement. A license may not be available on commercially reasonable terms, if at all. Our failure to obtain a license on commercially reasonable terms, or at all, could cause us to incur substantial costs and suspend manufacturing products using the infringed technology. If we obtain a license, we would likely be required to pay license fees or make royalty payments for sales under the license. Such payments would increase our costs of revenues and reduce our gross margins and gross profit. If we are unable to obtain a license from a third party for technology, we could incur substantial liabilities or be required to expend substantial resources redesigning our products to eliminate the infringement. There can be no assurance that we would be successful in redesigning our products or that we could obtain licenses on commercially reasonable terms, if at all. Product development or license negotiating would likely result in significant expense to us and divert the efforts of our technical and management personnel.

### **Our indemnification obligations for the infringement by our products of the intellectual property rights of others could require us to pay substantial damages.**

As is common in the industry, we currently have in effect a number of agreements in which we have agreed to defend, indemnify and hold harmless our customers and suppliers from damages and costs which may arise from the infringement by our products and services of third-party patents, trademarks or other proprietary rights. The scope of such indemnity varies, but may, in some instances, include indemnification for damages and expenses, including attorneys' fees. Our insurance does not cover intellectual property infringement. The term of these indemnification agreements is generally perpetual any time after execution of the agreement. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited. We may periodically have to respond to claims and litigate these types of indemnification obligations. Any such indemnification claims could require us to pay substantial damages that may result in a material adverse effect on our business and results of operations.

### **Our indemnification obligations to our customers and suppliers for product defects could require us to pay substantial damages.**

A number of our product sales and product purchase agreements provide that we will defend, indemnify and hold harmless our customers and suppliers from damages and costs which may arise from product warranty claims or claims for injury or damage resulting from defects in our products. We maintain insurance to protect against certain claims associated with the use of our products, but our insurance coverage may not be adequate to cover all or any part of the claims asserted against us. A successful claim brought against us that is in excess of, or excluded from, our insurance coverage could substantially harm our business, financial condition and results of operations.

### **Our intellectual property may not be adequately protected, which could harm our competitive position.**

Our intellectual property is critical to our success. As of October 23, 2009, we had 19 patents issued and in force and 62 patent pending applications. We protect our intellectual property rights through patents, trademarks, copyrights and trade secret laws, confidentiality procedures and employee disclosure and invention assignment agreements. It is possible that our efforts to protect our intellectual property rights may not:

prevent the challenge, invalidation or circumvention of our existing patents;

result in patents that lead to commercially viable products or provide competitive advantages for our products;

prevent our competitors from independently developing similar products, duplicating our products or designing around the patents owned by us;

prevent third-party patents from having an adverse effect on our ability to do business;

provide adequate protection for our intellectual property rights;

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prevent disputes with third parties regarding ownership of our intellectual property rights;

prevent disclosure of our trade secrets and know-how to third parties or into the public domain; and

result in patents from any of our pending applications

In addition, despite our efforts to protect our intellectual property rights and confidential information, third parties could copy or otherwise obtain and make unauthorized use of our technologies or independently develop similar technologies. In addition, if any of our patents are challenged and found to be invalid, our ability to exclude competitors from making, using or selling the same or similar products related to such patents would cease. From time to time, we receive letters from third parties suggesting that some or all of our products may be covered by third party patents. In each instance, our management determines whether the letters have sufficient justification and specificity to require or permit a response. When they believe it appropriate to do so, our management seeks advice of counsel in these matters.

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We further have on at least one occasion applied for and may in the future apply for patent protection in foreign countries. The laws of foreign countries, however, may not adequately protect our intellectual property rights. Many U.S. companies have encountered substantial infringement problems in foreign countries. Because we sell some of our products overseas, we have exposure to foreign intellectual property risks.

### **Incurring indebtedness could adversely affect our cash flow and prevent us from fulfilling our financial obligations.**

On July 30, 2008, we entered into a credit agreement for a \$35 million revolving credit facility. As of the date of the issuance of these financial statements, we do not have outstanding any indebtedness under this credit facility; however, we may incur debt which could have important consequences, such as:

requiring us to dedicate a portion of our cash flow from operations and other capital resources to debt service, thereby reducing our ability to fund working capital, capital expenditures, and other cash requirements;

increasing our vulnerability to adverse economic and industry conditions;

limiting our flexibility in planning for, or reacting to, changes and opportunities in, our business and industry, which may place us at a competitive disadvantage; and

limiting our ability to incur additional debt on acceptable terms, if at all.

Additionally, if we were to default under our credit agreement and were unable to obtain a waiver for such a default, interest on the obligations would accrue at an increased rate and the lenders could accelerate our obligations under the credit agreement; however, acceleration will be automatic in the case of bankruptcy and insolvency events of default.

Additionally, to the extent we have made intercompany loans to our subsidiaries that have required us to pledge such loans to the lenders under the credit agreement, our subsidiaries would be required to pay the amount of the intercompany loans to the lenders in the event we are in default under the credit agreement. Any actions taken by the lenders against us in the event we are in default under the credit agreement could harm our financial condition. Finally, the credit facility contains certain restrictive covenants, including provisions restricting our ability to incur additional indebtedness, guarantee certain obligations, create or assume liens and pay dividends.

### **Failure to maintain effective internal control over financial reporting could result in a negative market reaction.**

Section 404 of the Sarbanes-Oxley Act of 2002 requires that we undertake a thorough examination of our internal control systems and procedures for financial reporting. We also are required to completely document and test those systems. Section 404 of the Sarbanes-Oxley Act of 2002 requires us to evaluate the effectiveness of our internal control over financial reporting as of the end of each year, and to include a management report assessing the effectiveness of our internal control over financial reporting in our annual reports. Section 404, as updated, also requires our independent registered public accounting firm to annually attest to, and report on, the effectiveness of our internal control over financial reporting.

Although our management has determined, and our independent registered public accounting firm has attested, that our internal control over financial reporting was effective as of December 31, 2008, we cannot assure you that we or our independent registered public accounting firm will not identify a material weakness in our internal controls in the future. If our internal control over financial reporting is not considered adequate, we may experience a loss of public confidence, which could have an adverse effect on our business and our stock price.

### **We may make acquisitions that are dilutive to existing shareholders, result in unanticipated accounting charges or otherwise adversely affect our results of operations.**

We intend to grow our business through business combinations or other acquisitions of businesses, products or technologies that allow us to complement our existing product offerings, expand our market coverage, increase our engineering workforce or enhance our technological capabilities. If we make any future acquisitions, we could issue stock that would dilute our shareholders' percentage ownership, incur substantial debt, reduce our cash reserves or assume contingent liabilities. Furthermore, acquisitions may require material infrequent charges and could

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result in adverse tax consequences, substantial depreciation, deferred compensation charges, in-process research and development charges, the amortization of amounts related to deferred compensation and identifiable purchased intangible assets or impairment of goodwill, any of which could negatively impact our results of operations.

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**Our limited experience in acquiring other businesses, product lines and technologies may make it difficult for us to overcome problems encountered in connection with any acquisitions we may undertake.**

We continually evaluate and explore strategic opportunities as they arise, including business combinations, strategic partnerships, capital investments and the purchase, licensing or sale of assets. Our experience in acquiring other businesses, product lines and technologies is limited. The attention of our management team may be diverted from our core business if we undertake any future acquisitions. Any potential future acquisition involves numerous risks, including, among others:

problems or delays in successfully closing the acquisition;

problems and delays assimilating and integrating the purchased operations, personnel, technologies, products and information systems;

unanticipated costs and expenditures associated with the acquisition, including any need to infuse significant capital into the acquired operations;

adverse effects on existing business relationships with suppliers, customers and strategic partners;

risks associated with entering markets and foreign countries in which we have no or limited prior experience;

contractual, intellectual property or employment issues;

potential loss of key employees of purchased organizations; and

potential litigation arising from the acquired company's operations before the acquisition.

These risks could disrupt our ongoing business, distract our management and employees, harm our reputation and increase our expenses. Our inability to overcome problems encountered in connection with any acquisition could divert the attention of management, utilize scarce corporate resources and otherwise harm our business. These challenges are magnified as the size of an acquisition increases, and we cannot assure you that we will realize the intended benefits of any acquisition.

We are unable to predict whether or when any prospective acquisition candidate will become available or the likelihood that any acquisition will be completed. Even if we do find suitable acquisition opportunities, we may not be able to consummate the acquisitions on commercially acceptable terms or realize the anticipated benefits of any acquisitions we do undertake.

**Failure to comply with governmental laws and regulations could harm our business.**

Our business is subject to regulation by various U.S. federal, state, local and foreign governmental agencies. Such regulation includes employment and labor laws, workplace safety, product safety, environmental laws, consumer protection laws, import/export controls and tax. In certain jurisdictions, such regulatory requirements may be more stringent than in the United States. Noncompliance with applicable regulations or requirements could subject us to investigations, sanctions, mandatory product recalls, enforcement actions, disgorgement of profits, fines, damages, civil and criminal penalties, or injunctions. These enforcement actions could harm our business, financial condition, results of operations and cash flows. If any governmental sanctions are imposed, or if we do not prevail in any possible civil or criminal litigation, our business, financial condition, results of operations and cash flows could be materially adversely affected. In addition, responding to any action will likely result in a significant diversion of management's attention and resources and an increase in professional fees.

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We also may be required to meet and adjust to evolving environmental requirements relating to the materials composition of our products. As environmental requirements change, for some products, substituting particular components with conforming components to meet new environmental standards may prove to be difficult or costly, and additional redesign efforts could result in production delays. Our operations may be affected by significant changes to existing or new environmental laws and regulations. Although we cannot predict the ultimate impact of any such new laws and regulations, they may result in additional costs or decreased revenue, which could have a material adverse effect on our business.

In addition from time to time we have received, and expect to continue to receive, correspondence from former employees terminated by us who threaten to bring claims against us alleging that we have violated one or more labor and employment regulations. In certain of these instances, the former employees have brought claims against us and we expect that we will encounter similar actions against us in the future. An adverse outcome in any such litigation could require us to pay contractual damages, compensatory damages, punitive damages, attorneys' fees and costs.

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**Changes in the applicable tax laws could materially affect our future results.**

Because we operate in different countries and are subject to taxation in different jurisdictions, our future effective tax rates could be impacted by changes in the applicable tax laws of such jurisdictions or the interpretation of such tax laws. For example, on May 5, 2009, President Obama and the U.S. Treasury Department proposed changing certain tax rules for U.S. corporations doing business outside the United States. The proposed changes would restrict the ability of U.S. corporations to transfer funds between foreign subsidiaries without triggering U.S. income tax, limit the ability of U.S. corporations to deduct expenses attributable to un-repatriated foreign earnings and modify the foreign tax credit rules. These changes have been proposed to be effective beginning January 1, 2011. We cannot determine whether these proposals will be enacted into law or what changes, if any, may be made to such proposals prior to their being enacted into law. Depending on their content, such proposals (if enacted) or other changes in the applicable tax laws could increase our effective tax rate and adversely affect our after-tax profitability.

***Risks related to our common stock***

**Two of our beneficial shareholders are our largest shareholders and are executives and directors of our company and their interests may diverge from other shareholders.**

Manouch Moshayedi and Mark Moshayedi are brothers who (along with a third brother Mike Moshayedi) founded our company. They have owned a substantial amount of shares since our inception and prior to our initial public offering in 2000. As of October 16, 2009, Manouch Moshayedi and Mark Moshayedi beneficially owned approximately 17.1% of our outstanding common stock (assuming the inclusion of shares of common stock subject to options that are exercisable within 60 days). As shareholders, Manouch Moshayedi and Mark Moshayedi may have interests that diverge from those of other holders of our common stock. In addition, Manouch Moshayedi and Mark Moshayedi are executive officers and directors. As a result, they have the potential ability to control or influence all matters requiring approval by our shareholders, including approval of significant corporate transactions and the decision of whether a change in control will occur. This potential control could affect the price that certain investors may be willing to pay in the future for shares of our common stock.

**Certain provisions in our charter documents and stock option plan could prevent or delay a change in control and, as a result, negatively impact our shareholders.**

We have taken a number of actions that could have the effect of discouraging a takeover attempt. For example, provisions of our articles of incorporation and bylaws could make it more difficult for a third party to acquire us, even if doing so would be beneficial to our shareholders. These provisions also could limit the price that certain investors might be willing to pay in the future for shares of our common stock.

These provisions include:

limitations on who may call special meetings of shareholders;

advance notice requirements for nominations for election to the board of directors or for proposing matters that can be acted upon by shareholders at shareholder meetings;

elimination of cumulative voting in the election of directors;

the right of a majority of directors in office to fill vacancies on the board of directors; and

the ability of our board of directors to issue, without shareholder approval, blank check preferred stock to increase the number of outstanding shares and thwart a takeover attempt.





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In addition, provisions of our 2000 Stock Incentive Plan allow for the automatic vesting of all outstanding equity awards granted under the 2000 Stock Incentive Plan upon a change in control under certain circumstances. Such provisions may also have the effect of discouraging a third party from acquiring us, even if doing so would be beneficial to our shareholders.

### **Our stock price is likely to be volatile, which could cause the value of your investment to decline.**

Our common stock has been publicly traded since September 2000. The market price of our common stock has been subject to significant fluctuations since the date of our initial public offering. The stock market has from time to time experienced significant price and volume fluctuations that have affected the market prices of securities, particularly securities of technology companies. As a result, the market price of our common stock may materially decline, regardless of our operating performance. In the past, following periods of volatility in the market price of a particular company's securities, securities class action litigation has often been brought against that company. We may become involved in this type of litigation in the future. Litigation of this type is often expensive and diverts management's attention and resources.

### **We expect our quarterly operating results to fluctuate in future periods, causing our stock price to fluctuate or decline.**

Our quarterly operating results have fluctuated in the past, and we believe they will continue to do so in the future. Some of these fluctuations may be more pronounced than they were in the past due to the uncertain current global economic environment. Fluctuations in our operating results may be due to a number of factors, including, but not limited to, those identified throughout this "Risk Factors" section and the following:

impact of changing and recently volatile U.S. and global economic conditions;

our suppliers' production levels for the components used in our products;

our ability to procure required components;

market acceptance of new and enhanced versions of our products;

expansion of our international business, including the opening by us of offices and facilities in foreign countries;

the timing of the introduction of new products or components and enhancements to existing products or components by us, our competitors or our suppliers;

fluctuations in the cost of components and changes in the average sales prices of our products;

fluctuating market demand for our products;

changes in our customer or product revenue mix;

the loss of one or more of our customers;

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our ability to successfully integrate any acquired businesses or assets;

expenses associated with the start up of new operations or divisions;

order cancellations, product returns, inventory buildups by customers and inventory write-downs;

manufacturing inefficiencies associated with the start-up of new manufacturing operations, new products and volume production;

expenses associated with strategic transactions, including acquisitions, joint ventures and capital investments;

our ability to adequately support potential future rapid growth;

our ability to absorb manufacturing overhead if revenues decline;

the effects of litigation; and

increases in our sales and marketing and research and development expenses in connection with decisions to pursue new product initiatives.

Due to such factors, quarterly revenues and results of operations are difficult to forecast, and period-to-period comparisons of our operating results may not be predictive of future performance. In one or more future quarters, our results of operations may fall below the expectations of securities analysts and investors. In that event, the market price of our common stock would likely decline. In addition, the market price of our common stock may fluctuate or decline regardless of our operating performance.

**Table of Contents****ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS***Issuer Purchases of Equity Securities*

The following is a summary of our common stock repurchased and average price paid per share for the three months ended September 30, 2009:

<b>Period</b>	<b>Total Number of Shares Purchased</b>	<b>Average Price Paid per Share</b>	<b>Total Number of Shares as Part of Publicly Announced Program (1)</b>	<b>Maximum Dollar Value that May Yet be Purchased Under the Program</b>
As of June 30, 2009	1,335,541	\$ 3.74	\$ 4,999,967	\$ 5,000,033
July 1 through July 31, 2009		\$	\$	\$
August 1 through August 31, 2009		\$	\$	\$
September 1 through September 30, 2009		\$	\$	\$
<b>Total</b>	<b>1,335,541</b>	<b>\$ 3.74</b>	<b>\$ 4,999,967</b>	<b>\$ 5,000,033</b>

- (1) In November 2008, our board of directors authorized a share repurchase program effective November 19, 2008 enabling us to repurchase up to \$10 million of our common stock over an 18-month period expiring on May 18, 2010. Repurchases under our share repurchase program was and will be made in open market or privately negotiated transactions in compliance with Rule 10b-18 promulgated under the Securities Exchange Act of 1934, as amended. There is no guarantee as to the exact number of shares that will be repurchased by us, and we may discontinue purchases at any time that management determines that additional purchases are not warranted. Repurchased shares were returned to the status of authorized but unissued shares of common stock and may be issued by us in the future. All shares were purchased pursuant to our existing share repurchase program.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

None.

**ITEM 5. OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS****Exhibit****Number****Description**

31.1 Section 302 Certification of Chief Executive Officer

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- 31.2 Section 302 Certification of Chief Financial Officer
- 32.1\* Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2\* Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

\* The information in Exhibits 32.1 and 32.2 shall not be deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended (the Exchange Act), or otherwise subject to the liabilities of that section, nor shall they be deemed incorporated by reference in any filing under the Securities Act of 1933, as amended, or the Exchange Act (including this Report), unless STEC, Inc. specifically incorporates the foregoing information into those documents by reference.

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

STEC, INC.,

a California corporation

Date: November 3, 2009

/s/ **RAYMOND COOK**  
**Raymond Cook**

**Chief Financial Officer**

**(Principal Financial Officer and Duly Authorized Signatory)**

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**STEC, INC.**

**Index to Exhibits**

**Exhibit**

<b>Number</b>	<b>Description</b>
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