SEMTECH CORP
Form 10-Q
September 04, 2015

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 July 26, 2015
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 August 28, 2015: 65,291,455

SEMTECH CORPORATION
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FOR THE QUARTER ENDED JULY 26, 2015

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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 the Company’s current expectations, estimates and projections about its operations, industry, financial condition, and expected performance. 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,” “believes,” “anticipates,” “expects,” “intends,” “plans,” “projects,” “estimates,” “should,” “will,” “designed to,” “proje “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:

- variation in market demand for the Company’s products including as a result of downturns in the business cycle and changes in global economic conditions;
- business interruptions caused by natural disasters, health epidemics, or violence affecting the locations in which the Company, its customers or its suppliers operate;
- the availability and cost of raw materials, components and equipment;
- product liability or warranty claims and availability of sufficient liability insurance;
- the Company‘s ability to timely develop, manufacture, market and provide support for new products that meet industry standards in a dynamic technological environment;
- the Company’s ability to protect its intellectual property rights and avoid infringement of the intellectual property rights of others;
- the financial impact of inadequate or excess inventory that results from demand that differs from projections;
- increased business risk from trade with multiple foreign entities, including compliance with or changes in the complex laws, rules and regulations applicable to international business transactions, social, political and economic instability, increased challenges in collection and management of distributors, representatives and staff, and exposure to foreign currency fluctuations ;
- potential increased tax liabilities and effective tax rate if the Company needs to repatriate funds held by foreign subsidiaries;
- industry consolidation and the Company’s ability to compete against larger, more established entities;
- volatility of customer demand or the loss of any one of the Company’s significant customers;
- financial difficulties of our distributors or their termination of our contracts or promotion of competing product lines to the Company’s detriment;
- the ability of the Company to comply, and the costs associated with complying, with the complex laws, rules and government regulations and standards to which the Company is or may become subject, and any action of an enforcement authority, that restricts our ability to manufacture our products or operate our business, or subjects us to fines, penalties, legal liabilities or reputational harm;
- changes in the tax rate applicable to the Company as a result of changes in tax laws and the outcome of examinations by global taxing authorities;
- the Company’s ability to maintain effective internal control over financial reporting and disclosure controls and procedures;
- the Company’s ability to recruit and retain skilled personnel;
- the Company’s ability to successfully integrate acquired businesses and benefit from expected synergies;
- impairments of our non-financial assets;
- the Company’s ability to generate cash to service its debt obligations;

- the Company’s ability to pursue business strategies that may be restricted by the terms of the Company’s credit agreement;
- the possible disruption of the Company’s critical communications and information systems necessary to operate its business;

- costs associated with indemnification of customers, distributors and other parties;
- the fluctuation of the Company’s share price;
- the Company’s ability to realize expected benefits of the implementation of a new enterprise resource planning (“ERP”) system; and disruption of the Company’s operations caused by the adjustment to the new ERP system and the transition from the Company’s legacy systems and databases; and
- the Company’s ability to achieve the expected reduction in the Company’s operating expenses from its restructuring activities.

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 25, 2015 including, without limitation information under the caption “Risk Factors”, 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.

PART I - FINANCIAL INFORMATION

ITEM 1. Financial Statements

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

	Three Months Ended		Six Months Ended	
	July 26, 2015	July 27, 2014	July 26, 2015	July 27, 2014
Net sales	$125,712	$145,742	$255,800	$278,601
Cost of sales	50,136	57,521	101,824	112,296
Gross profit	75,576	88,221	153,976	166,305
Operating costs and expenses:				
Selling, general and administrative	34,528	31,547	72,203	63,243
Product development and engineering	28,239	28,173	57,917	55,986
Intangible amortization	6,177	6,444	12,340	12,869
Restructuring charge	3,564	—	3,564	1,001
Total operating costs and expenses	72,508	66,164	146,024	133,099
Operating income	3,068	22,057	7,952	33,206
Interest expense, net	(1,900)	(1,588)	(3,734)	(2,975)
Non-operating expense, net	117	(345)	(376)	(623)
Income before taxes	1,285	20,124	3,842	29,608
Provision for taxes	1,598	2,226	4,297	3,843
Net (loss) income	$(313)	$17,898	$(455)	$25,765
(Loss) earnings per share:				
Basic	$0.00	$0.27	$(0.01)	$0.38
Diluted	$0.00	$0.26	$(0.01)	$0.38
Weighted average number of shares used in computing earnings per share:				
Basic	65,920	67,208	66,319	67,254
Diluted	65,920	67,850	66,319	67,888

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

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

	Three Months Ended		Six Months Ended	
	July 26, 2015	July 27, 2014	July 26, 2015	July 27, 2014
Net (loss) income	$(313)	$17,898	$(455)	$25,765
Other comprehensive (loss) income, before tax:				
Available-for-sale investments:				
Change in unrealized holding income on available-for-sale investments	—	(2)	—	(1)
Interest rate hedge:				
Change in unrealized loss on interest rate cap	(14)	(51)	(33)	(161)
Reclassification to interest expense	154	47	269	80
Other comprehensive income (loss), before tax	140	(6)	236	(82)
(Provision) benefit for taxes related to items of other comprehensive income	(56)	(16)	(98)	12
Other comprehensive income (loss), net of tax	84	(22)	138	(70)
Total comprehensive (loss) income	$(229)	$17,876	$(317)	$25,695

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

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

	July 26, 2015 (unaudited)	January 25, 2015
Assets		
Current assets:		
Cash and cash equivalents	$212,602	$230,328
Accounts receivable, less allowances of $4,285 at July, 26 2015 and $3,523 at January 25, 2015	61,509	69,301
Inventories	80,291	73,668
Deferred tax assets	2,486	2,478
Prepaid taxes	2,891	1,544
Other current assets	17,171	19,369
Total current assets	376,950	396,688
Non-current assets:		
Property, plant and equipment, net of accumulated depreciation of $132,306 at July 26, 2015 and $120,588 at January 25, 2015	109,075	115,471
Deferred tax assets	23	106
Goodwill	329,703	280,319
Other intangible assets, net	101,166	101,600
Other assets	32,988	35,247
TOTAL ASSETS	$949,905	$929,431
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$46,540	$32,448
Accrued liabilities	41,744	49,754
Deferred revenue	6,890	5,848
Current portion - long-term debt	18,555	18,547
Other current liabilities	10,000	—
Deferred tax liabilities	1,444	1,444
Total current liabilities	125,173	108,041
Non-current liabilities:		
Deferred tax liabilities	2,477	2,477
Long term debt, less current portion	260,464	234,746
Other long-term liabilities	51,090	32,809
Stockholders' equity:		
Common stock, $0.01 par value, 250,000,000 shares authorized, 78,136,144 issued and 65,050,133 outstanding on July 26, 2015 and 78,136,144 issued and 66,812,919 outstanding on January 25, 2015	785	785
Treasury stock, at cost, 13,086,011 shares as of July 26, 2015 and 11,323,225 shares as of January 25, 2015	(265,974)	(222,969)
Additional paid-in capital	374,260	371,596
Retained earnings	401,329	401,783
Accumulated other comprehensive income	301	163
Total stockholders' equity	510,701	551,358
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$949,905	$929,431

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

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

	Six Months Ended	
	July 26, 2015	July 27, 2014
Cash flows from operating activities:		
Net (loss) income	$(455)	$25,765
Adjustments to reconcile net (loss) income to net cash provided by operating activities, net of effects of acquisitions:		
Depreciation, amortization and impairments	24,020	24,030
Accretion of deferred financing costs and debt discount	660	511
Deferred income taxes	(430)	3,143
Stock-based compensation	8,282	13,121
Earn-out liabilities	568	(46)
Environmental reserve	2,855	—
Loss (gain) on disposition of property, plant and equipment	23	(14)
Changes in assets and liabilities:		
Accounts receivable, net	7,977	(2,135)
Inventories	(6,335)	5,816
Prepaid expenses and other assets	988	(4,247)
Accounts payable	15,960	(2,544)
Accrued liabilities	(9,353)	(1,681)
Deferred revenue	1,042	(840)
Income taxes payable and prepaid taxes	1,398	(1,839)
Other liabilities	1,546	2,097
Net cash provided by operating activities	48,746	61,137
Cash flows from investing activities:		
Proceeds from sales and maturities of available-for-sale investments	—	3,124
Proceeds from sales of property, plant and equipment	—	71
Purchase of property, plant and equipment	(8,244)	(12,662)
Purchase of intangible assets	—	(1,000)
Acquisitions, net of cash acquired	(34,932)	—
Purchases of other investments	(3,230)	(3,264)
Proceeds from sale of equity investments	5,261	—
Net cash used in investing activities	(41,145)	(13,731)
Cash flows from financing activities:		
Borrowings under line of credit	35,000	—
Payment for employee stock-based compensation payroll taxes	(4,073)	(3,533)
Proceeds from exercises of stock options	2,968	5,975
Repurchase of outstanding common stock	(49,847)	(20,000)
Payment of long term debt	(9,375)	(34,375)
Net cash used in financing activities	(25,327)	(51,933)
Net decrease in cash and cash equivalents	(17,726)	(4,527)
Cash and cash equivalents at beginning of period	230,328	243,194
Cash and cash equivalents at end of period	$212,602	$238,667

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

SEMTECH CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 1: Organization and Basis of Presentation

Nature of Business

The Company is a global supplier of analog and mixed-signal semiconductor products. The end-customers for the Company’s products are primarily original equipment manufacturers (“OEM’s”) 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, desktops, notebooks, servers, graphic boards, monitors, printers and other computer peripherals.

Communications: base stations, optical networks, carrier networks, switches and routers, cable modems, wireless LAN and other communication infrastructure equipment.

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

Industrial: video broadcast equipment, automated meter reading, alternative energy, Internet of Things (“IoT”), smart grid, 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 second quarter of fiscal years 2016 and 2015 each consisted of 13 weeks.

Principles of Consolidation

The accompanying interim condensed consolidated financial statements 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 the Company for the interim periods presented. All significant intercompany balances have been eliminated. 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. The Company evaluated all subsequent events through the date these interim condensed consolidated financial statements were issued.

In January 2015, the Company completed the acquisition of EnVerv, Inc. (“EnVerv”). In March 2015, the Company completed the acquisition of Triune Systems, L.L.C. (“Triune”). These interim condensed consolidated financial statements include the results of operations of EnVerv and Triune commencing as of their acquisition dates.

These interim condensed consolidated 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 25, 2015. The results reported in these interim condensed consolidated 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

In the first quarter of fiscal year 2016, the Company completed a reassessment of its operations in light of its recent strategic business decisions. Based on this reassessment, the Company has identified five operating segments in total. Four of the operating segments aggregate into one reportable segment, the Semiconductor Products Group. The remaining operating segment, the Systems Innovation Group (shown as “All others”), could not be aggregated with the other operating segments and did not meet the criteria for a separate reportable segment as defined by the guidance regarding segment disclosure. The Company’s Chief Executive Officer (“CEO”) has been identified as the Chief Operating Decision Maker (“CODM”) as defined by the segment disclosure guidance (see Note 14 for further discussion) and now receives discrete financial information pertaining to the Systems Innovation Group. As a result, the financial activity associated with the Systems Innovation Group is being reported separately from the Company's reportable segment. This separate reporting is included in the "All others" category. The Company reported "All others" separately from the Company's Semiconductor Products Group beginning in the three month period ended July 27, 2014. The historical activity of the reportable segment has been recast for consistent presentation for the three and six month periods ended July 27, 2014.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of 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.

Recent Accounting Pronouncements

In April 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-08, Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity. ASU 2014-08 changes the requirements for reporting discontinued operations in FASB Accounting Standards Codification ("ASC") Subtopic 205-20, such that a disposal of a component of an entity or a group of components of an entity is required to be reported in discontinued operations if the disposal represents a strategic shift that has (or will have) a major effect on an entity's operations and financial results. ASU 2014-08 requires an entity to present, for each comparative period, the assets and liabilities of a disposal group that includes a discontinued operation separately in the asset and liability sections, respectively, of the statement of financial position, as well as additional disclosures about discontinued operations. Additionally, ASU 2014-08 requires disclosures about a disposal of an individually significant component of an entity that does not qualify for discontinued operations presentation in the financial statements and expands the disclosures about an entity's significant continuing involvement with a discontinued operation. The accounting update is effective for annual periods beginning on or after December 15, 2014. Accordingly, the Company has adopted the provisions of this new accounting standard at the beginning of fiscal year 2016, and has assessed the impact on its consolidated financial statements to be immaterial.

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606), which requires an entity to recognize revenue from the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance addresses, in particular, contracts with more than one performance obligation, as well as the accounting for some costs to obtain or fulfill a contract with a customer, and provides for additional disclosures with respect to revenues and cash flows arising from contracts with customers. Public entities are required to apply the amendments on either a full- or modified-retrospective basis for annual periods beginning after December 15, 2017 and for interim periods within those annual periods. This update will be effective for the Company beginning in the first quarter of fiscal year 2018. Early adoption is not permitted. The Company is currently assessing the basis of adoption and evaluating the impact of the adoption of the update on its consolidated financial statements.

In April 2015, the FASB issued ASU 2015-03, Simplifying the Presentation of Debt Issuance Costs. The new standard intends to simplify the presentation of debt issuance costs to be presented in the balance sheet as a direct deduction from the carrying value of the associated debt liability. The new guidance is effective for annual reporting periods beginning after December 15, 2015, including interim reporting periods within that reporting period and early application is permitted. The Company plans to adopt the provisions of this new accounting standard at the beginning of fiscal year 2017. The adoption of this standard is not expected to have a significant impact on the Company's consolidated financial statements.

Note 2: Acquisitions
Triune Systems, L.L.C
On March 4, 2015 the Company acquired Triune Systems, L.L.C., a privately-held supplier of isolated switching wireless charging and power management platforms targeted at, among other things, high and low power, high efficiency applications. Under the terms of the purchase agreement the Company acquired all of the outstanding equity interest in Triune for a guaranteed minimum purchase price of $45.0 million consisting of $35.0 million in cash paid at closing, with an additional cash consideration of $10.0 million to be paid six months after the transaction closing date and additional contingent consideration subject to achieving certain future financial goals (“Triune Earn-out”). Under the terms of the Triune Earn-out, up to $70.0 million of consideration will be paid over three years if certain revenue targets are achieved in each of the fiscal years 2016 through 2018. An additional payment of up to $16.0 million will be paid after fiscal year 2018 if certain cumulative revenue and operating income targets are achieved. During the six months ended July 26, 2015, the Company borrowed $35.0 million under its revolving line of credit in connection with this acquisition (see Note 10 for discussion regarding Credit Facilities).
The Triune Systems L.L.C. business meets the definition of a business and is accounted for under the acquisition method of accounting in accordance with the FASB’s ASC Topic 805, Business Combinations. Total acquisition consideration will be allocated to the acquired tangible and intangible assets and assumed liabilities of Triune based on their respective estimated fair values as of the acquisition date. Acquisition-related transaction costs are not included as a component of consideration transferred, but are accounted for as an expense in the period in which the costs are incurred. Any excess of the acquisition consideration over the fair value of the assets acquired and liabilities assumed will be allocated to goodwill. The goodwill resulted from expected synergies from the transaction, including complementary products that will enhance the Company’s overall product portfolio, and opportunities within new markets. As of July 26, 2015, $10.0 million of the total acquisition consideration has been allocated to core technologies, $2.0 million to customer relationships and $49.4 million to goodwill. The remaining balance was allocated to identifiable tangible assets and assumed liabilities. The Company expects that all such goodwill will be deductible for tax purposes.
The purchase price allocation for the Triune acquisition was finalized in the second quarter of fiscal year 2016.
Net revenues and earnings attributable to Triune since the acquisition date were not material. Pro forma results of operations have not been presented as Triune’s annual operating results are not material to the Company’s consolidated financial results.
EnVerv, Inc.
On January 13, 2015, the Company paid $4.9 million to acquire select assets from EnVerv, Inc., a privately-held supplier of power line communications (“PLC”) and Smart Grid solutions targeted at advanced metering infrastructure, home energy management systems and IoT applications. The Company has concluded that the acquired assets constituted a business and accordingly accounted for this transaction as a business combination.
The purchase price allocation for the EnVerv acquisition was finalized in the first quarter of fiscal year 2016. Total acquisition consideration has been allocated to the acquired tangible and intangible assets and assumed liabilities based on their respective estimated fair values as of the acquisition date. The excess of the acquisition consideration over the fair value of assets acquired and liabilities assumed has been allocated to goodwill. As of July 26, 2015, $1.4 million of the total acquisition consideration has been allocated to core technologies and $3.4 million has been allocated to goodwill. The remaining balance has been allocated to acquired tangible assets and assumed liabilities. The Company expects that all such goodwill will be deductible for tax purposes.
Net revenues and earnings attributable to EnVerv since the acquisition date were not material. Pro forma results of operations have not been presented as EnVerv’s annual operating results are not material to the Company’s consolidated financial statements.

Note 3: (Loss) Earnings per Share

The computation of basic and diluted (loss) earnings per common share is as follows:

	Three Months Ended		Six Months Ended	
(in thousands, except per share amounts)	July 26, 2015	July 27, 2014	July 26, 2015	July 27, 2014
Net (loss) income	$(313)	$17,898	$(455)	$25,765
Weighted average common shares outstanding - basic	65,920	$67,208	$66,319	$67,254
Dilutive effect of options and restricted stock units	—	642	—	634
Weighted average common shares outstanding - diluted	65,920	$67,850	$66,319	$67,888
Basic (loss) earnings per common share	$0.00	$0.27	$(0.01)	$0.38
Diluted (loss) earnings per common share	$0.00	$0.26	$(0.01)	$0.38
Anti-dilutive shares not included in the above calculations	2,894	1,463	2,418	1,427

Basic (loss) earnings per common share is computed by dividing net (loss) 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 incorporate the incremental shares issuable, calculated using the treasury stock method, upon the assumed exercise of stock options and the vesting of restricted stock. For periods of operating loss, no common share equivalents are included because their effect would be anti-dilutive.

Note 4: 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 in “Net sales” within the condensed consolidated statements of operations. 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 arrangements 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 included in “Deferred revenue” within the condensed consolidated balance sheets.

The Company records a provision for estimated sales returns and rebates in the same period as the related revenues are recorded. The Company bases these estimates on historical sales returns, rebates 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. The Company reviews material subject to return for impairment for purposes of computing deferred cost of sales. There were no significant impairments of deferred cost of sales in the second quarter or first half of fiscal year 2016 or fiscal year 2015.

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Note 5: Stock-Based Compensation

Financial Statement Effects and Presentation. The following table summarizes pre-tax, stock-based compensation expense included in the unaudited condensed consolidated statements of operations captions for the three and six months ended July 26, 2015 and July 27, 2014, respectively.

(in thousands)	Three Months Ended		Six Months Ended	
	July 26, 2015	July 27, 2014	July 26, 2015	July 27, 2014
Cost of sales	$400	$355	$875	$718
Selling, general and administrative	(141)	3,448	3,073	7,513
Product development and engineering	2,076	2,472	4,333	4,891
Stock-based compensation	$2,335	$6,275	$8,281	$13,122
Net change in stock-based compensation capitalized into inventory	$204	$37	$279	$28

Stock-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 July 26, 2015, 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, for which 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 granted in the first six months of fiscal year 2016 and prior years are classified as liabilities rather than equity. For grants classified as equity, stock-based compensation cost is measured at the grant date, based on the fair value of the award, and is recognized as an expense over the grantee's requisite service period. For grants classified as liabilities, stock-based compensation cost is measured at fair value at the end of each reporting period until the date of settlement, and is recognized as an expense over the grantee'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 and six months ended July 26, 2015 and July 27, 2014, respectively:

	Three Months Ended		Six Months Ended	
	July 26, 2015	July 27, 2014	July 26, 2015	July 27, 2014
Expected lives, in years	4.2	4.3 - 4.4	4.2 - 4.3	3.0 - 4.4
Estimated volatility	32%	33%	29% - 32%	33% - 34%
Dividend yield	—	—	—	—
Risk-free interest rate	1.3%	1.30% - 1.43%	1.24% - 1.29%	1.26% - 1.43%
Weighted average fair value on grant date	$6.50	$7.43	$7.32	$7.26

Stock Option Awards. The Company has historically granted stock options to both employees and non-employee directors. The fair value of these grants was measured on the grant date and is being recognized as an expense over the requisite vesting period (typically 3-4 years).
The following table summarizes the activity for stock options for the six months ended July 26, 2015:

(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 25, 2015	1,763	$23.70	$7,722	$ 4,688	986	
Options granted	184	28.21				
Options exercised	(186)	15.96	1,592			
Options cancelled/forfeited	(132)	26.18				
Balance at July 26, 2015	1,629	$24.89	$552	$ 4,340	943	
Exercisable at July 26, 2015	943	$23.25	$552			2.5

Performance-Based Units. The Company grants performance-based 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 explicit service and 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 547,032 shares and an additional 547,032 shares would be settled in cash. The Company would have a liability accrued under "Other liabilities" within the condensed consolidated balance sheet equal to the value of 547,032 shares on the settlement date, which would be settled in cash. Only cash performance-based restricted stock unit awards are classified as liabilities and the value of these awards is re-measured at each reporting date. At July 26, 2015, the performance metrics associated with the outstanding awards issued in fiscal years 2016, 2015 and 2014 are expected to be met at a level which would result in a grant at 50%, 65%, and 0% of target, respectively.
In the first quarter of fiscal year 2016 the Company granted performance-based vesting restricted stock units to select employees as part of the EnVerv acquisition. These awards have a performance condition in addition to a service condition. The performance metrics are determined based on a pre-defined revenue target. In addition to the performance vesting condition, these awards have a requisite four year vesting term (which is also the requisite vesting period) whereby 25% will vest, subject to attainment of the performance condition, on each anniversary of the grant date. Under the terms of these awards, assuming the highest performance level of 100% with no cancellations due to forfeitures, the maximum number of shares that can be earned would be 45,000. At July 26, 2015, the performance metrics associated with the outstanding awards issued in fiscal year 2016 are expected to be met at a level which would result in a grant at 30,000 shares.
The Performance-based restricted stock units are valued as of the measurement date and expense is recognized on a straight line basis for the awards expected to vest based on the probability of attainment of the performance condition for each separately vesting portion of the award.

The following table summarizes the activity for performance-based restricted stock units for the six months ended July 26, 2015:

(in thousands, except for per unit amounts)	Total Units	Subject to Share Settlement Units	Subject to Cash Settlement Units	Recorded Liability	Weighted Average Grant Date Fair Value (per unit)	Aggregate Unrecognized Compensation	Weighted Average Period Over Which Expected to be Recognized (in years)
Balance at January 25, 2015	426	211	215	$1,891	$ 27.17	$ 6,164	1.6
Performance-based units granted	235	145	90		28.60		
Performance-based units vested	—	—	—		—		
Performance-based units cancelled/forfeited	(70)	(40)	(30)		27.93		
Change in liability				(1,317)			
Balance at July 26, 2015	591	316	275	$574	$ 27.65	$ 4,485	1.7

Changes in the liability associated with performance-based restricted stock units, which is recorded in “Other long-term liabilities” within the condensed consolidated balance sheets, is due to changes in proportionate vesting and estimated forfeitures, re-measurement adjustments related to changes in market value and changes in the expected performance results.

Market Performance Restricted Stock 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 fair value of the awards was determined to be $17.26 and $14.88 for Tranche 1 and Tranche 2, respectively, on the grant date by application of the Monte Carlo simulation model.

The following table summarizes the activity for market performance restricted stock units for the six months ended July 26, 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 25, 2015	220	$15.59	$—	1.2
Market performance units granted	—	—		
Market performance units vested	—	—		
Market performance units cancelled/forfeited	—	—		
Balance at July 26, 2015	220	$15.59	$827	0.5

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Restricted Stock Units, Employees. The Company grants restricted stock units 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 recognized as an expense over the requisite vesting period (typically 4 years).

The following table summarizes the employees' restricted stock unit activity for the six months ended July 26, 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 25, 2015	2,138	$ 26.43		$44,506	2.4
Restricted stock units granted	370	27.10			
Restricted stock units vested	(340)	27.78	$9,325		
Restricted stock units forfeited	(220)	26.15			
Balance at July 26, 2015	1,948	$ 26.35		$39,039	2.3

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

Restricted Stock Units, Cash Settled, Non-Employee Directors. The Company maintains a compensation program pursuant to which restricted stock units are granted to the Company's directors that are not employed by the Company or any of its subsidiaries. In June 2015, the Company changed its director compensation program so that a portion of the stock units granted under the program would be settled in cash and a portion would be settled in stock. Restricted stock units awarded under the program are scheduled to vest on the earlier of (i) one year after the grant date or (ii) the day immediately preceding the annual meeting of shareholders in the year following the grant. The portion of a restricted stock unit award under the program that is to be settled in cash will, subject to vesting, be paid when the director who received the award separates from the board of directors. The portion of a restricted stock unit award under the program that is to be settled in stock will, subject to vesting, be paid promptly following vesting. There were no changes to the terms and conditions of the existing awards.

The restricted stock units that are to be settled in cash are accounted for as liabilities because they are cash settled. 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 non-employee directors' activity for restricted stock units settled in cash for the six months ended July 26, 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 25, 2015	24	$5,214	$ 26.59	$275	0.4
Restricted stock units granted	28		19.70		
Restricted stock units vested	(24)		26.59		
Restricted stock units forfeited	—		—		
Change in liability		(1,447)			
Balance at July 26, 2015	28	$3,767	$ 19.70	$472	0.9

As of July 26, 2015, the total number of vested but unsettled restricted stock units for non-employee directors is 175,132 units. As of July 26, 2015, $1.4 million of the liability associated with these awards is included in "Other long-term liabilities" within the condensed consolidated balance sheet.

Restricted Stock Units, Stock Settled, Non-Employee Directors. As a result of the June 2015 changes to the Company's director compensation program, beginning in July 2015, the Company began granting restricted stock units to non-employee Directors which are expected to be settled with stock at the time of vesting. The grant date for these awards is equal to the measurement date. These awards are valued as of the measurement date and recognized as an expense over the requisite vesting period (typically one year).

The following table summarizes the non-employee directors' activity for restricted stock units settled with stock for the six months ended July 26, 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	Period Over Which Expected to be Recognized (in years)
Balance at January 25, 2015	—	$ —		$—	0.0
Restricted stock units granted	24	19.70			