

CREE INC
Form 10-Q
January 25, 2008
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended December 30, 2007

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 0-21154

CREE, INC.

(Exact name of registrant as specified in its charter)

North Carolina
(State or other jurisdiction
of incorporation or organization)

4600 Silicon Drive

56-1572719
(I.R.S. Employer

Identification No.)

27703

Edgar Filing: CREE INC - Form 10-Q

Durham, North Carolina
(Address of principal executive offices)

(Zip Code)

(919) 313-5300

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

Large accelerated filer Accelerated filer Non-accelerated filer

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

The number of shares outstanding of the registrant's common stock, par value \$0.00125 per share, as of January 15, 2008, was 85,610,550.

Table of Contents

CREE, INC.

FORM 10-Q

For the Three and Six Months Ended December 30, 2007

INDEX

	Page No.
<u>PART I. FINANCIAL INFORMATION</u>	
Item 1. <u>Financial Statements</u>	
<u>Consolidated Balance Sheets as of December 30, 2007 (unaudited) and June 24, 2007</u>	3
<u>Consolidated Statements of Income for the three and six months ended December 30, 2007 (unaudited) and December 24, 2006 (unaudited)</u>	4
<u>Consolidated Statements of Cash Flow for the six months ended December 30, 2007 (unaudited) and December 24, 2006 (unaudited)</u>	5
<u>Notes to Consolidated Financial Statements (unaudited)</u>	6
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	15
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	26
Item 4. <u>Controls and Procedures</u>	27
Item 4T. <u>Controls and Procedures</u>	27
<u>PART II. OTHER INFORMATION</u>	
Item 1. <u>Legal Proceedings</u>	27
Item 1A. <u>Risk Factors</u>	28
Item 4. <u>Submission of Matters to a Vote of Security Holders</u>	36
Item 6. <u>Exhibits</u>	37
<u>SIGNATURES</u>	38

Table of Contents**PART I - FINANCIAL INFORMATION****Item 1. Financial Statements****CREE, INC.****CONSOLIDATED BALANCE SHEETS****(In thousands, except per share amounts)**

	December 30, 2007 (Unaudited)	June 24, 2007
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 205,185	\$ 93,881
Short-term investments:		
Held-to-maturity	89,936	132,074
Available-for-sale		16,700
Accounts receivable, net	90,520	79,668
Income tax receivable and prepaid income taxes	3,246	7,947
Inventories, net	75,063	71,068
Deferred income taxes	19,939	23,573
Prepaid expenses and other current assets	10,539	9,221
Total current assets	494,428	434,132
Property and equipment, net	354,252	372,345
Long-term investments, held-to-maturity	66,828	68,363
Intangible assets, net	89,573	96,138
Goodwill	144,334	141,777
Other assets	3,526	3,475
Total assets	\$ 1,152,941	\$ 1,116,230
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable, trade	\$ 36,612	\$ 32,940
Accrued salaries and wages	10,197	10,241
Income taxes payable	6,856	4,504
Other current liabilities	6,784	6,764
Total current liabilities	60,449	54,449
Long-term liabilities:		
Deferred income taxes	36,499	38,758
Contingent tax reserves	5,792	5,792
Other long-term liabilities	173	129
Long-term liabilities of discontinued operations	924	1,103
Total long-term liabilities	43,388	45,782
Shareholders' equity:		
Preferred stock, par value \$0.01; 3,000 shares authorized at December 30, 2007 and June 24, 2007; none issued and outstanding		

Edgar Filing: CREE INC - Form 10-Q

Common stock, par value \$0.00125; 200,000 shares authorized at December 30, 2007 and June 24, 2007; 85,591 and 84,675 shares issued and outstanding at December 29, 2007 and June 24, 2007, respectively	107	106
Additional paid-in-capital	736,242	713,778
Accumulated other comprehensive income, net of taxes	1,168	9,826
Retained earnings	311,587	292,289
Total shareholders' equity	1,049,104	1,015,999
Total liabilities and shareholders' equity	\$ 1,152,941	\$ 1,116,230

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

Table of Contents**CREE, INC.****CONSOLIDATED STATEMENTS OF INCOME****(In thousands, except per share amounts)****(Unaudited)**

	Three Months Ended		Six Months Ended	
	December 30	December 24	December 30	December 24
	2007	2006	2007	2006
Revenue:				
Product revenue, net	\$ 111,341	\$ 81,522	\$ 217,304	\$ 178,940
Contract revenue, net	7,658	7,268	15,081	13,760
Total revenue	118,999	88,790	232,385	192,700
Cost of revenue:				
Product revenue, net	71,251	52,626	143,831	108,499
Contract revenue, net	5,952	5,795	12,018	10,932
Total cost of revenue	77,203	58,421	155,849	119,431
Gross margin	41,796	30,369	76,536	73,269
Operating expenses:				
Research and development	14,901	14,287	27,678	28,653
Sales, general and administrative	18,211	12,576	36,373	24,522
Amortization of acquisition related intangibles	4,048	341	8,096	341
Loss on disposal or impairment of long-lived assets	474	85	1,209	182
Total operating expenses	37,634	27,289	73,356	53,698
Income from operations	4,162	3,080	3,180	19,571
Non-operating income:				
Gain on sale of investments, net		11,409	14,117	11,408
Interest and other non-operating income, net	4,582	3,982	8,309	7,848
Income from continuing operations before income taxes	8,744	18,471	25,606	38,827
Income tax expense	2,104	2,208	6,098	9,197
Income from continuing operations	6,640	16,263	19,508	29,630
Loss (income)from discontinued operations, net of related income tax benefit	(20)	216	(174)	139
Net income	\$ 6,620	\$ 16,479	\$ 19,334	\$ 29,769
Earnings (loss) per share:				
Basic:				
Income from continuing operations	\$ 0.08	\$ 0.21	\$ 0.23	\$ 0.38
(Loss) income from discontinued operations	\$	\$	\$	\$
Net income	\$ 0.08	\$ 0.21	\$ 0.23	\$ 0.38

Edgar Filing: CREE INC - Form 10-Q

Diluted:

Income from continuing operations	\$ 0.08	\$ 0.21	\$ 0.22	\$ 0.38
-----------------------------------	---------	---------	---------	---------

(Loss) income from discontinued operations	\$	\$	\$	\$
--	----	----	----	----

Net income	\$ 0.08	\$ 0.21	\$ 0.22	\$ 0.38
------------	---------	---------	---------	---------

Shares used in per share calculation:

Basic	85,190	76,948	84,936	77,005
-------	--------	--------	--------	--------

Diluted	86,848	78,093	86,713	78,043
---------	--------	--------	--------	--------

The accompanying notes are an integral part of the consolidated financial statements

Table of Contents**CREE, INC.****CONSOLIDATED STATEMENTS OF CASH FLOW****(In thousands)****(Unaudited)**

	Six Months Ended	
	December 30	December 24
	2007	2006
Cash flows from operating activities:		
Net income	\$ 19,334	\$ 29,769
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	49,711	39,790
Stock-based compensation	7,184	6,425
Excess tax benefit from share-based payment arrangements	(1,562)	
Loss on disposal or impairment of long-lived assets	1,209	176
Gain on sale of investment in securities	(14,117)	(11,408)
Amortization of (premium) discount on investments held-to-maturity	(228)	18
Deferred income taxes		(3,635)
Changes in operating assets and liabilities:		
Accounts receivable	(10,702)	5,062
Inventories	(4,263)	(17,808)
Prepaid expenses and other assets	3,442	3,610
Accounts payable, trade	3,166	10,081
Accrued expenses and other liabilities	7,472	(1,042)
Net cash provided by operating activities	60,646	61,038
Cash flows from investing activities:		
Purchase of property and equipment	(21,095)	(60,622)
Purchase of patent and licensing rights	(3,443)	(2,844)
Purchase of INTRINSIC Semiconductor Corporation, net of cash acquired		(43,834)
Purchase of investments	(32,769)	(91,896)
Proceeds from maturities of investments	76,670	129,129
Proceeds from sale of property and equipment	52	67
Proceeds from sale of available-for-sale investments	17,000	16,721
Net cash provided by (used in) investing activities	36,415	(53,279)
Cash flows from financing activities:		
Net proceeds from issuance of common stock	12,849	3,783
Excess tax benefit from share-based payment arrangements	1,562	
Repayments of capital lease obligations		(198)
Repurchase of common stock	(168)	(18,742)
Net cash provided by (used in) financing activities	14,243	(15,157)
Effects of foreign exchange changes on cash and cash equivalents		(32)
Net increase (decrease) in cash and cash equivalents	111,304	(7,430)
Cash and cash equivalents:		
Beginning of period	\$ 93,881	\$ 88,768

Edgar Filing: CREE INC - Form 10-Q

End of period	\$ 205,185	\$ 81,338
Supplemental disclosure of cash flow information:		
Cash paid for income taxes	\$	\$ 12,000

The accompanying notes are an integral part of the consolidated financial statements

Table of Contents

CREE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 30, 2007

(Unaudited)

1. Basis of Presentation

The consolidated balance sheet at December 30, 2007 and the consolidated statements of income for the three and six months ended December 30, 2007 and December 24, 2006, and the consolidated statements of cash flows for the six months ended December 30, 2007 and December 24, 2006 have been prepared by Cree, Inc. (collectively with its subsidiaries, the Company) and have not been audited. In the opinion of management, all normal and recurring adjustments necessary to present fairly the consolidated financial position, results of operations and cash flows at December 30, 2007, and for all periods presented, have been made. The consolidated balance sheet at June 24, 2007 has been derived from the audited financial statements as of that date.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. It is suggested that these financial statements be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended June 24, 2007. The results of operations for the period ended December 30, 2007 are not necessarily indicative of the operating results that may be attained for the entire fiscal year.

2. Accounting Policies

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All material intercompany accounts and transactions have been eliminated in consolidation.

Fiscal Year

The Company's fiscal year is a 52- or 53-week period ending on the last Sunday in the month of June. The Company's 2008 fiscal year extends from June 25, 2007 through June 29, 2008 and is a 53-week fiscal year, with the additional week included in the Company's fiscal second quarter. The Company's 2007 fiscal year extended from June 26, 2006 through June 24, 2007 and was a 52-week fiscal year.

Accounting Changes

In the first quarter of fiscal 2008, the Company adopted Financial Accounting Standards Board (FASB) Interpretation No. 48 Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109, (FIN 48). See Note 10 Income Taxes below for further discussion on the Company's adoption of FIN 48.

Reclassifications

Certain fiscal 2007 amounts in the accompanying consolidated financial statements have been reclassified to conform to the fiscal 2008 presentation. These reclassifications had no effect on previously reported consolidated net income or shareholders' equity.

Table of Contents

Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and the disclosure of contingent assets and liabilities, at December 30, 2007 and June 24, 2007, and the reported amounts of revenues and expenses during the three and six months ended December 30, 2007 and December 24, 2006. Actual amounts could differ from those estimates.

Revenue Recognition

The Company provides its customers with limited rights of return for non-conforming shipments. In addition, certain of the Company's contractual sales arrangements provide for limited product exchanges and the potential for reimbursement of certain sales costs. As a result, the Company records an allowance, which is recorded as a reduction of product revenue in the consolidated statements of income and as a reduction to accounts receivable in the consolidated balance sheets.

The Company estimates its allowance in accordance with the provisions of Statement of Financial Accounting Standards (SFAS) No. 48, Revenue Recognition When Right of Return Exists (SFAS 48). Specifically, the Company reviews historical sales returns and other relevant data and matches returns or other credits to the quarter when the sales were originally recorded. Based on historical return percentages and other relevant factors, the Company estimates its potential future exposure on product sales that have been recorded. The allowance for sales returns at December 30, 2007 and June 24, 2007 was \$4.8 million and \$4.6 million, respectively.

In accordance with SFAS 48, the Company also records an estimate for the value of product returns that it believes will be returned to inventory in the future and resold. As of December 30, 2007 and June 24, 2007, the Company estimated the cost of future product returns at \$1.6 million and \$1.3 million, respectively, which is recorded in prepaid expenses and other current assets in the consolidated balance sheets.

3. Acquisition

On March 30, 2007, Cree, Inc., acquired COTCO Luminant Device Limited, a Hong Kong company (COTCO), from COTCO Holdings Limited, a Hong Kong company (Holdings). The Company acquired all of the outstanding share capital of COTCO in exchange for consideration consisting of 7,604,785 shares of the Company's common stock and \$77 million cash. Additional consideration of up to \$125 million may be payable to Holdings or its designees in the event COTCO achieves specific EBITDA targets over the Company's next two fiscal years. The Company may elect to pay the additional consideration, if any, in cash, shares of the Company's common stock or a combination of cash and stock, so long as the total number of shares of the Company's common stock issued to Holdings relating to the transaction is less than 9.99% of the Company's then outstanding common stock.

This acquisition has been accounted for under the purchase method of accounting as prescribed by SFAS 141, Business Combinations. All related goodwill and other intangible assets have been accounted for in accordance with SFAS 142, Goodwill and Other Intangible Assets. The goodwill associated with the acquisition of COTCO is not expected to be tax deductible.

Table of Contents

The total purchase price for this acquisition is as follows (amounts in 000 s):

Cash Consideration paid to COTCO shareholder	\$ 77,334
Fair value of common stock issued by the Company	126,943
Direct transaction fees and expenses	3,060
 Total purchase price	 \$ 207,337

The purchase price for this acquisition has been preliminarily allocated based on estimated fair values of assets acquired and liabilities assumed. The allocation of the purchase price will be finalized within one year of the date of the acquisition. The Company's preliminary purchase price allocation is as follows (amounts in 000 s):

Cash and cash equivalents	\$ 1,110
Accounts receivable	20,376
Inventories	25,065
Other current assets	54
Property and equipment	24,066
Customer relationships	51,000
Trade names and license agreements	150
Developed technology	7,220
In-process research and development charge	950
Goodwill	107,328
Accounts payable	(10,871)
Accrued expenses	(5,576)
Deferred tax liability	(13,535)
 Total purchase price	 \$ 207,337

The following unaudited pro forma information presents a summary of the Company's consolidated results of operations as if the COTCO transaction occurred at the beginning of the fiscal year for the period presented (amounts in 000 s, except per share data):

	Three Months Ended December 24,	Six Months Ended December 24,
	2006	2006
Revenue	\$ 106,888	\$ 229,622
Income from continuing operations	\$ 19,366	\$ 40,848
Net income	\$ 17,386	\$ 31,261
Earnings per share, basic	\$ 0.21	\$ 0.37
Earnings per share, diluted	\$ 0.20	\$ 0.36

Table of Contents**4. Inventories**

Inventories are stated at the lower of cost or market, with cost determined using the first-in, first-out (FIFO) method for finished goods and work-in-progress accounts. The Company uses the average cost method to value raw materials. The Company records a reserve against inventory once it has been determined that conditions exist which may not allow the Company to sell the inventory for its intended purpose, the inventory's value is determined to be less than cost or it is determined to be obsolete. The charge for the inventory reserves is recorded in cost of revenue in the consolidated statements of income. Reserves are adjusted quarterly to reflect inventory values in excess of forecasted sales, as well as overall inventory risk assessed by management. The following is a summary of inventory:

	As of (in 000's)	
	December 30,	June 24,
	2007	2007
Raw material	\$ 16,335	\$ 13,941
Work-in-progress	34,633	28,108
Finished goods	28,814	31,661
	79,782	73,710
Inventory reserve	(4,719)	(2,642)
Total inventories, net	\$ 75,063	\$ 71,068

5. Investments

During the fourth quarter of fiscal 2007, Color Kinetics Incorporated (Color Kinetics) announced that it had been acquired. The transaction closed during the fiscal quarter ended September 23, 2007, and as a result the Company liquidated its remaining 500,000 shares of Color Kinetics stock. The Company no longer holds an equity investment in Color Kinetics. The Company received proceeds of \$17.0 million and recognized a pre-tax gain of \$14.1 million from this transaction in the consolidated statement of income during the quarter.

6. Intangible Assets

The following table reflects the components of intangible assets:

	As of (in 000's)	
	December 30,	June 24,
	2007	2007
Customer relationships	\$ 51,320	\$ 51,320
Developed technology	12,360	12,360
Patent and license rights	49,261	46,201
	112,941	109,881
Accumulated amortization	(23,368)	(13,743)
Intangible assets, net	\$ 89,573	\$ 96,138

Amortization expense recognized during the three and six months ended December 30, 2007 and December 24, 2006 was \$4.9 million and \$9.7 million and \$1.0 million and \$1.7 million, respectively.

Edgar Filing: CREE INC - Form 10-Q

Customer relationships are amortized over ten years. Developed technology is amortized over seven years. Patent and license rights are amortized over twenty years.

Table of Contents**7. Earnings Per Share**

The following computation reconciles the differences between the basic and diluted earnings per share presentations:

	Three Months Ended		Six Months Ended	
	(in 000's except per share data)		(in 000's except per share data)	
	December 30, 2007	December 24, 2006	December 30, 2007	December 24, 2006
Basic:				
Net income	\$ 6,620	\$ 16,479	\$ 19,334	\$ 29,769
Weighted average common shares	85,190	76,948	84,936	77,005
Basic earnings per share	\$ 0.08	\$ 0.21	\$ 0.23	\$ 0.38
Diluted:				
Net income	\$ 6,620	\$ 16,479	\$ 19,334	\$ 29,769
Weighted average common shares - basic	85,190	76,948	84,936	77,005
Dilutive effect of stock options	1,658	1,145	1,777	1,038
Weighted average common shares - diluted	86,848	78,093	86,713	78,043
Diluted earnings per share	\$ 0.08	\$ 0.21	\$ 0.22	\$ 0.38

Potential common shares that would have the effect of increasing diluted earnings per share are considered to be antidilutive. In accordance with SFAS No. 128, Earnings per Share, these shares were not included in calculating diluted earnings per share. For the three and six months ended December 30, 2007 there were 4.6 million and 4.2 million shares, respectively, not included in calculating diluted earnings per share because their effect was antidilutive. For the three and six months ended December 24, 2006 there were 8.0 million shares in both periods that were not included in calculating diluted earnings per share because their effect was antidilutive.

Table of Contents**8. Shareholders Equity**

The following presents a summary of activity in shareholders equity for the six months ended December 30, 2007 (dollars and shares in thousands):

	Common Stock Par Value	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total Share- holders Equity
Balance at June 24, 2007	\$ 106	\$ 713,778	\$ 292,289	\$ 9,826	\$ 1,015,999
Common stock options exercised for cash, 719 shares	1	11,105			11,106
Issuance of common stock for cash, 76 shares		1,806			1,806
Purchase and retirement of restricted stock awards, 6 shares		(168)			(168)
Income tax benefits from stock option exercises		2,824			2,824
Stock-based compensation		6,897			6,897
Net income			19,334		19,334
Cumulative effect of change in accounting principle			(36)		(36)
Foreign Currency Translation				5	5
Unrealized gain on marketable securities, net of tax of \$71				166	166
Reclassification of realized gain on sale of Color Kinetics stock, net of tax of \$5,288				(8,829)	(8,829)
Comprehensive income					10,640
Balance at December 30, 2007	\$ 107	\$ 736,242	\$ 311,587	\$ 1,168	\$ 1,049,104

9. Stock-Based Compensation

The Company currently has one equity-based compensation plan from which stock-based compensation awards can be granted to employees and directors. In addition, the Company has five plans that have been terminated as to future grants, but under which options are currently outstanding. The Company also has an Employee Stock Purchase Plan (ESPP) that provides employees with the opportunity to purchase common stock at 85% of the fair market value of the common stock at two designated times each year.

The Company recorded stock-based compensation expense of \$3.9 million and \$7.2 million for the three and six months ended December 30, 2007, respectively. The Company recorded stock-based compensation of \$2.7 million and \$6.4 million for the three and six months ended December 24, 2006, respectively. Approximately \$429,000 and \$699,000 of stock-based compensation has been recorded in inventory in the Company's consolidated balance sheets as of December 30, 2007 and June 24, 2007, respectively.

Table of Contents

The fair value of each award is estimated on the date of grant using the Black-Scholes-Merton option-pricing model using the following assumptions:

	Three Months Ended		Six Months Ended	
	December 30, 2007	December 24, 2006	December 30, 2007	December 24, 2006
Stock Option Grants:				
Risk-free interest rate	3.87%	4.55%	4.23%	4.69%
Expected life, in years	4.5	4.5	4.5	4.5
Expected volatility	45.4%	51.2%	45.4%	51.2%
Dividend yield	0%	0%	0%	0%
Employee Stock Purchase Plan:				
Risk-free interest rate	3.95%	5.10%	3.95%	5.10%
Expected life, in years	0.5	0.5	0.5	0.5
Expected volatility	45.4%	51.2%	45.4%	51.2%
Dividend yield	0%	0%	0%	0%

The following table summarizes option activity as of December 30, 2007, and changes during the six months then ended:

	Number of Shares (in 000's)	Weighted- Average Exercise price
Outstanding at June 24, 2007	10,303	\$ 25.34
Granted	1,229	\$ 27.46
Exercised	(719)	\$ 15.48
Forfeited or expired	(183)	\$ 26.91
Outstanding at December 30, 2007	10,630	\$ 26.23

A summary of nonvested shares of restricted stock awards outstanding under the Company's 2004 Long-Term Incentive Compensation Plan as of December 30, 2007, and changes during the six months then ended, follows:

	Number of Shares (in 000's)	Weighted- Average Grant- Date Fair Value
Nonvested at June 24, 2007	215	\$ 20.56
Granted	127	\$ 27.47
Vested	(70)	\$ 19.91
Forfeited	(3)	\$ 27.47
Nonvested at December 30, 2007	269	\$ 23.93

Table of Contents

10. Income Taxes

The variation between income taxes and income tax expense at the statutory rate of 35% is primarily due to the consolidation of our foreign operations, which are subject to income taxes at lower statutory rates.

Effective with the beginning of the first quarter of 2008, the Company adopted the provisions of FIN 48. FIN 48 contains a two-step approach to recognizing and measuring uncertain tax positions accounted for in accordance with SFAS No. 109, Accounting for Income Taxes. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates that it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount that is cumulatively more than 50% likely to be realized upon ultimate settlement.

As a result of the implementation of FIN 48, the Company recognized an increase in total unrecognized tax benefits of \$2.7 million, and accounted for the increase as a cumulative effect of a change in accounting principle that resulted in a decrease to retained earnings of \$36,000 and an increase to the goodwill associated with the acquisition of COTCO of \$2.7 million. The total amount of gross unrecognized tax benefits as of the date of adoption was \$8.4 million. The Company has historically classified all unrecognized tax benefits as long-term deferred tax liabilities. As a result of the adoption of FIN 48, unrecognized tax benefits have been reclassified to long-term contingent tax reserves. The total amount of gross unrecognized tax benefits remains unchanged at December 30, 2007. Of the \$8.4 million total unrecognized tax benefits, \$5.2 million represents tax positions that, if recognized, would impact the effective tax rate. Although timing of the resolution and/or closure on audits is highly uncertain, the Company believes it is reasonably possible that the balance of gross unrecognized tax benefits will materially change in the next 12 months.

The Company's policy is to include interest and penalties related to unrecognized tax benefits within the income tax expense line item in the consolidated statements of income. This classification has not changed as a result of implementing the provisions of FIN 48. As of the date of adoption, the Company accrued \$96,000 for the payment of interest related to unrecognized tax benefits. The Company has accrued additional interest related to uncertain tax positions of \$40,000 through the second quarter.

The Company files U.S. federal, U.S. state, and foreign tax returns. For U.S. Federal purposes, the Company is generally no longer subject to tax examinations for fiscal years ended June 26, 2005 and prior. For foreign purposes, the Company is no longer subject to examination for tax periods 2000 and prior. Certain carryforward tax attributes generated in years prior remain subject to examination and adjustment. For U.S. state tax returns the Company is generally no longer subject to tax examinations for fiscal years prior to 1997.

Subsequent to the end of the first quarter of fiscal 2008, the Internal Revenue Service issued Coordinated Issue Paper (CIP) LMSB-04-090762 dated September 27, 2007. The Company is in the process of evaluating the impact the issuance of this CIP will have on its consolidated financial statements.

11. Recent Accounting Pronouncements

In December 2006, the FASB issued SFAS No. 141 (revised 2007), Business Combinations, (SFAS 141R) to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial reports about a business combination and its effects. This Statement applies to all transactions or other events in which an entity obtains control of one or more businesses, and combinations achieved without the transfer of consideration. The standard is effective for the Company beginning in fiscal 2010. Earlier adoption is not permitted. The issuance of this Statement has no current impact on the Company.

Table of Contents

In December 2006, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements* an amendment of ARB No. 51, (SFAS 160) to improve the relevance, comparability, and transparency of the financial information that a reporting entity provides in its consolidated financial statements. This Statement applies to all entities that prepare consolidated financial statements, except not-for-profit organizations, but will affect only those entities that have an outstanding noncontrolling interest in one or more subsidiaries or that deconsolidate a subsidiary. This Statement is effective for the Company beginning in fiscal 2010. Earlier adoption is prohibited. The issuance of this Statements has no current impact on the Company.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* Including an amendment of FASB Statement No. 115 (SFAS 159). SFAS 159 permits entities to choose to measure certain financial assets and liabilities at fair value at specified election dates. The statement also establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. The statement is effective for the Company beginning in fiscal 2009. The Company has not yet determined the impact, if any, of the adoption of SFAS 159.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, (SFAS 157) to provide enhanced guidance when using fair value to measure assets and liabilities. SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. The standard applies whenever other standards require or permit assets or liabilities to be measured at fair value and, while not requiring new fair value measurements, may change current practices. The standard is effective for the Company beginning in fiscal 2009. The Company is currently evaluating the impact SFAS 157 will have on its consolidated financial statements.

12. Commitments and Contingencies

Please refer to Part I, Item 3 of the Company's Annual Report on Form 10-K for the fiscal year ended June 24, 2007 and Part II, Item 1 of the Company's Quarterly Report on Form 10-Q for the quarterly period ended September 23, 2007 for a description of material legal proceedings, in addition to the proceedings discussed below.

Honeywell Litigation

On October 19, 2007, Honeywell International, Inc. and Honeywell Intellectual Properties Inc. commenced a patent infringement lawsuit against us and a third party by filing a complaint in the U.S. District Court for the Eastern District of Texas. In the complaint, the plaintiffs allege that we are infringing U.S. Patent No. 6,373,188, entitled *Efficient Solid-State Light Emitting Device with Excited Phosphors for Producing a Visible Light Output*. The complaint seeks damages in an unspecified amount, an injunction against future infringements, attorneys' fees and costs. We have answered, denying any infringement and seeking declaratory judgment that the patent is invalid, unenforceable and not infringed.

Other Matters

The Company is currently a party to other legal proceedings incidental to its business. Although the resolution of these matters cannot be predicted with certainty, management's present judgment is that the final outcome will not likely have a material adverse effect on the Company's consolidated financial condition or results of operations. If an unfavorable resolution occurs, the Company's business, results of operations and financial condition could be materially adversely affected.

Table of Contents

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

Information set forth in this Quarterly Report on Form 10-Q contains various 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. All information contained in this report relative to future markets for our products and trends in and anticipated levels of revenue, gross margins and expenses, as well as other statements containing words such as may, will, anticipate, target, plan, estimate, expect, and intend, and other similar expressions constitute forward-looking statements. These forward-looking statements are subject to business, economic, and other risks and uncertainties, both known and unknown, and actual results may differ materially from those contained in the forward-looking statements. Any forward-looking statements we make are as of the date made and we do not intend to update them if our views later change. These forward-looking statements should not be relied upon as representing our views as of any date subsequent to the date of this quarterly report. To review risk factors that could cause actual results to differ, see Risk Factors in Part II, Item 1A, of this report.

The following discussion should be read in conjunction with, and is qualified in its entirety by reference to, our consolidated financial statements, including the notes thereto.

Overview

We develop and manufacture semiconductor materials and electronic devices primarily made from silicon carbide, or SiC, gallium nitride, or GaN, and related compounds. The majority of our products are manufactured at our main production facilities in Durham and Research Triangle Park, North Carolina and in our facility in Huizhou, China. We also use contract manufacturers in Asia to perform some of our manufacturing steps for certain light emitting diode, or LED, and power products. We generate revenues from the following product lines:

LED chips and packaged products. We derive the largest portion of our revenue from the sale of blue and green LED chips and packaged LEDs of all colors, including white.

Materials products. These products include our SiC and GaN wafers which are used in manufacturing LEDs, radio frequency, or RF, devices, power devices and for research and development. They also include SiC material in bulk crystal form, which is used in gemstone applications.

High-power products. These products include power switching devices made from SiC, which provide faster switching speeds than comparable silicon-based power devices, and also include wide bandgap RF and microwave devices made from SiC or GaN, which allow for higher power densities as compared to silicon or gallium arsenide.

Contracts with government agencies. Government agencies provide us with funding to support the development of primarily SiC and GaN based new technology.

Table of Contents

Industry Dynamics

Our business is primarily focused on selling high-brightness and high-power LED products. Industry factors affecting our business include overall demand in products using high-brightness LEDs, an intense and constantly evolving competitive environment, and intellectual property issues. Average LED sales prices generally decline each year as market players implement pricing strategies to gain or protect market share. To remain competitive, LED producers generally must increase product performance and reduce costs to support lower average sales prices.

Highlights of the Second Quarter of Fiscal 2008

The following is a summary of our financial results for the three months ended December 30, 2007:

Our revenue from continuing operations was \$119.0 million.

Our gross margin was 35% of revenue.

We reported consolidated net income of \$6.6 million and net income per diluted share of \$0.08.

We generated positive cash flow from operations of \$35.1 million.

Combined cash and investments totaled \$361.9 million at December 30, 2007.

Outlook for Fiscal 2008

We project that the LED chip market will remain highly competitive during the remainder of fiscal 2008. We plan to continue to expand our global sales, marketing, and distribution capabilities to support increased sales of our LED components, including those from our acquisition of COTCO.

We plan to work on increasing the brightness of our LED chips and packaged LED products. We plan to continue our work on the integration of COTCO by expanding our product offerings and customer base. We plan to continue cost reduction initiatives for both our LED and SiC-based high-power products by converting some production to four-inch wafers and transferring more of our LED production to our contract manufacturer in Asia and our production facility in Huizhou, China. In addition, we target to invest a total of \$45 million to \$50 million in capital expenditures during fiscal 2008. This will support unit volume growth in our new product lines and is a critical part of our overall product cost reduction initiatives.

We plan to continue to evaluate strategic investments to expand and strengthen our technology and product portfolio as well as to increase access to our targeted markets.

Critical Accounting Policies

The following discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. In preparing our financial statements, we must make estimates and judgments that affect the reported amounts of assets and liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities at the date of our financial statements. We base our assumptions, estimates and judgments on historical experience, current trends and other factors that management believes to be relevant at the time the consolidated financial statements are prepared. On a regular basis, management reviews our accounting policies, assumptions, estimates and judgments to ensure that our consolidated financial statements are presented fairly and in accordance with generally accepted accounting principles. However, because future events and their effects cannot be determined

Table of Contents

with certainty, actual results could differ from our assumptions and estimates, and we may be exposed to gains or losses that could be material.

Our significant accounting policies are discussed in Note 2, Summary of Significant Accounting Policies and Other Matters, of the Notes to Consolidated Financial Statements, included in Part II, Item 8 of our Annual Report on Form 10-K for the fiscal year ended June 24, 2007. Management believes the following accounting policies are the most critical to aid in fully understanding and evaluating our reported financial results. These policies require management's most difficult, subjective or complex judgments, resulting from the need to make estimates about the effect of matters that are inherently uncertain. Management has reviewed these critical accounting policies and related disclosures with the Audit Committee of our Board of Directors.

Description of Policy	Judgments and Uncertainties	Effect If Actual Results Differ From Assumptions and Adjustments Recorded
Revenue Recognition:		
We provide our customers with limited rights of return for non-conforming shipments and product warranty claims. In addition, certain of our sales arrangements provide for limited product exchanges and the reimbursement of certain sales costs incurred by our customers. As a result, we record an allowance at the time of sale, which is recorded as a reduction of product revenue and accounts receivable.	We apply judgment in estimating the amount of product that will be returned in the future. Our estimate of product returns and the amount of those returns that will be placed back in inventory is based primarily on historical transactional experience and judgment regarding market factors and trends.	As of December 30, 2007 the amount of our sales return allowance was \$4.8 million. As of December 30, 2007 we estimated the value of future product returns that would be returned to inventory was \$1.6 million.
In connection with the allowance for sales returns, we also record an asset for the value of product returns that we believe will be returned to inventory.		A 10% increase or decrease in our sales return estimates and deferred product costs asset at December 30, 2007 would have affected net income by approximately \$240,000 for the three months ended December 30, 2007.
Accounting for Stock-Based Compensation:		
We account for stock-based compensation arrangements in accordance with the provisions of Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment, SFAS 123R. Under SFAS 123R, compensation cost is calculated on the date of the grant using the Black-Scholes-Merton model. The compensation expense is then amortized over the vesting period.	We use the Black-Scholes-Merton model in determining fair value of our options at the grant date and apply judgment in estimating the key assumptions that are critical to the model such as the expected term, volatility and forfeiture rate of an option. Our estimate of these key assumptions is based on historical information and judgment regarding market factors and trends.	If actual results are not consistent with our assumptions and judgments used in estimating key assumptions, we may be required to adjust compensation expense, which could be material to our results of operations.

Table of Contents

Description of Policy	Judgments and Uncertainties	Effect If Actual Results Differ From Assumptions and Adjustments Recorded
<p>Valuation of Long-Lived Assets:</p> <p>We review long-lived assets such as property, equipment, goodwill, definite lived intangible assets and patents for impairment on a routine basis and when events and circumstances indicate that the carrying value of the assets recorded in our financial statements may not be recoverable. For example, a portion of our equipment may be scrapped; certain of our patents or patent applications may be abandoned. In these cases, we would directly write off these long-lived assets.</p> <p>In addition, we evaluate property, equipment and definite lived intangible assets for potential impairment by comparing the carrying value of our assets to the estimated future cash flows of the assets (undiscounted and without interest charges). If the estimated undiscounted future cash flows are less than the carrying value of the asset, we calculate an impairment loss. The impairment loss calculation compares the carrying value of the asset to the asset's estimated fair value, which may be based on estimated discounted future cash flows. We recognize an impairment loss if the amount of the asset's carrying value exceeds the asset's estimated fair value. If we recognize an impairment loss, the adjusted carrying amount of the asset will be its new cost basis. For a depreciable (amortized) long-lived asset, the new cost basis will be depreciated (amortized) over the remaining useful life of that asset.</p> <p>For goodwill, on at least an annual basis, we evaluate impairment in a two-step process. The first step compares the fair value of the reporting unit with its carrying value. If the fair value of the reporting unit exceeds its carrying value, no impairment is recorded. If the carrying amount of the reporting unit exceeds its fair value, the</p>	<p>Our impairment loss calculations require management to apply judgment in estimating future cash flows and asset fair values, including estimating useful lives of the assets. To make these judgments, we may use internal discounted cash flow estimates, quoted market prices when available, and independent appraisals as appropriate to determine fair value. We derive the required cash flow estimates from our internal business plans.</p>	<p>If actual results are not consistent with our assumptions and judgments used in estimating future cash flows and asset fair values, we may be required to record additional impairment losses that could be material to our results of operations.</p> <p>Using this impairment review methodology, we recorded \$307,000 of impairments of long-lived assets during the three months ended December 30, 2007, and \$1.1 million during the six months ended December 30, 2007. We recorded no long-lived asset impairment charges during the three or six months ended December 24, 2006.</p>

Table of Contents

Description of Policy	Judgments and Uncertainties	Effect If Actual Results Differ From Assumptions and Adjustments Recorded
<p>second step of the impairment analysis is performed. The second step is used to measure the amount of the impairment loss and compares the implied fair value of the reporting unit's goodwill with the carrying amount of the reporting unit's goodwill. If the carrying amount exceeds the implied fair value of the goodwill, an impairment loss is recognized for the excess. However, it should be noted that the loss recognized shall not be in excess of the carrying amount. Once a goodwill impairment loss is recognized, the adjusted carrying value shall be its new accounting basis.</p> <p>We do not restore a previously recognized impairment loss if the asset's carrying value decreases below its estimated fair value.</p>	<p>Tax Contingencies:</p> <p>We are subject to periodic audits of our income tax returns by federal, state and local agencies. These audits include questions regarding our tax filing positions, including the timing and amount of deductions and the allocation of income among various tax jurisdictions. In evaluating the exposures associated with our various tax filing positions, including state and local taxes, we record reserves for what we identify as more likely than not. A number of years may elapse before a particular matter for which we have established a reserve is audited and fully resolved.</p> <p>We have also established a valuation allowance for capital loss carryforwards and unrealized losses on certain securities where we believe that it is more likely than not that the tax benefits of the items will not be realized.</p>	<p>To the extent we prevail in matters for which reserves have been established, or are required to pay amounts in excess of our reserves, our effective tax rate in a given financial statement period could be materially affected. An unfavorable tax settlement might require use of our cash and result in an increase in our effective rate in the year of resolution. A favorable tax settlement would be recognized as a reduction in our effective tax rate in the year of resolution. When we establish or reduce the valuation allowance against our deferred tax assets, our income tax expense will increase or decrease, respectively in the period such determination is made.</p> <p>As of December 30, 2007, we had established tax reserves of \$5.8 million and a valuation allowance of \$2.8 million.</p>

Table of Contents

Description of Policy	Judgments and Uncertainties	Effect If Actual Results Differ From Assumptions and Adjustments Recorded
Inventories:		
We value our inventory at the lower of cost of the inventory or fair market value by establishing a write-down or an inventory loss reserve.	Our inventory reserve is based on our analysis of sales levels by product and projections of future customer demand derived from historical order patterns and input received from our customers and our sales team. To mitigate uncertainties, we reserve for all inventory greater than twelve months old, unless there is an identified need for the inventory. In addition, we reserve for items that are considered obsolete based on changes in customer demand, manufacturing process changes or new product introductions that may eliminate demand for a product. When inventory is physically destroyed, we remove the inventory and the associated reserve from our financial records.	If our estimates regarding customer demand and physical inventory losses are inaccurate or changes in technology affect demand for certain products in an unforeseen manner, we may be exposed to losses or gains in excess of our established reserves that could be material. As of December 30, 2007 the amount of our inventory reserve was \$4.7 million. A 10% increase or decrease in our actual inventory reserve at December 30, 2007 would have affected net income by approximately \$359,000 for the three months ended December 30, 2007.
We base our lower of cost or market write-down on the excess carrying value of the inventory, which is typically its cost, over the amount that we expect to realize from the ultimate sale of the inventory based upon our assumptions regarding the average sales price to be received for the product.		
Accruals for Self-Insured and Other Liabilities:		
We make estimates for the amount of costs that have been incurred but not yet billed for our self-funded medical insurance, general services, including legal fees, accounting fees and other expenses.	Our liabilities contain uncertainties because we must make assumptions and apply judgment to estimate the ultimate cost to settle claims and claims incurred but not reported as of the balance sheet date. When estimating our liabilities, we consider a number of factors, including interviewing our service providers for bills that have not yet been received. For self-insured liabilities, we estimate our liabilities based on historical claims experience.	If actual costs billed to us are not consistent with our assumptions and judgments, our expenses could be understated or overstated and these adjustments could materially affect our net income.

Table of Contents**Results of Operations**

The following table shows our consolidated statements of income expressed as a percentage of total revenue from continuing operations for the periods indicated:

	Three Months Ended		Six Months Ended	
	December 30, 2007	December 24, 2006	December 30, 2007	December 24, 2006
Revenue:				
Product revenue, net	93.6%	91.8%	93.5%	92.9%
Contract revenue, net	6.4	8.2	6.5	7.1
Total revenue	100.0	100.0	100.0	100.0
Cost of revenue:				
Product revenue	59.9	59.3	61.9	56.3
Contract revenue	5.0	6.5	5.2	5.7
Total cost of revenue	64.9	65.8	67.1	62.0
Gross margin	35.1	34.2	32.9	38.0
Operating expenses:				
Research and development	12.5	16.5	11.9	15.0
Sales, general and administrative	15.3	14.2	15.7	12.7
Amortization of acquisition related intangibles	3.4		3.5	
Loss on disposal or impairment of long-lived assets	0.4	0.1	0.5	0.1
Total operating expenses	31.6	30.8	31.6	27.8
Income from operations	3.5	3.4	1.3	10.2
Non-operating income:				
Gain on sale of investments, net		12.8	6.1	5.9
Interest and other non-operating income, net	3.9	4.5	3.6	4.1
Income from continuing operations before income taxes	7.4	20.7	11.0	20.2
Income tax expense	1.8	2.5	2.6	4.8
Income from continuing operations	5.6	18.2	8.4	15.4
(Loss) income from discontinued operations, net of related income tax benefit		0.2	(0.1)	0.1
Net income	5.6%	18.4%	8.3%	15.5%

Comparison of Three Months Ended December 30, 2007 and December 24, 2006

Revenue. Revenue from continuing operations increased 34.0% to \$119.0 million in the second quarter of fiscal 2008 from \$88.8 million in the second quarter of fiscal 2007. Product revenue increased 36.6% to \$111.3 million from \$81.5 million. The increase in product revenue primarily resulted from an increase in our high-brightness and high-powered packaged products, which was offset by a decline in revenue from material and high-power products.

Table of Contents

LED revenue increased 50.9% to \$98.9 million in the second quarter of fiscal 2008 from \$65.5 million in the second quarter of fiscal 2007, making up 83% of our total revenue from continuing operations. Unit shipments of our LED products increased 9.8% over the second quarter of fiscal 2007 and our blended average LED sales price increased 26.8%. The increase in unit shipments is due to higher demand and the increase in blended average sales price is attributable to a shift in product mix.

Materials revenue decreased 28.9% in the second quarter of fiscal 2008 to \$7.5 million from \$10.6 million in the second quarter of fiscal 2007 making up 6% of our revenue from continuing operations. The decrease in materials revenue was attributable to a 18.5% decrease in the number of units sold and a 15.9% decrease in the average sales price, which were primarily due to changes in the mix of product sold and a decrease in the amount of revenue generated from sales to Charles & Colvard, Ltd. during the quarter.

Revenue from our high-power devices decreased 10.6% to \$4.8 million in the second quarter of fiscal 2008 from \$5.3 million in the second quarter of fiscal 2007. A 73.0% increase in the number of units sold was offset by a 48.3% decrease in the average sales price due to changes in the mix of product that were sold, as there was a higher concentration of Schottky diode products sold in the quarter-to-quarter comparison. Revenue from high-power devices was 4% of revenue from continuing operations in the second quarter of fiscal 2008.

Contract revenue increased 5.4% to \$7.7 million in the second quarter of fiscal 2008 from \$7.3 million in the second quarter of fiscal 2007, making up 6% of revenue from continuing operations. The increase in revenue was primarily due to new contract awards.

Gross Margin. Gross margin from continuing operations in the second quarter of fiscal 2008 increased 37.6% to \$41.8 million from \$30.4 million in the second quarter of fiscal 2007. Our gross margin percentage increased from 34% to 35% of revenue from continuing operations in the quarter-to-quarter comparison. The increase was caused primarily from increased utilization by our factories, the initial contribution from our high-power packaged products being produced in our factory in China, manufacturing yield improvements and the transition of our high power devices to four-inch wafers.

Contract gross margin increased to 22.2% in the second quarter of fiscal 2008 from 20.3% in the second quarter of fiscal 2007. The increase in gross margin is primarily related to a larger number of cost-plus contracts in the comparable periods.

Research and Development. Research and development expenses from continuing operations increased 4.3% in the second quarter of fiscal 2008 to \$14.9 million from \$14.3 million in the second quarter of fiscal 2007. The increase in research and development spending is primarily related to the continued investment in the development of higher brightness LED chips, higher brightness and high power packaged LEDs, larger wafer process development and the ongoing development of high-power devices.

Sales, General and Administrative. Sales, general and administrative, or SG&A expenses, from continuing operations increased 49.1% in the second quarter of fiscal 2008 to \$18.2 million compared to \$12.6 million in the second quarter of fiscal 2007. During the second quarter of fiscal 2008, SG&A expenses reflected increased stock based compensation expense as we continue to comply with the provision of Statement of Financial Accounting Standards No. 123 (revised 2004), Share Based Payments (SFAS 123R), higher costs incurred in connection with patent litigation, increased spending on sales and marketing to support the growth of our global sales force and additional expenses related to the acquisition of COTCO.

Table of Contents

Amortization of Acquisition Related Intangibles. Amortization of acquisition related intangibles was \$4.0 million in the second quarter of fiscal 2008 compared to \$341,000 in the second quarter of fiscal 2007. During fiscal 2007, we acquired INTRINSIC Semiconductor Corporation, or INTRINSIC, and COTCO, resulting in \$63.7 million of acquisition related intangibles required to be amortized.

Loss on Disposal or Impairment of Long-Lived Assets. We recorded \$474,000 of losses on the disposal of long-lived assets in the second quarter of fiscal 2008 compared to a loss of \$85,000 in the second quarter of fiscal 2007 as a result of the long-lived assets disposed of or impaired in each comparative quarter.

Gain (Loss) on Sale of Investments, Net. During the second quarter of fiscal 2007, we sold 931,275 shares of Color Kinetics Incorporated, or Color Kinetics, common stock for \$16.7 million in proceeds and recognized a gain of \$11.4 million.

Interest and Other Non-Operating Income, Net. Net interest and other non-operating income increased 13.5% to \$4.6 million in the second quarter of fiscal 2008 from \$4.0 million in the second quarter of fiscal 2007. The increase is primarily due to the higher levels of cash and investments and due to the second quarter including an additional week as fiscal 2008 is a 53 week year.

Income Tax Benefit or Expense. We recorded income tax expense of \$2.1 million from continuing operations in the second quarter of fiscal 2008 as compared to income tax expense of \$2.2 million in the second quarter of fiscal 2007. The decrease is attributable to lower levels of taxable income in the comparable periods and the consolidation of our foreign operations that are subject to lower statutory tax rates. We currently estimate our effective tax rate for fiscal 2008 will be approximately 24%.

(Loss) income from Discontinued Operations, Net of Related Income Tax Benefit. During the second quarter of fiscal 2008, we recorded an after-tax loss of \$20,000 versus \$216,000 after-tax income recorded in the second quarter of fiscal 2007. The after-tax loss from discontinued operations is attributable to the continued expenses arising from the Sunnyvale facility operating lease.

Comparison of Six Months Ended December 30, 2007 and December 24, 2006

Revenue. Revenue from continuing operations increased 20.6% to \$232.4 million in the first six months of fiscal 2008 from \$192.7 million in the first six months of fiscal 2007. Product revenue increased 21.4% to \$217.3 million from \$178.9 million. The increase in product revenue resulted from an increase in our high-brightness packaged products, which was offset by a decline in revenue from material and advance device products.

LED revenue increased 29.7% to \$192.3 million in the first six months of fiscal 2008 from \$148.3 million in the first six months of fiscal 2007, making up 83% of our total revenue from continuing operations. Unit shipments of our LED products increased 3.1% over the first six months of fiscal 2007 and our blended average LED sales price increased 25.7%. The increase in unit shipments is due to higher demand and the increase in the blended average sales price is attributable to a shift in product mix.

Materials revenue decreased 22.6% in the first six months of fiscal 2008 to \$16.0 million from \$20.7 million in the first six months of fiscal 2007 making up 7.0% of our revenue from continuing operations. The decrease in materials revenue was attributable to a 8.6% decrease in the number of units sold and a 15.9% decrease in the average sales price, which were primarily due to changes in the mix of product sold and a decrease in the amount of revenue generated from sales to Charles & Colvard, Ltd. during the comparable periods.

Table of Contents

Revenue from our high-power devices decreased 10.5% to \$8.8 million in the first six months of fiscal 2008 from \$9.8 million in the first six months of fiscal 2007. A 40.0% increase in the number of units sold was offset by a 36.3% decrease in the average sales price due to changes in the mix of product that were sold during the six month period. Revenue from high-power devices was 4.0% of revenue from continuing operations in the first six months of fiscal 2008.

Contract revenue increased 9.6% to \$15.1 million in the first six months of fiscal 2008 from \$13.8 million in the first six months of fiscal 2007, making up 6.0% of total revenue from continuing operations. The increase in revenue was primarily due to new contract awards.

Gross Margin. Gross margin from continuing operations in the first six months of fiscal 2008 increased 4.5% to \$76.5 million from \$73.3 million in the first six months of fiscal 2007. Our gross margin percentage decreased from 38% to 33% of revenue from continuing operations in the six month comparison. The decrease was caused primarily by lower gross margins on sales of LED chip products and higher costs relating to our new component products.

Contract gross margin remained relatively flat at 20.3% in the first six months of fiscal 2008 from 20.6% in the first six months of fiscal 2007. The slight decrease in gross margin is primarily related to the mix of contracts in place during the comparable periods.

Research and Development. Research and development expenses from continuing operations decreased 3.4% in the first six months of fiscal 2008 to \$27.7 million from \$28.7 million in the first six months of fiscal 2007. The decrease in research and development spending was due to the reallocation of research and development resources to support the manufacturing ramp-up of several new products during the first quarter of fiscal 2008. We continue to invest in the development of higher brightness LED chips, higher brightness and high power packaged LEDs, larger wafer process development and ongoing development of high-power devices.

Sales, General and Administrative. SG&A expenses from continuing operations increased 50.5% in the first six months of fiscal 2008 to \$36.4 million compared to \$24.5 million in the first six months of fiscal 2007. During the first six months of fiscal 2008, SG&A expenses reflected increased stock based compensation expense as we continue to comply with the provision of SFAS 123R, higher costs incurred in connection with patent litigation, increased spending on sales and marketing to support the growth of our global sales force, additional personal property tax expense resulting from an audit of our 2002 through 2007 personal property tax returns and additional expenses related to the acquisition of COTCO.

Amortization of Acquisition Related Intangibles. Amortization of acquisition related intangibles were \$8.1 million in the first six months of fiscal 2008 compared to \$341,000 in the first six months of fiscal 2007. During fiscal 2007, we acquired INTRINSIC and COTCO, resulting in \$63.7 million of acquisition related intangibles required to be amortized.

Loss on Disposal or Impairment of Long-Lived Assets. We recorded \$1.2 million of losses on the disposal of long-lived assets in the first six months of fiscal 2008 compared to a loss of \$182,000 in the first six months of fiscal 2007 as a result of the long-lived assets disposed of or impaired in each comparative period.

Gain (Loss) on Sale of Investments, Net. During the first six months of fiscal 2008 we recorded a gain on sale of investments of \$14.1 million as we liquidated our remaining shares of Color Kinetics upon completion of its acquisition by Koninklijke Philips Electronics NV. During the first six months of fiscal 2007, we sold 931,275 shares of Color Kinetics common stock for \$16.7 million in proceeds and recognized a gain of \$11.4 million.

Table of Contents

Interest and Other Non-Operating Income, Net. Net interest and other non-operating income increased 4.9% to \$8.3 million in the first six months of fiscal 2008 from \$7.8 million in the first six months of fiscal 2007 primarily due to the higher levels of cash and investments invested during the comparable periods.

Income Tax Benefit or Expense. We recorded income tax expense of \$6.1 million from continuing operations in the first six months of fiscal 2008 as compared to income tax expense of \$9.2 million in the first six months of fiscal 2007. The decrease is primarily attributable to a decrease in our taxable income in the comparable periods and the consolidation of our foreign operations that are subject to lower statutory tax rates. We currently estimate our effective tax rate for fiscal 2008 will be approximately 24%.

(Loss) income from Discontinued Operations, Net of Related Income Tax Benefit. During the first six months of fiscal 2008, we recorded an after-tax loss of \$174,000 versus \$139,000 of after-tax income recorded in the first six months of fiscal 2007. The after-tax loss from discontinued operations is attributable to the continued expenses arising from the Sunnyvale facility operating lease.

Liquidity and Capital Resources

Our cash generating capability and financial condition give us the financial ability to grow our business. Our principal source of liquidity is operating cash flows, which is derived from net income. This cash generating capability is one of our fundamental strengths and provides us with substantial flexibility in meeting our operating, financing and investing needs. We have no debt or lines-of-credit.

Operating Activities:

During the first six months of fiscal 2008, our operations provided \$60.6 million of cash as compared to \$61.0 million of cash provided in the first six months of fiscal 2007. This \$400,000 decrease is due to the change in operating assets and liabilities in the comparable six month period.

At December 30, 2007, our inventory days on hand were 88 days as compared to 81 days at June 24, 2007. The increase in inventory during the first six months of fiscal 2008 primarily reflects increased levels of work-in-progress for our packaged LED products to meet anticipated increases in demand. Accounts receivable days sales outstanding were 68 days at December 30, 2007 as compared to 64 days at June 24, 2007.

Investing Activities:

During the first six months of fiscal 2008, we generated \$36.4 million from investing activities as compared to \$53.3 million of cash used in the first six months of fiscal 2007. During the first six months of fiscal 2008 we received \$17.0 million in cash from the liquidation of Color Kinetics, \$43.9 million, net, from the maturity of various investments in our managed portfolio offset by \$24.5 million of capital and patent related expenditures. This compares to the first six months of fiscal 2007 in which we used \$43.8 million for the INTRINSIC acquisition and expended \$60.6 million on capital expenditures.

Financing Activities:

We generated \$14.2 million of cash from financing activities in the first six months of fiscal 2008, primarily all from the issuance of common stock upon the exercise of stock options, as compared to \$15.2 million of financing cash used in the first six months of fiscal 2007, which primarily resulted from the repurchase of our common stock during the period.

Table of Contents

As of December 30, 2007, there remained approximately 4.4 million shares of our common stock approved for repurchase under the repurchase program authorized by the Board of Directors that extends through June 2008. Since the inception of our stock repurchase program in January 2001, we have repurchased approximately 7.7 million shares of our common stock at an average price of \$18.18 per share, with an aggregate value of \$139.7 million. At the discretion of our management, the repurchase program can be implemented through open market or privately negotiated transactions. We will determine the time and extent of repurchases based on our evaluation of market conditions and other factors.

Financial Condition

As of December 30, 2007, our cash and cash equivalents and short-term investments combined increased \$69.2 million, or 30.6%, from balances reported as of June 24, 2007. Our long-term investments held-to-maturity decreased by \$1.5 million, or 2.3%, from balances reported as of June 24, 2007. Our net property and equipment has decreased by \$16.1 million, or 4.3%, since June 24, 2007, as depreciation expense and disposals of fixed assets have exceeded capital additions during the period. During the first six months of fiscal 2008, we spent \$21.1 million on capital additions. Except as previously disclosed in Note 3 Acquisitions, Note 14 Lease Commitments, and Note 16 Commitments and Contingencies, included in Part II, Item 8 of our Annual Report on Form 10-K for the fiscal year ended June 24, 2007, we have no off-balance sheet obligations, commitments or contingencies or guarantees, and we do not use special purpose entities for any transactions.

We plan to meet the cash needs for the business for the remainder of fiscal 2008 through cash from operations and cash on hand. Actual results may differ from our targets for a number of reasons addressed in this report. We may also issue debt, additional shares of common stock, or use available cash on hand for the acquisition of complementary businesses or other significant assets. From time to time, we evaluate strategic opportunities and potential investments in complementary businesses and anticipate continuing to make such evaluations.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

During the first six months of fiscal 2008, we fully liquidated our investments in the common stock of Color Kinetics. We received proceeds of \$17.0 million and recognized a pre-tax gain of \$14.1 million from the sale during the period.

We hold and expect to continue to consider investments in minority interests in companies having operations or technology in areas within our strategic focus. We generally are not subject to material market risk with respect to our investments classified as marketable securities as such investments are readily marketable, liquid, and do not fluctuate substantially from stated values. Management continues to evaluate our investment positions on an ongoing basis.

We have invested some of the proceeds from our cash from operations into high-grade corporate debt, commercial paper, government securities, and other investments at fixed interest rates that vary by security. These investments are A grade or better in accordance with our cash management policy. At December 30, 2007, we had \$156.8 million invested in these securities, compared to \$200.4 million at June 24, 2007. Although these securities generally earn interest at fixed rates, the historical fair values of such investments have not differed materially from the amounts reported in our consolidated balance sheets. Therefore, we believe that potential changes in future interest rates will not create material exposure for us from differences between the fair value and the amortized cost of these investments. The potential loss in fair value resulting from a hypothetical 10% decrease in quoted market price was approximately \$15.7 million at December 30, 2007 and \$20.0 million at June 24, 2007.

Table of Contents

Except as previously disclosed in Note 3 Acquisitions, Note 14 Lease Commitments, and Note 16 Commitments and Contingencies, included in Part II, Item 8 of our Annual Report on Form 10-K for the fiscal year ended June 24, 2007, we have no off-balance sheet obligations, commitments, contingencies, or guarantees, nor do we use special purpose entities for any transactions. With two of our larger customers, we maintain a foreign currency adjustment to our sales price if Japanese yen and euro exchange rates against the U.S. dollar are not maintained. These revenue adjustments represent our main risk with respect to foreign currency since our contracts and purchase orders are denominated in U.S. dollars and have not had a material impact to our results of operations. We have no commodity risk.

Item 4. Controls and Procedures

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of the end of the period covered by this Form 10-Q. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by this Form 10-Q, our disclosure controls and procedures are effective in that they provide reasonable assurances that the information we are required to disclose in the reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods required by the United States Securities and Exchange Commission's rules and forms.

We routinely review our internal control over financial reporting and from time to time make changes intended to enhance the effectiveness of our internal control over financial reporting. We will continue to evaluate the effectiveness of our disclosure controls and procedures and internal control over financial reporting on an ongoing basis and will take action as appropriate. There have been no changes to our internal control over financial reporting, as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act, during the second quarter of fiscal 2008 that we believe materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Item 4T. Controls and Procedures

Not applicable.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

Please refer to Part I, Item 3 of our Annual Report on Form 10-K for the fiscal year ended June 24, 2007 and Part II, Item 1 of the Company's Quarterly Report on Form 10-Q for the quarterly period ended September 23, 2007 for a description of material legal proceedings, in addition to the proceedings discussed below.

Honeywell Litigation

On October 19, 2007, Honeywell International, Inc. and Honeywell Intellectual Properties Inc. commenced a patent infringement lawsuit against us and a third party by filing a complaint in the U.S. District Court for the Eastern District of Texas. In the complaint, the plaintiffs allege that we are infringing U.S. Patent No. 6,373,188, entitled Efficient Solid-State Light Emitting Device with Excited Phosphors for Producing a Visible Light Output. The complaint seeks damages in an unspecified amount, an injunction against future infringements, attorneys' fees and costs. We have answered, denying any infringement and seeking declaratory judgments that the patent is invalid, unenforceable and not infringed.

Table of Contents

Other Matters

We are currently a party to other legal proceedings incidental to our business. Although the resolution of these matters cannot be predicted with certainty, management's present judgment is that the final outcome will not likely have a material adverse effect on our consolidated financial condition or results of operations. If an unfavorable resolution occurs, our business, results of operations and financial condition could be materially adversely affected.

Item 1A. Risk Factors

Described below are various risks and uncertainties that may affect our business. These risks and uncertainties are not the only ones we face. Additional risks and uncertainties, both known and unknown, including ones that we currently deem immaterial or that are similar to those faced by other companies in our industry or business in general, may also affect our business. If any of the risks described below actually occur, our business, financial condition or results of operations could be materially and adversely affected.

Our operating results and margins may fluctuate significantly.

Although we experienced significant fluctuation in our revenue over the past few years, we may not be able to sustain such growth or maintain or grow our margins, and we may experience significant fluctuations in our revenue, earnings and margins in the future. Historically, the prices of our LEDs have declined based on market trends. We attempt to maintain our margins by constantly developing improved or new products, which provide greater value and result in higher prices, or by lowering the cost of our LEDs. If we are unable to do so, our margins will decline. Our operating results and margins may vary significantly in the future due to many factors, including the following:

average sales prices for our products declining at a greater rate than anticipated;

fluctuations in foreign currency as more of our revenue may be in non-U.S. currencies;

our ability to develop, manufacture and deliver products in a timely and cost-effective manner;

variations in the amount of usable product produced during manufacturing (our yield);

our ability to improve yields and reduce costs in order to allow lower product pricing without margin reductions;

our increased reliance on and our ability to ramp up capacity at COTCO and our subcontractors in Asia;

our ability to ramp up production for our new products;

our ability to convert our substrates used in our volume manufacturing to larger diameters;

our ability to produce higher brightness and more efficient LED products that satisfy customer design requirements;

Edgar Filing: CREE INC - Form 10-Q

our ability to develop new products to specifications that meet the evolving needs of our customers;

changes in demand for our products and our customers' products may cause fluctuations in revenue and possible inventory obsolescence;

raw material price fluctuations;

effects of an economic slow down on consumer spending on such items as cell phones, electronic devices and automobiles;

effects of an economic slowdown in non-consumer spending on such items as video display boards, gaming machines and other general lighting applications;

changes in the competitive landscape, such as availability of higher brightness LED products, higher volume production and lower pricing from competitors;

changes in the mix of products we sell, which may vary significantly;

other companies' inventions of new technology that may make our products obsolete;

product returns or exchanges due to quality related matters or improper use of our products;

Table of Contents

changes in purchase commitments permitted under our contracts with large customers;

changes in production capacity and variations in the utilization of that capacity;

disruptions of manufacturing that could result from fire, flood, drought or other disasters, particularly in the case of our single site for SiC wafer and LED production or disruptions from some of our sole source vendors; and

changes in accounting rules, such as recording expenses for stock option grants.

These or other factors could adversely affect our future operating results and margins. If our future operating results or margins are below the expectations of stock market analysts or our investors, our stock price will likely decline.

If we fail to evaluate, implement and integrate strategic opportunities successfully, our business may suffer.

From time to time we evaluate strategic opportunities available to us for product, technology or business acquisitions. For example, in July 2006 we acquired INTRINSIC and in March 2007 we acquired COTCO. If we choose to make acquisitions, we face certain risks, such as failure of the acquired business to meet our performance expectations, diversion of management attention, retention of existing customers of our current and acquired business, and difficulty in integrating the acquired business's operations, personnel and financial and operating systems into our current business. We may not be able to successfully address these risks or any other problems that arise from our recent or future acquisitions. Any failure to successfully evaluate strategic opportunities and address risks or other problems that arise related to any acquisition could adversely affect our business, results of operations and financial condition.

If we are unable to effectively expand the distribution channels for our component products, our operating results may suffer.

We are expecting to be working in business channels that are different from those we currently operate in as we grow our business and sell more components versus LED chips. If we are unable to complete the development of these new distribution channels to ensure our products are reaching the appropriate customer base, our financial results may be impacted. In addition, if we are successful in penetrating these new distribution channels, we cannot guarantee that the customer will accept our components or that we will be able to manufacture and deliver them in the timeline established by the customer.

Our traditional LED chip customers may reduce orders as a result of our entry into the packaged LED markets.

We began shipping packaged LED devices in fiscal 2005. In addition, during the fourth quarter of fiscal 2007, we acquired COTCO. As a result, some of our customers may reduce their orders for our chips because we are competing with them in the packaged LED business. This reduction in orders could occur faster than our packaged LED business can grow in the near term, which could reduce our overall revenue and profitability.

Our operating results are substantially dependent on the development and acceptance of new products based on our technology.

Our future success may depend on our ability to develop new and lower cost solutions for existing and new markets and for customers to accept those solutions. We must introduce new products in a timely and cost-effective manner, and we must secure production orders for those products from our customers. The development of new products is a highly complex process, and we historically have experienced delays in completing the development and introduction of new products. Products currently under development include larger, higher quality substrates and epitaxy, wide bandgap RF and microwave power devices, SiC power switches, higher brightness LED products such as the new EZBright™ LED,

Table of Contents

and high brightness packaged LEDs. The successful development and introduction of these products depends on a number of factors, including the following:

achievement of technology breakthroughs required to make commercially viable devices;

the accuracy of our predictions of market requirements and evolving standards;

acceptance of our new product designs;

acceptance of new technology in certain markets;

the availability of qualified research and development personnel;

our timely completion of product designs and development;

our ability to expand sales and influence key customers to adopt our products;

our ability to develop repeatable processes to manufacture new products in sufficient quantities and at low enough costs for commercial sales;

our customers' ability to develop competitive products incorporating our products; and

acceptance of our customers' products by the market.

If any of these or other factors become problematic, we may not be able to develop and introduce these new products in a timely or cost-efficient manner.

We face significant challenges managing our growth.

We have experienced a period of significant growth over the past few years that may challenge our management and other resources. We are also in the process of transforming our business to support a global components customer base. In order to manage our growth and change in our strategy effectively, we must continue to:

expand global sales, marketing and distribution;

implement and improve operating systems;

maintain adequate manufacturing facilities and equipment to meet customer demand;

maintain a sufficient supply of raw materials to support our growth;

improve the skills and capabilities of our current management team;

add experienced senior level managers;

attract and retain qualified people with experience in engineering, design, sales and marketing; and

recruit and retain qualified manufacturing employees.

We expect to spend substantial amounts of money in supporting our growth and may have additional unexpected costs. We may not be able to expand quickly enough to exploit potential market opportunities. Our future operating results will also depend on expanding sales and marketing, research and development, and administrative functions to support a global components customer base. If we cannot attract qualified people or manage growth and change effectively, our business, operating results and financial condition could be adversely affected.

Changes in our effective tax rate may have an adverse effect on our results of operations.

Our future effective tax rates may be adversely affected by a number of factors including:

Changes in tax laws or interpretation of such tax laws and changes in generally accepted accounting principles;

The jurisdiction in which profits are determined to be earned and taxed;

The resolution of issues arising from tax audits with various authorities;

Changes in the valuation of our deferred tax assets and liabilities;

Adjustments to estimated taxes upon finalization of various tax returns;

Table of Contents

Increases in expenses not deductible for tax purposes, including write-offs of acquired in-process research and development and impairment of goodwill in connection with acquisitions;

Changes in available tax credits;

Changes in share-based compensation expense; and

The repatriation of non-U.S. earnings for which we have not previously provided for U.S. taxes
Any significant increase in our future effective tax rates could adversely impact net income for future periods.

Our acquisition of COTCO exposes us to the risks inherent in doing business in China, which may adversely affect our business, results of operations, and financial condition.

As a result of our March 2007 acquisition of COTCO, which has operations and a manufacturing facility in China, we are exposed to risk associated with operating in China, including the following:

foreign exchange fluctuations, as COTCO's operations and sales are denominated in non-U.S. currency;

tariffs and other barriers;

timing and availability of export licenses;

disruptions in operations due to the expansion of China's domestic infrastructure;

difficulties in accounts receivable collections;

difficulties in staffing and managing a distant international subsidiary;

the burden of complying with foreign and international laws and treaties; and

the burden of complying with and changes in international taxation policies.

In addition, the Chinese government and provincial and local governments have provided, and continue to provide, various incentives to encourage the development of the technology industry in China. Such incentives include tax rebates, reduced tax rates, favorable lending policies, and other measures, some or all of which may be available to us with respect to the facility we have acquired in China. Any of these incentives could be reduced or eliminated by governmental authorities at any time. Any such reduction or elimination of incentives currently provided to COTCO could adversely affect our business and results of operations.

If we are unable to produce and sell adequate quantities of our LED products and improve our yields and reduce costs, our operating results may suffer.

Edgar Filing: CREE INC - Form 10-Q

We believe that our ability to gain customer acceptance of our products and to achieve higher volume production and lower production costs for those products will be important to our future operating results. We must reduce costs of these products to avoid margin reductions from the lower selling prices we may offer due to our competitive environment and/or to satisfy prior contractual commitments. Achieving greater volumes and lower costs requires improved production yields for these products. We may encounter manufacturing difficulties as we ramp up our capacity to make our newest high-brightness products. Our failure to produce adequate quantities and improve the yields of any of these products could have a material adverse effect on our business, results of operations and financial condition.

Table of Contents

Our results of operations, financial condition and business would be harmed if we were unable to balance customer demand and capacity.

We are in the process of taking steps to address our manufacturing capacity needs for certain products. If we are not able to increase our capacity or if we increase our capacity too quickly, our business and results of operations could be adversely impacted. We are also expanding capacity for our XLamp products and qualifying production of XLamp at our factory in Huizhou, China. If we experience delays or additional unforeseen costs associated with this expansion, we may not be able to achieve our financial targets.

Our LED revenues are highly dependent on our customers' ability to produce competitive white LED products using our LED chips.

Some of our customers package our blue LEDs in combination with phosphors to create white LEDs. Growth in sales of our high-brightness LED chips used in white light applications is dependent upon our customers' ability to develop efficient white LED products using our chips. Nichia Corporation, or Nichia, currently has the majority of the market share for white LEDs and other companies, such as Toyoda Gosei Co., Ltd., or Toyoda Gosei, offer highly competitive blue chips and white products to compete with Nichia. The white LEDs that our customers produce with our chips historically have not been as bright as Nichia's white LEDs. Even if our customers are able to develop higher performance white LED products, there can be no assurance that they will be able to compete with Nichia, Toyoda Gosei, or other competitors.

If we experience poor production yields or cannot reduce costs, our margins could decline and our operating results may suffer.

Our materials products, our LED products, and our high-power products are manufactured using technologies that are highly complex. We manufacture our SiC wafer products from bulk SiC crystals, and we use these SiC wafers to manufacture our LED products and our SiC-based high-power semiconductors. During our manufacturing process, each wafer is processed to contain numerous die, which are the individual semiconductor devices. Our high-power devices and XLamp products are then further processed by incorporating them into packages for sale as packaged components. The number of usable crystals, wafers, dies and packaged components that result from our production processes can fluctuate as a result of many factors, including but not limited to the following:

variability in our process repeatability and control;

impurities in the materials used;

contamination of the manufacturing environment;

equipment failure, power outages or variations in the manufacturing process;

lack of consistency and adequate quality and quantity of piece parts and other raw materials;

losses from broken wafers or human errors;

defects in packaging either within our control or at our subcontractors; and

transition of our LED wafer production from 3-inch to 4-inch wafers.

We refer to the proportion of usable product produced at each manufacturing step relative to the gross number that could be constructed from the materials used as our manufacturing yield.

Edgar Filing: CREE INC - Form 10-Q

If our yields decrease, our cost per wafer could increase, our margins could decline and our operating results would be adversely affected. In the past, we have experienced difficulties in achieving acceptable yields on new products, which has adversely affected our operating results. We may experience similar problems in the future, and we cannot predict when they may occur or their severity. In some instances, we may offer products for future delivery at prices based on planned yield improvements. Reduced yields or failure to achieve planned yield improvements could continue to significantly affect our margins and operating results.

Table of Contents

We rely on a few key sole source and limited source suppliers.

We depend on a small number of sole source and limited source suppliers for certain raw materials, components, services and equipment used in manufacturing our products, including key materials and equipment used in critical stages of our manufacturing processes. Although alternative sources generally exist for these items, qualification of many of these alternative sources could take up to six months or longer. Where possible, we are attempting to identify alternative sources for our sole and limited source suppliers.

We generally purchase these sole or limited source items with purchase orders, and we have limited guaranteed supply arrangements with such suppliers. We do not control the time and resources that these suppliers devote to our business, and we cannot be sure that these suppliers will perform their obligations to us. In the past, we have experienced decreases in our production yields when suppliers have varied from previously agreed upon specifications that have impacted our cost of sales.

Any delay in product delivery or other interruption or variation in supply from these suppliers could prevent us from meeting commercial demand for our products. If we were to lose key suppliers, our key suppliers were unable to support our demand, or we were unable to identify and qualify alternative suppliers, our manufacturing operations could be interrupted or hampered significantly.

The markets in which we operate are highly competitive and have evolving technology standards.

The markets for our LED and high-power products are highly competitive. In the LED market, we compete with companies that manufacture or sell nitride-based LED chips as well as those that sell packaged LEDs. Competitors are offering new blue, green and white LEDs with aggressive prices and improved performance. These competitors may reduce average sales prices faster than our cost reduction, and competitive pricing pressures may accelerate the rate of decline of our average sale prices. The market for SiC wafers is also becoming competitive as other firms in recent years have begun offering SiC wafer products or announced plans to do so.

Competition is increasing. In order to achieve our revenue growth objectives in fiscal 2008 and beyond, we need to continue to develop new products that enable our customers to win new designs and increase market share in key applications such as mobile products. One major supplier dominates this market and we anticipate that the competition for these designs has intensified and will result in pressure to lower sales prices of our products. Therefore, our ability to provide higher performance LEDs at lower costs will be critical to our success. Competitors may also try to align with some of our strategic customers. This could mean lower prices for our products, reduced demand for our products and a corresponding reduction in our ability to recover development, engineering and manufacturing costs. Competitors also could invent new technologies that may make our products obsolete. Any of these developments could have an adverse effect on our business, results of operations and financial condition.

Our business may be impaired by claims that we, or our customers, infringe intellectual property rights of others.

Vigorous protection and pursuit of intellectual property rights characterize the semiconductor industry. These traits have resulted in significant and often protracted and expensive litigation. Litigation to determine the validity of patents or claims by third parties of infringement of patents or other intellectual property rights could result in significant expense and divert the efforts of our technical personnel and management, even if the litigation results in a determination favorable to us. In the event of an adverse result in such litigation, we could be required to:

pay substantial damages;

indemnify our customers;

stop the manufacture, use and sale of products found to be infringing;

discontinue the use of processes found to be infringing;

Table of Contents

expend significant resources to develop non-infringing products and processes; and/or

obtain a license to use third party technology.

There can be no assurance that third parties will not attempt to assert infringement claims against us or our customers with respect to our products. In addition, our customers may face infringement claims directed to the customer's products that incorporate our products, and an adverse result could impair the customer's demand for our products. We have also promised certain of our customers that we will indemnify them in the event they are sued by our competitors for infringement claims directed to the products we supply. Under this indemnification obligation we may be responsible for future payments to resolve infringement claims against them. From time to time we receive correspondence asserting that our products or processes are or may be infringing patents or other intellectual property rights of others. Our practice is to investigate such claims to determine whether the assertions have merit and, if so, we take appropriate steps to seek to obtain a license or to avoid the infringement. However, we cannot predict whether a license will be available or that we would find the terms of any license offered acceptable or commercially reasonable. Failure to obtain a necessary license could cause us to incur substantial liabilities and costs and to suspend the manufacture of products.

There are limitations on our ability to protect our intellectual property.

Our intellectual property position is based in part on patents owned by us and patents exclusively licensed to us by North Carolina State University, Boston University and others. The licensed patents include patents relating to the SiC crystal growth process that is central to our SiC materials and device business. We intend to continue to file patent applications in the future, where appropriate, and to pursue such applications with U.S. and foreign patent authorities.

However, we cannot be sure that patents will be issued on such applications or that our existing or future patents will not be successfully contested by third parties. Also, since issuance of a valid patent does not prevent other companies from using alternative, non-infringing technology, we cannot be sure that any of our patents, or patents issued to others and licensed to us, will provide significant commercial protection, especially as new competitors enter the market.

In addition to patent protection, we also rely on trade secrets and other non-patented proprietary information relating to our product development and manufacturing activities. We try to protect this information through appropriate efforts to maintain its secrecy, including requiring employees and third parties to sign confidentiality agreements. We cannot be sure that these efforts will be successful or that the confidentiality agreements will not be breached. We also cannot be sure that we would have adequate remedies for any breach of such agreements or other misappropriation of our trade secrets, or that our trade secrets and proprietary know-how will not otherwise become known or be independently discovered by others.

Where necessary, we may initiate litigation to enforce our patent or other intellectual property rights. Any such litigation may require us to spend a substantial amount of time and money and could distract management from our day-to-day operations. Moreover, there is no assurance that we will be successful in any such litigation.

Table of Contents

Performance of our investments in other companies could affect our financial results.

We may make investments in companies, which subjects us to risks inherent in the business of the company in which we have invested and to trends affecting the equity markets as a whole. Investments in private companies are subject to additional risks relating to the limitations on transferability of the interests due to the lack of a public market and to other transfer restrictions. Investments in publicly held companies are subject to market risks and may not be liquidated easily. As a result, we may not be able to reduce the size of our positions or liquidate our investments when we deem appropriate to limit our downside risk.

If government agencies discontinue or curtail their funding for our research and development programs, our business may suffer.

Changes in federal budget priorities could adversely affect our contract revenue. Historically, government agencies have funded a significant portion of our research and development activities. When the government changes budget priorities, such as in times of war, our funding has the risk of being redirected to other programs. Government contracts are also subject to the risk that the government agency may not appropriate and allocate all funding contemplated by the contract. In addition, our government contracts generally permit the contracting authority to terminate the contracts for the convenience of the government. The full value of the contracts would not be realized if they were prematurely terminated. Furthermore, we may be unable to incur sufficient allowable costs to generate the full estimated contract values and there is some risk that any technologies developed under these contracts may not have commercial value. If government funding is discontinued or reduced, our ability to develop or enhance products could be limited, and our business, results of operations and financial condition could be adversely affected.

If our products fail to perform or meet customer requirements, we could incur significant additional costs.

The manufacture of our products involves highly complex processes. Our customers specify quality, performance and reliability standards that we must meet. If our products do not meet these standards, we may be required to replace or rework the products. In some cases, our products may contain undetected defects or flaws that only become evident after shipment. We have experienced product quality, performance or reliability problems from time to time. Defects or failures may occur in the future. If failures or defects occur, we could:

lose revenue;

incur increased costs, such as warranty expense and costs associated with customer support;

experience delays, cancellations or rescheduling of orders for our products;

write down existing inventory; or

experience product returns.

We are subject to risks from international sales.

We expect that revenue from international sales will continue to be the majority of our total revenue. International sales are subject to a variety of risks, including risks arising from currency fluctuations, trading restrictions, tariffs, trade barriers and taxes. Our sales are subject to variability as prices become less competitive in countries with currencies that are low or are declining in value against the U.S. dollar and more competitive in countries with currencies that are high or increasing in value against the U.S. dollar.

Table of Contents***Litigation could adversely affect our operating results and financial condition.***

We are defendants in pending litigation as described in Part II, Item 1. Legal Proceedings of this report that alleges, among other things, violations of securities laws and patent infringement. Defending against existing and potential litigation will likely require significant attention and resources and, regardless of the outcome, result in significant legal expenses, which will adversely affect our results unless covered by insurance or recovered from third parties. If our defenses are ultimately unsuccessful, or if we are unable to achieve a favorable resolution, we could be liable for damage awards that could materially adversely affect our results of operations and financial condition.

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

Our Annual Meeting of Shareholders was held on November 1, 2007. The following matters were submitted to a vote of the shareholders with the results shown below:

- (a) Election of seven directors, each elected to serve until the later of the next Annual Meeting of Shareholders or until such time as his successor has been duly elected and qualified.

Name	Votes For	Votes Withheld
Charles M. Swoboda	64,851,194	12,641,268
John W. Palmour, Ph. D.	64,940,576	12,551,886
Dolph W. von Arx	62,530,262	14,962,200
James E. Dykes	64,800,717	12,691,745
Clyde R. Hosein	64,834,063	12,658,399
Harvey A. Wagner	64,806,007	12,686,455
Thomas H. Werner	64,861,510	12,630,952

- (b) Approval of amendments to the 2004 Long-Term Incentive Compensation Plan.

Votes For	Votes Against	Abstained
49,005,723	11,034,693	122,622

- (c) Ratification of the appointment of Ernst & Young LLP as independent auditors for the fiscal year ended June 29, 2008.

Votes For	Votes Against	Abstained
76,901,047	507,184	84,231

The matters listed above are described in detail in our definitive proxy statement dated September 17, 2007 for the Annual Meeting of Shareholders held on November 1, 2007.

Table of Contents

Item 6. Exhibits

The following exhibits are being filed herewith and are numbered in accordance with Item 601 of Regulation S-K:

Exhibit No.	Description
10.1	2004 Long-Term Incentive Compensation Plan, as amended (incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K, dated November 1, 2007, as filed with the Securities and Exchange Commission on November 7, 2007)
31.1	Certification by Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification by Chief Financial Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification by 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 by Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Table of Contents

SIGNATURE

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.

CREE, INC.

Date: January 25, 2008

/s/ John T. Kurtzweil
John T. Kurtzweil
Chief Financial Officer and Treasurer
(Authorized Officer and Chief Financial and
Accounting Officer)

Table of Contents

EXHIBIT INDEX

Exhibit No.	Description
10.1	2004 Long-Term Incentive Compensation Plan, as amended (incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K, dated November 1, 2007, as filed with the Securities and Exchange Commission on November 7, 2007)
31.1	Certification by Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification by Chief Financial Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification by 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 by Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002