SEMTECH CORP
Form 10-Q
June 06, 2014

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

# FORM 10-Q

(Mark One)

x Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended April 27, 2014

or

o Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from to

Commission File Number 1-6395

## SEMTECH CORPORATION

(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Delaware | 95-2119684 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

200 Flynn Road, Camarillo, California, 93012-8790
(Address of principal executive offices, Zip Code)

Registrant’s telephone number, including area code: (805) 498-2111

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 x No ¨

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

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

| | | | |
|---|---|---|---|
| Large accelerated filer | x | Accelerated filer | o |
| Non-accelerated filer | o (Do not check if a smaller reporting company) | Smaller reporting company | o |

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

Number of shares of Common Stock, $0.01 par value per share, outstanding at May 30, 2014: 67,278,932

SEMTECH CORPORATION
INDEX TO FORM 10-Q
FOR THE QUARTER ENDED April 27, 2014

Unless the context otherwise requires, the use of the terms “Semtech,” “the Company,” “we,” “us” and “our” in this quarterly Report on Form 10-Q refers to Semtech Corporation and its consolidated subsidiaries.

Special Note Regarding Forward-Looking and Cautionary Statements
This Quarterly Report on Form 10-Q contains “forward-looking statements” within the meaning of the “safe harbor” provisions of the Private Securities Litigation Reform Act of 1995, as amended, based on our current expectations, estimates and projections about our operations, industry, financial condition, performance, results of operations, and liquidity. Forward-looking statements are statements other than historical information or statements of current condition and relate to matters such as future financial performance, future operational performance, the anticipated impact of specific items on future earnings, and our plans, objectives and expectations. Statements containing words such as “may,” “believe,” “anticipate,” “expect,” “intend,” “plan,” “project,” “estimate,” “should,” “will,” “designed to,” “proj “business outlook,” or other similar expressions constitute forward-looking statements. Forward-looking statements involve known and unknown risks and uncertainties that could cause actual results and events to differ materially from those projected. Potential factors that could cause actual results to differ materially from those in the forward-looking statements include, but are not limited to: the continuation and/or pace of key trends considered to be main contributors to the Company's growth, such as demand for increased network bandwidth, demand for increasing energy efficiency in the Company's products or end use applications of the products, and demand for increasing miniaturization of electronic components; shifts in demand among target customers, and other comparable changes or protracted weakness in projected or anticipated end-user markets; competitive changes in the marketplace, including, but not limited to the pace of growth or adoption rates of applicable products or technologies; shifts in focus among target customers, and other comparable changes in projected or anticipated end-user markets; adequate supply of components and materials from our suppliers, and of our products from our third-party manufacturers, to include disruptions due to natural causes or disasters, or related extraordinary weather events; the Company's ability to forecast and achieve anticipated revenues and earnings estimates in light of periodic economic uncertainty, to include impacts arising from European and global economic dynamics; the Company's ability to manage expenses to achieve anticipated amounts; and the amount and timing of expenditures for capital equipment deemed necessary or advisable by the Company. Additionally, forward-looking statements should be considered in conjunction with the cautionary statements contained in this Quarterly Report on Form 10-Q, including, without limitation, information under the captions “Management's Discussion and Analysis of Financial Condition and Results of Operations” and “Risk Factors” and additional factors that accompany the related forward-looking statements in this Quarterly Report on Form 10-Q, in our Annual Report on Form 10-K for the fiscal year ended January 26, 2014, in other filings with the Securities and Exchange Commission (“SEC”), and in material incorporated herein and therein by reference. In light of the significant risks and uncertainties inherent in the forward-looking information included herein that may cause actual performance and results to differ materially from those predicted, any such forward-looking information should not be regarded as representations or guarantees by the Company of future performance or results, or that its objectives or plans will be achieved, or that any of its operating expectations or financial forecasts will be realized. Reported results should not be considered an indication of future performance. Investors are cautioned not to place undue reliance on any forward-looking information contained herein, which reflect management's analysis only as of the date hereof. Except as required by law, the Company assumes no obligation to publicly release the results of any update or revision to any forward-looking statement that may be made to reflect new information, events or circumstances after the date hereof or to reflect the occurrence of unanticipated or future events, or otherwise.

In addition to regarding forward-looking statements with caution, you should consider that the preparation of the consolidated financial statements requires us to draw conclusions and make interpretations, judgments, assumptions and estimates with respect to certain factual, legal, and accounting matters. Our financial statements might have been materially impacted if we had reached different conclusions or made different interpretations, judgments, assumptions or estimates.

3

PART I - FINANCIAL INFORMATION

ITEM 1. Financial Statements

SEMTECH CORPORATION AND SUBSIDIARIES
UNAUDITED CONSOLIDATED CONDENSED STATEMENTS OF INCOME
(in thousands, except per share data)

| | Three Months Ended | |
|---|---|---|
| | April 27, 2014 | April 28, 2013 |
| Net sales | $132,859 | $162,407 |
| Cost of sales | 54,775 | 65,120 |
| Gross profit | 78,084 | 97,287 |
| Operating costs and expenses: | | |
| Selling, general and administrative | 31,696 | 34,794 |
| Product development and engineering | 27,813 | 34,559 |
| Intangible amortization and impairments | 6,425 | 7,856 |
| Restructuring charge | 1,001 | — |
| Total operating costs and expenses | 66,935 | 77,209 |
| Operating income | 11,149 | 20,078 |
| Interest and amortization of debt discount and expense | (1,387) | (4,060) |
| Non-operating expense, net | (278) | (807) |
| Income before taxes | 9,484 | 15,211 |
| Provision for taxes | 1,617 | 434 |
| Net income | $7,867 | $14,777 |
| Earnings per share: | | |
| Basic | $0.12 | $0.22 |
| Diluted | $0.12 | $0.22 |
| Weighted average number of shares used in computing earnings per share: | | |
| Basic | 67,300 | 66,956 |
| Diluted | 67,970 | 68,579 |

See accompanying notes. The accompanying notes are an integral part of these statements.

SEMTECH CORPORATION AND SUBSIDIARIES
UNAUDITED CONSOLIDATED CONDENSED STATEMENTS OF COMPREHENSIVE INCOME
(in thousands)

| | Three Months Ended | |
|---|---|---|
| | April 27, 2014 | April 28, 2013 |
| Net income | $7,867 | $14,777 |
| Other comprehensive loss, before tax: | | |
| Available for sales investments: | | |
| Change in unrealized holding income (loss) on available-for-sale investments | 1 | (1) |
| Interest rate hedge: | | |
| Change in unrealized loss on interest rate cap | (110) | (232) |
| Reclassification to Net income | 33 | — |
| Other comprehensive loss, before tax | (76) | (233) |
| Benefit for taxes related to items of other comprehensive loss | 28 | 85 |
| Other comprehensive loss, net of tax | (48) | (148) |
| Total comprehensive income, net of tax | $7,819 | $14,629 |

See accompanying notes. The accompanying notes are an integral part of these statements.

SEMTECH CORPORATION AND SUBSIDIARIES
CONSOLIDATED CONDENSED BALANCE SHEETS
(in thousands, except share data)

| | April 27, 2014 (unaudited) | January 26, 2014 |
|---|---|---|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | $241,154 | $243,194 |
| Accounts receivable, less allowances of $3,956 at April 27, 2014 and $3,825 at January 26, 2014 | 61,722 | 66,333 |
| Inventories | 55,296 | 60,267 |
| Deferred tax assets | 2,956 | 2,946 |
| Prepaid taxes | 2,529 | 4,993 |
| Other current assets | 16,484 | 15,863 |
| Total current assets | 380,141 | 393,596 |
| Non-current assets: | | |
| Property, plant and equipment, net of accumulated depreciation of $127,066 at April 27, 2014 and $112,610 at January 26, 2014 | 111,221 | 110,121 |
| Long-term investments | 3,176 | 3,674 |
| Deferred tax assets | 365 | 348 |
| Goodwill | 276,898 | 276,898 |
| Other intangible assets, net | 134,205 | 140,944 |
| Other assets | 29,250 | 23,359 |
| TOTAL ASSETS | $935,256 | $948,940 |
| Liabilities and Stockholders’ Equity | | |
| Current liabilities: | | |
| Accounts payable | $38,716 | $40,016 |
| Accrued liabilities | 33,636 | 44,148 |
| Deferred revenue | 5,694 | 7,267 |
| Current portion - long-term debt | 18,534 | 18,529 |
| Deferred tax liabilities | 930 | 930 |
| Total current liabilities | 97,510 | 110,890 |
| Non-current liabilities: | | |
| Deferred tax liabilities | 3,626 | 3,626 |
| Long term debt, less current portion | 268,658 | 273,293 |
| Other long-term liabilities | 26,952 | 25,288 |
| Stockholders’ equity: | | |
| Common stock, $0.01 par value, 250,000,000 shares authorized, 78,136,144 issued and 67,225,178 outstanding on April 27, 2014 and 78,136,144 issued and 67,283,221 outstanding on January 26, 2014 | 785 | 785 |
| Treasury stock, at cost, 10,910,966 shares as of April 27, 2014 and 10,852,923 shares as of January 26, 2014 | (205,524) | (201,152) |
| Additional paid-in capital | 361,341 | 362,121 |
| Retained earnings | 381,703 | 373,836 |
| Accumulated other comprehensive income | 205 | 253 |
| Total stockholders’ equity | 538,510 | 535,843 |
| TOTAL LIABILITIES AND STOCKHOLDERS’ EQUITY | $935,256 | $948,940 |

See accompanying notes. The accompanying notes are an integral part of these statements.

6

SEMTECH CORPORATION AND SUBSIDIARIES
UNAUDITED CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS
(in thousands)

| | Three Months Ended | |
|---|---|---|
| | April 27, 2014 | April 28, 2013 |
| Cash flows from operating activities: | | |
| Net income | $7,867 | $14,777 |
| Adjustments to reconcile net income to net cash provided by operating activities, net of effects of acquisitions: | | |
| Depreciation, amortization and impairments | 12,004 | 13,346 |
| Effect of acquisition fair value adjustments | — | 2,476 |
| Accretion of deferred financing costs and debt discount | 250 | 760 |
| Deferred income taxes | 1 | 98 |
| Stock-based compensation | 6,847 | 8,626 |
| Loss (gain) on disposition of property, plant and equipment | 2 | (1) |
| Changes in assets and liabilities: | | |
| Accounts receivable, net | 4,611 | (11,054) |
| Inventories | 4,962 | (4,016) |
| Prepaid expenses and other assets | (1,235) | (1,184) |
| Accounts payable | (1,352) | 2,308 |
| Accrued liabilities | (10,557) | (11,287) |
| Deferred revenue | (1,573) | 1,251 |
| Income taxes payable and prepaid taxes | 154 | (1,342) |
| Other liabilities | 788 | 2,392 |
| Net cash provided by operating activities | 22,769 | 17,150 |
| Cash flows from investing activities: | | |
| Purchases of available-for-sale investments | — | (1,050) |
| Proceeds from sales and maturities of available-for-sale investments | 500 | 7,998 |
| Proceeds from sales of property, plant and equipment | — | 8 |
| Purchase of property, plant and equipment | (6,379) | (10,750) |
| Purchase of intangible assets | — | (2,847) |
| Purchase of cost method investment | (3,043) | — |
| Net cash used in investing activities | (8,922) | (6,641) |
| Cash flows from financing activities: | | |
| Payment for employee stock-based compensation payroll taxes | (2,985) | (4,619) |
| Proceeds from exercises of stock options | 1,785 | 6,971 |
| Repurchase of outstanding common stock | (10,000) | — |
| Payment of long term debt | (4,687) | (5,625) |
| Net cash used in financing activities | (15,887) | (3,273) |
| Net (decrease) increase in cash and cash equivalents | (2,040) | 7,236 |
| Cash and cash equivalents at beginning of period | 243,194 | 223,192 |
| Cash and cash equivalents at end of period | $241,154 | $230,428 |

See accompanying notes. The accompanying notes are an integral part of these statements.

7

SEMTECH CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
(Unaudited)
Note 1: Organization and Basis of Presentation

Semtech Corporation (together with its consolidated subsidiaries, the “Company” or “Semtech”) is a global supplier of high performance analog and mixed-signal semiconductor products. The end-customers for the Company’s products are primarily original equipment manufacturers (“OEMs”) that produce and sell electronics.

The Company designs, develops and markets a wide range of products for commercial applications, the majority of which are sold into the enterprise computing, communications, high-end consumer and industrial end-markets.

Enterprise Computing: datacenters, passive optical networks, storage networks, optical receiver and transceiver, desktops, notebooks, servers, graphic boards, monitors, printers and other computer peripherals.

Communications: base stations, backplane, optical networks, carrier networks, switches and routers, servers, cable modems, signal conditioners, wireless local area network (“LAN”) and other communication infrastructure equipment.

High-End Consumer: Smartphones and other handheld products, set-top boxes, digital televisions, tablets, wearable devices, digital video recorders and other consumer equipment.

Industrial: broadcast studio equipment, automated meter reading, military and aerospace, medical, security systems, automotive, industrial and home automation, video security and surveillance and other industrial equipment.

Fiscal Year

The Company reports results on the basis of 52 and 53 week periods and ends its fiscal year on the last Sunday in January. The other quarters generally end on the last Sunday of April, July and October. All quarters consist of 13 weeks except for one 14-week period in 53-week years. The first quarter of fiscal years 2015 and 2014 each consisted of 13 weeks.

Principles of Consolidation

The accompanying interim unaudited consolidated condensed financial statements of Semtech have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (the “SEC”). In the opinion of the Company, these unaudited statements contain all adjustments (consisting of normal recurring adjustments) necessary to present fairly, in all material respects, the financial position of Semtech for the interim periods presented. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States (“GAAP”) have been condensed or omitted pursuant to such rules and regulations, and the Company believes that the included disclosures are adequate to make the information presented not misleading.

These interim unaudited consolidated condensed financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto included in the Company’s Annual Report on Form 10-K for the year ended January 26, 2014. The results reported in these interim unaudited consolidated condensed financial statements should not be regarded as indicative of results that may be expected for any subsequent period or for the entire year.

Segment Information

The Company operates and accounts for its results in one reportable segment. The Company identified three operating segments which aggregate into one reportable segment. The Company designs, develops, manufactures and markets high-performance analog and mixed signal integrated circuits. The Chief Executive Officer (“CEO”) has been identified as the Chief Operating Decision Maker (“CODM”) as defined by guidance regarding segment disclosures. The Company has evaluated its operating segments, subsequent to its recent reorganization (discussed in Note 8), and

concluded that it continues to operate and account for its results in one reportable segment.
Use of Estimates
The preparation of financial statements in conformity with accounting principles GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Note 2: Earnings per Share
The computation of basic and diluted earnings per common share is as follows:

| | Three Months Ended | |
|---|---|---|
| (in thousands, except per share amounts) | April 27, 2014 | April 28, 2013 |
| Net income | $7,867 | $14,777 |
| | | |
| Weighted average common shares outstanding - basic | 67,300 | 66,956 |
| Dilutive effect of employee equity incentive plans | 670 | 1,623 |
| Weighted average common shares outstanding - diluted | 67,970 | 68,579 |
| | | |
| Basic earnings per common share | $0.12 | $0.22 |
| Diluted earnings per common share | $0.12 | $0.22 |
| | | |
| Anti-dilutive shares not included in the above calculations | 1,662 | 318 |

Basic earnings per common share is computed by dividing income available to common stockholders by the weighted-average number of shares of common stock outstanding during the reporting period. Diluted earnings per common share incorporates the incremental shares issuable, calculated using the treasury stock method, upon the assumed exercise of stock options and the vesting of restricted stock.
Note 3: Revenue Recognition
The Company recognizes product revenue when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable and collectability is reasonably assured. Recovery of costs associated with product design and engineering services are recognized during the period in which services are performed. The product design and engineering recovery, when recognized, will be reported as a reduction to product development and engineering expense. Historically, these recoveries have not exceeded the cost of the related development efforts.
The Company includes revenue related to granted technology licenses as part of “Net sales.” Historically, revenue from these arrangements has not been significant though it is part of the Company’s recurring ordinary business.
The Company defers revenue recognition on shipment of products to certain customers, principally distributors, under agreements which provide for limited pricing credits or return privileges, until these products are sold through to end-users or the return privileges lapse. For sales subject to certain pricing credits or return privileges, the amount of future pricing credits or inventory returns cannot be reasonably estimated given the relatively long period in which a particular product may be held by the customer. Therefore, the Company has concluded that sales to customers under these agreements are not fixed and determinable at the date of the sale and revenue recognition has been deferred. The Company estimates the deferred gross margin on these sales by applying an average gross profit margin to the actual gross sales. The average gross profit margin is calculated for each category of material using standard costs which is expected to approximate actual costs at the date of sale. The estimated deferred gross margins on these sales, where there are no outstanding receivables, are recorded on the consolidated condensed balance sheets under the heading of “Deferred revenue.”
The Company records a provision for estimated sales returns in the same period as the related revenues are recorded. The Company bases these estimates on historical sales returns and other known factors. Actual returns could be different from Company estimates and current provisions for sales returns and allowances, resulting in future charges to earnings. There were no significant impairments of deferred cost of sales in the first quarter of fiscal year 2015 or fiscal year 2014.

8

Note 4: Stock-Based Compensation

Financial Statement Effects and Presentation. The following table shows total pre-tax, stock-based compensation expense included in the unaudited consolidated condensed statements of income for the three months ended April 27, 2014 and April 28, 2013.

| (in thousands) | Three Months Ended April 27, 2014 | April 28, 2013 |
|---|---|---|
| Cost of sales | $363 | $328 |
| Selling, general and administrative | 4,065 | 4,882 |
| Product development and engineering | 2,419 | 3,416 |
| Stock-based compensation, pre-tax | $6,847 | $8,626 |
| Net change in stock-based compensation capitalized into inventory | $(9) | $77 |

Share-based Payment Arrangements

The Company has various equity award plans that provide for granting stock-based awards to employees and non-employee directors of the Company. The plans provide for the granting of several available forms of stock-based compensation. As of April 27, 2014, the Company has granted stock options, restricted stock and restricted stock units under the plans and has also issued some stock-based compensation outside of the plans, including stock options, restricted stock and restricted stock units issued as inducements to join the Company.

Grant Date Fair Values and Underlying Assumptions; Contractual Terms

The Company uses the Black-Scholes pricing model to value stock options. The estimated fair value of restricted stock units, whose vesting is not linked to a market condition, is calculated based on the market price of the Company’s common stock on the date of grant. For restricted stock units that vest according to a market condition, the Company uses a Monte Carlo simulation model to value the award.

Some of the restricted stock units awarded in the first quarter of fiscal year 2015 and prior years are classified as liabilities rather than equity. For awards classified as equity, stock-based compensation cost is measured at grant date, based on the fair value of the award, and is recognized as an expense over the employee’s or director’s requisite service period. For awards classified as liabilities, stock-based compensation cost is measured at fair value at the end of each reporting date until the date of settlement, and is recognized as an expense over the employee’s or director’s requisite service period. Expected volatilities are based on historical volatility using daily and monthly stock price observations.

The following table summarizes the assumptions used in the Black-Scholes model to determine the fair value of stock options granted in the three months ended April 27, 2014 and April 28, 2013:

| | Three Months Ended April 27, 2014 | April 28, 2013 |
|---|---|---|
| Expected lives, in years | 3.0 - 4.4 | 4.2 - 4.7 |
| Estimated volatility | 33% - 34% | 34% - 35% |
| Dividend yield | — | — |
| Risk-free interest rate | 1.26% - 1.31% | 0.65% - 0.69% |
| Weighted average fair value on grant date | $7.22 | $9.04 |

Stock Option Awards. The Company has historically granted stock options to both employees and non-employee directors. The grant date for these awards is equal to the measurement date. These awards were valued as of the measurement date and are amortized over the requisite vesting period (typically 3-4 years).

A summary of the activity for stock option awards during the first three months of fiscal year 2015 is presented below:

| (in thousands, except for per share amounts) | Number of Shares | Weighted Average Exercise Price (per share) | Aggregate Intrinsic Value | Aggregate Unrecognized Compensation | Number of Shares Exercisable | Weighted Average Contractual Term (in years) |
|---|---|---|---|---|---|---|
| Balance at January 26, 2014 | 1,935 | $21.33 | $7,722 | $ 4,354 | 1,275 | |
| Options granted | 201 | 24.74 | | | | |
| Options exercised | (103) | 17.31 | 768 | | | |
| Options cancelled/forfeited | (26) | 26.61 | | | | |
| Balance at April 27, 2014 | 2,007 | $21.81 | $8,266 | $ 4,971 | 1,322 | |
| Exercisable at April 27, 2014 | 1,322 | $18.86 | $8,094 | | | 2.3 |

Restricted Stock. The Company has not granted any restricted stock to employees since fiscal year 2009. There is no outstanding and unvested restricted stock as of April 27, 2014.

Performance Units.

The Company grants performance-based vesting restricted stock units to select employees. These awards have a performance condition in addition to a service condition. The performance metrics are determined based on a pre-defined cumulative three-year performance of the Company's revenue and operating income measured against internal goals. The performance award which is granted in any fiscal year will be tied to the Company's performance of that fiscal year and the succeeding two fiscal years. The performance award recipients must be employed for the entire three-year period, which is the requisite service period, and be an active employee at the time of vesting of the awards (cliff vesting at the end of the third year). Under the terms of these awards, assuming the highest performance level of 200% with no cancellations due to forfeitures, the maximum number of shares that can be earned would be 522,532 shares and an additional 522,532 shares would be settled in cash. The Company would have a liability accrued in the consolidated condensed balance sheets equal to the value of 522,532 shares on the settlement date, which would be settled in cash. Only cash performance unit awards are classified as liabilities and the value of these awards is re-measured at each reporting date. At April 27, 2014, the performance metrics associated with the outstanding awards issued in fiscal years 2015, 2014 and 2013 are expected to be met at a level which would result in a grant at 100%, 87%, and 0% of target, respectively.

The following table summarizes the activity for performance units for the first three months of fiscal year 2015:

| | | Subject to Share Settlement | Subject to Cash Settlement | | Weighted Average Grant Date | Aggregate | Period Over Which Expected |
|---|---|---|---|---|---|---|---|
| (in thousands, except for per unit amounts) | Total Units | Units | Units | Recorded Liability | Fair Value (per unit) | Unrecognized Compensation | to be Recognized (in years) |
| Balance at January 26, 2014 | 376 | 192 | 184 | $1,305 | $ 28.50 | $ 3,893 | 1.3 |
| Performance units granted | 256 | 128 | 128 | | 24.74 | | |
| Performance units vested | (93) | (52) | (41) | | 23.36 | | |
| Performance units cancelled/forfeited | (17) | (9) | (8) | | 25.51 | | |
| Change in liability | | | | (560) | | | |
| Balance at April 27, 2014 | 522 | 259 | 263 | $745 | $ 27.57 | $ 8,706 | 2.1 |

The liability associated with performance units has been reduced by $0.6 million in the first three months of fiscal year 2015 due to vesting in the first quarter of fiscal year 2014, forfeitures, re-measurement adjustments and change in the expected performance results.

Market Performance Units. On February 26, 2014, the Company granted its CEO restricted stock units with a market performance condition. The award is eligible to vest during the period commencing February 26, 2014 and ending February 26, 2019 (the “Performance Period”) as follows: 30% of the restricted stock units covered by the award will vest if, during any consecutive 120 calendar day period that commences and ends during the Performance Period, the average per-share closing price of the Company’s common stock equals or exceeds $35.00 (“Tranche 1”) and the award will vest in full if, during any consecutive 120 calendar day period that commences and ends during the Performance Period, the average per-share closing price of the Company's common stock equals or exceeds $40.00 ("Tranche 2"). The award will also vest if a majority change in control of the Company occurs during the Performance Period and, in connection with such event, the Company's stockholders become entitled to receive per-share consideration having a value equal to or greater than $40.00.

The following tables summarize the assumptions used in the Monte Carlo simulation model to determine the fair value of restricted stock units granted in the three months ended April 27, 2014 for both Tranche 1 and Tranche 2. The Company did not grant any restricted stock units that vest according to a market performance condition in the three months ended April 28, 2013.

Tranche 1:

| | Three Months Ended April 27, 2014 |
|---|---|
| Expected lives, in years | 1.6 |
| Estimated volatility | 34% |
| Dividend yield | — |
| Risk-free interest rate | 1.50% |
| Fair value on grant date | $17.26 |

Tranche 2:

| | Three Months Ended April 27, 2014 |
|---|---|
| Expected lives, in years | 2.1 |
| Estimated volatility | 34% |
| Dividend yield | — |
| Risk-free interest rate | 1.50% |
| Fair value on grant date | $14.88 |

The following table summarizes the activity for market performance units for the first three months of fiscal year 2015:

| (in thousands, except for per unit amounts) | Total Units | Weighted Average Grant Date Fair Value (per unit) | Aggregate Unrecognized Compensation | Period Over Which Expected to be Recognized (in years) |
|---|---|---|---|---|
| Balance at January 26, 2014 | — | $ — | $ — | 0.0 |
| Market performance units granted | 220 | 15.59 | | |
| Market performance units vested | — | — | | |
| Market performance units cancelled/forfeited | — | — | | |
| Balance at April 27, 2014 | 220 | $ 15.59 | $ 3,074 | 1.7 |

Restricted Stock Units, Employees. The Company issues restricted stock unit awards to employees which are expected to be settled with stock. The grant date for these awards is equal to the measurement date. These awards are valued as of the measurement date and amortized over the requisite vesting period (typically 4 years).

The following table summarizes the restricted stock unit award activity for the first three months of fiscal year 2015:

| (in thousands, except for per unit amounts) | Number of Units | Weighted Average Grant Date Fair Value (per unit) | Aggregate Intrinsic Value (1) | Aggregate Unrecognized Compensation | Weighted Average Period Over Which Expected to be Recognized (in years) |
|---|---|---|---|---|---|
| Balance at January 26, 2014 | 2,195 | $ 27.18 | | $ 49,563 | 2.5 |
| Restricted stock units granted | 256 | 24.74 | | | |
| Restricted stock units vested | (253) | 27.25 | $6,444 | | |
| Restricted stock units forfeited | (125) | 26.21 | | | |
| Balance at April 27, 2014 | 2,073 | $ 26.93 | | $ 48,052 | 2.5 |

(1) Reflects the value of Semtech stock on the date that the restricted stock unit vested.

Restricted Stock Units, Non-Employee Directors. The Company grants restricted stock unit awards to non-employee directors. These restricted stock units are accounted for as liabilities and accrued in the consolidated condensed balance sheets because they are cash settled. These awards are vested after 1 year of service. However, because these awards are not typically settled until a non-employee director's separation from service, the value of these awards is re-measured at the end of each reporting period until settlement. The following table summarizes the activity for stock unit awards for the first three months of fiscal year 2015:

| (in thousands, except for per unit amounts) | Number of Units | Recorded Liability | Weighted Average Grant Date Fair Value (per unit) | Aggregate Unrecognized Compensation | Period Over Which Expected to be Recognized (in years) |
|---|---|---|---|---|---|
| Balance at January 26, 2014 | 18 | $3,981 | $ 35.17 | $177 | 0.4 |
| Restricted stock units granted | — | | — | | |
| Restricted stock units vested | — | | — | | |
| Restricted stock units forfeited | — | | — | | |
| Change in liability | | 285 | | | |
| Balance at April 27, 2014 | 18 | $4,266 | $ 35.17 | $77 | 0.2 |

As of April 27, 2014, the total number of vested but unsettled restricted stock units for non-employee directors is 161,182 units which are included in the recorded liability.

Note 5: Investments

Investments that have original maturities of three months or less are accounted for as cash equivalents. This includes money market funds, time deposits and United States ("U.S.") government obligations. Temporary and long-term investments consist of government, bank and corporate obligations, and bank time deposits with original maturity dates in excess of three months. Temporary investments have original maturities in excess of three months, but mature within twelve months of the balance sheet date. Long-term investments have original maturities in excess of twelve months. The Company determines the cost of securities sold based on the specific identification method. Realized gains or losses are reported in "Non-operating expense, net" on the unaudited consolidated condensed statements of income.

The Company classifies its investments as "available for sale" because it may sell some securities prior to maturity. The Company's investments are subject to market risk, primarily interest rate and credit risks. The Company's investments are managed by a limited number of outside professional managers that operate within investment guidelines set by the Company. These guidelines include specified permissible investments, minimum credit quality ratings and maximum average duration restrictions and are intended to limit market risk by restricting the Company's investments to high quality debt instruments with relatively short-term maturities.

As of April 27, 2014, all of the Company's long-term investments mature on various dates through fiscal year 2016.

The following table summarizes the Company's available for sale investments:

| | April 27, 2014 | | | January 26, 2014 | | |
|---|---|---|---|---|---|---|
| (in thousands) | Market Value | Adjusted Cost | Gross Unrealized Gain | Market Value | Adjusted Cost | Gross Unrealized Gain |
| Agency securities | $3,176 | $3,174 | $2 | $3,674 | $3,673 | $1 |
| Total investments | $3,176 | $3,174 | $2 | $3,674 | $3,673 | $1 |

Agency securities are specific securities that are issued by U.S. government agencies such as Ginnie Mae, Fannie Mae, Freddie Mac or the Federal Home Loan Banks. Due to the expectation of federal backing, these securities usually hold the highest credit rating possible.

The following table summarizes the maturities of the Company's available for sale investments:

| | April 27, 2014 | | January 26, 2014 | |
|---|---|---|---|---|
| (in thousands) | Market Value | Adjusted Cost | Market Value | Adjusted Cost |
| Within 1 year | $— | $— | $— | $— |
| After 1 year through 5 years | 3,176 | 3,174 | 3,674 | 3,673 |
| Total investments | $3,176 | $3,174 | $3,674 | $3,673 |

Unrealized gains and losses are the result of fluctuations in the market value of the Company's available for sale investments and are included in "Accumulated other comprehensive income" on the consolidated condensed balance sheets. The following table summarizes net unrealized losses arising in the periods presented in addition to the tax associated with these comprehensive income items:

| | Three Months Ended | |
|---|---|---|
| (in thousands) | April 27, 2014 | April 28, 2013 |
| Unrealized gain (loss), net of tax | $1 | $(1) |
| Increase to deferred tax liability | 1 | — |

The following table summarizes interest income generated from investments and cash and cash equivalents:

| | Three Months Ended | |
|---|---|---|
| (in thousands) | April 27, 2014 | April 28, 2013 |
| Interest income | $8 | $100 |

The Company has investments in two privately held companies. The Company accounts for these equity investments under the cost method of accounting since it does not have the ability to exercise significant influence over the investees. These equity investment interests are included in “Other assets” on the consolidated balance sheet as of April 27, 2014.

| (in thousands) | Equity Investment |
|---|---|
| Balance as of January 26, 2014 | $5,000 |
| Additions | 3,043 |
| Balance as of April 27, 2014 | $8,043 |

Note 6: Fair Value Measurements

Instruments Measured at Fair Value on a Recurring Basis

Financial assets measured and recorded at fair value on a recurring basis consisted of the following types of instruments:

| | Fair Value as of April 27, 2014 | | | | Fair Value as of January 26, 2014 | | | |
|---|---|---|---|---|---|---|---|---|
| (in thousands) | Total | (Level 1) | (Level 2) | (Level 3) | Total | (Level 1) | (Level 2) | (Level 3) |
| Agency securities | $3,176 | $— | $3,176 | $— | $3,674 | $— | $3,674 | $— |
| Total available-for-sale securities | 3,176 | — | 3,176 | — | 3,674 | — | 3,674 | — |
| Interest rate cap | 206 | — | 206 | — | 316 | — | 316 | — |
| Total financial assets | $3,382 | $— | $3,382 | $— | $3,990 | $— | $3,990 | $— |

Available for sale securities included in Level 2 are valued utilizing inputs obtained from an independent service (the “Service”), which uses quoted market prices for identical or comparable instruments rather than direct observations of quoted prices in active markets. The Service gathers observable inputs for all of our fixed income securities from a variety of industry data providers, for example, large custodial institutions and other third-party sources. Once the observable inputs are gathered by the Service, all data points are considered and an average price is determined. The Service’s providers utilize a variety of inputs to determine their quoted prices. The Company reviews and evaluates the values provided by the Service and agrees with the valuation methods and assumptions used in determining the fair value of investments. The Company believes this method provides a reasonable estimate for fair value.

The fair value of the interest rate cap at April 27, 2014 is estimated as described in Note 10 and is included in “Other assets” on the consolidated condensed balance sheets.

Financial assets measured and recorded at fair value on a recurring basis were presented on the Company’s consolidated condensed balance sheets as follows:

| | Fair Value as of April 27, 2014 | | | | Fair Value as of January 26, 2014 | | | |
|---|---|---|---|---|---|---|---|---|
| (in thousands) | Total | (Level 1) | (Level 2) | (Level 3) | Total | (Level 1) | (Level 2) | (Level 3) |
| Long-term investments | $3,176 | $— | $3,176 | $— | $3,674 | $— | $3,674 | $— |
| Other assets | 206 | — | 206 | — | 316 | — | 316 | — |
| Total financial assets | $3,382 | $— | $3,382 | $— | $3,990 | $— | $3,990 | $— |

During the three months ended April 27, 2014, the Company had no transfers of financial assets or liabilities between Level 1, Level 2 or Level 3. As of April 27, 2014 and January 26, 2014, the Company had not elected the fair value option for any financial assets and liabilities for which such an election would have been permitted.

Instruments Not Recorded at Fair Value on a Recurring Basis

Some of the Company’s financial instruments are not measured at fair value on a recurring basis but are recorded at amounts that approximate fair value due to their liquid or short-term nature. Such financial assets and financial liabilities include cash and cash equivalents, receivables, net, certain other assets, accounts payable and accrued expenses, accrued personnel costs, and other current liabilities.

The Company’s long-term debt is not recorded at fair value on a recurring basis, but is measured at fair value for disclosure purposes. The fair value of the Company’s Term Loans (as defined herein) is $109.6 million and $114.3 million and Revolving Commitments (as defined herein) is $177.6 million and $177.5 million at April 27, 2014 and January 26, 2014, respectively. These are based on Level 2 inputs which are derived from transactions with similar amounts, maturities, credit ratings and payment terms.

Assets and Liabilities Recorded at Fair Value on a Non-Recurring Basis

The Company reduces the carrying amounts of its goodwill, intangible assets, long-lived assets and non-marketable equity security to fair value when held for sale or determined to be impaired.

For its investment in equity interests, the Company has not identified events or changes in circumstances that may have a significant adverse effect on the fair value of its cost method investment during the first three months of fiscal year 2015.

Note 7: Inventories

Inventories, consisting of material, material overhead, labor, and manufacturing overhead, are stated at the lower of cost (first-in, first-out) or market and consist of the following:

| (in thousands) | April 27, 2014 | January 26, 2014 |
|---|---|---|
| Raw materials | $2,746 | $1,971 |
| Work in progress | 35,704 | 45,508 |
| Finished goods | 16,846 | 12,788 |