

SEMTECH CORP  
Form 10-Q  
September 06, 2013

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 July 28, 2013

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 1-6395

SEMTECH CORPORATION  
(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of  
incorporation or organization)

95-2119684  
(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  No

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

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

Large accelerated filer  Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company

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

Number of shares of Common Stock, \$0.01 par value per share, outstanding at August 30, 2013: 68,053,222



SEMTECH CORPORATION  
INDEX TO FORM 10-Q  
FOR THE QUARTER ENDED JULY 28, 2013

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## 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		Six Months Ended	
	July 28, 2013	July 29, 2012	July 28, 2013	July 29, 2012
Net sales	\$165,010	\$150,704	\$327,417	\$267,346
Cost of sales	64,302	76,179	129,422	137,484
Gross profit	100,708	74,525	197,995	129,862
Operating costs and expenses:				
Selling, general and administrative	33,315	31,220	68,109	76,038
Product development and engineering	33,125	32,613	67,684	56,696
Intangible amortization and impairments	9,811	7,977	17,667	13,555
Total operating costs and expenses	76,251	71,810	153,460	146,289
Operating income (loss)	24,457	2,715	44,535	(16,427 )
Interest expense	(10,584 )	(3,442 )	(14,644 )	(4,955 )
Interest income and other (expense), net	(198 )	(590 )	(1,005 )	(706 )
Income (loss) before taxes	13,675	(1,317 )	28,886	(22,088 )
Benefit for taxes	(5,437 )	(11,339 )	(5,003 )	(34,319 )
Net income	\$19,112	\$10,022	\$33,889	\$12,231
Earnings per share:				
Basic	\$0.28	\$0.15	\$0.50	\$0.19
Diluted	\$0.28	\$0.15	\$0.49	\$0.18
Weighted average number of shares used in computing earnings per share:				
Basic	67,614	65,587	67,285	65,435
Diluted	69,090	67,165	68,812	67,207

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		Six Months Ended	
	July 28, 2013	July 29, 2012	July 28, 2013	July 29, 2012
Net income	\$19,112	\$10,022	\$33,889	\$12,231
Other comprehensive income (loss), before tax:				
Change in unrealized holding loss on available-for-sale investments	(7	) (9	) (8	) (33
Change in unrealized income (loss) on interest rate cap	288	(305	) 47	(305
Less: Reclassification adjustments for losses on interest rate cap included in interest expense	(10	) —	(19	) —
Change in cumulative translation adjustment	—	(257	) —	119
Other comprehensive income (loss), before tax	291	(571	) 58	(219
(Benefit) provision for taxes related to items of other comprehensive income (loss)	(106	) 113	(21	) 117
Other comprehensive income (loss), net of tax	185	(458	) 37	(102
Total comprehensive income, net of tax	\$19,297	\$9,564	\$33,926	\$12,129

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)

	July 28, 2013 (unaudited)	January 27, 2013
Assets		
Current assets:		
Cash and cash equivalents	\$237,060	\$223,192
Temporary investments	—	4,973
Accounts receivable, less allowances of \$4,389 at July 28, 2013 and \$4,917 at January 27, 2013	80,595	69,160
Inventories	78,214	74,878
Deferred tax assets	7,334	7,473
Prepaid taxes	7,073	7,794
Other current assets	19,214	18,523
Total current assets	429,490	405,993
Non-current assets:		
Property, plant and equipment, net of accumulated depreciation of \$111,944 at July 28, 2013 and \$101,766 at January 27, 2013	113,314	101,837
Long-term investments	4,923	7,907
Deferred tax assets	40,828	33,563
Goodwill	393,584	393,584
Other intangible assets, net	187,916	206,058
Other assets	19,595	22,071
TOTAL ASSETS	\$1,189,650	\$1,171,013
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$50,404	\$51,991
Accrued liabilities	36,866	49,276
Deferred revenue	5,398	3,745
Current portion - long term debt	18,385	48,449
Deferred tax liabilities	3,245	4,221
Total current liabilities	114,298	157,682
Non-current liabilities:		
Deferred tax liabilities	3,636	2,042
Long term debt, less current portion	282,157	282,286
Other long-term liabilities	39,073	34,177
Stockholders' equity:		
Common stock, \$0.01 par value, 250,000,000 shares authorized, 78,136,144 issued and 67,785,261 outstanding on July 28, 2013 and 78,136,144 issued and 66,607,347 outstanding on January 27, 2013		785
Treasury stock, at cost, 10,350,883 shares as of July 28, 2013 and 11,528,797 shares as of January 27, 2013	(180,321)	(200,604)
Additional paid-in capital	357,441	355,990
Retained earnings	572,191	538,302
Accumulated other comprehensive income	390	353
Total stockholders' equity	750,486	694,826
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$1,189,650	\$1,171,013

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

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

	Six Months Ended		
	July 28, 2013	July 29, 2012	
Cash flows from operating activities:			
Net income	\$33,889	\$12,231	
Adjustments to reconcile net income to net cash provided by operating activities, net of effects of acquisitions:			
Depreciation, amortization and impairments	28,937	22,545	
Effect of acquisition fair value adjustments	2,529	28,600	
Accretion of deferred financing costs and debt discount	1,010	1,081	
Write-off of deferred financing costs and debt discount	8,773	—	
Deferred income taxes	(6,529)	(12,425)	)
Stock-based compensation	14,782	10,245	
Excess tax benefits on stock based compensation	—	(2,913)	)
(Gain) loss on disposition of property, plant and equipment	(27)	85	)
Changes in assets and liabilities:			
Accounts receivable, net	(11,435)	(13,079)	)
Inventories	(5,659)	3,426	)
Prepaid expenses and other assets	46	6,301	
Accounts payable	(2,479)	(2,344)	)
Accrued liabilities	(10,140)	(19,764)	)
Deferred revenue	1,532	1,314	
Income taxes payable and prepaid taxes	(1,389)	(24,757)	)
Other liabilities	4,605	1,325	
Net cash provided by operating activities	58,445	11,871	
Cash flows from investing activities:			
Purchases of available-for-sale investments	(1,050)	(10,106)	)
Proceeds from sales and maturities of available-for-sale investments	8,998	103,199	
Proceeds from sales of property, plant and equipment	57	—	
Purchase of property, plant and equipment	(23,565)	(10,715)	)
Purchase of intangible assets	(2,583)	—	)
Acquisitions, net of cash acquired	—	(491,717)	)
Net cash used in investing activities	(18,143)	(409,339)	)
Cash flows from financing activities:			
Proceeds from debt issuance, net of discount	326,448	347,000	
Deferred financing cost	(2,085)	(8,962)	)
Payment on interest rate cap	—	(1,100)	)
Excess tax benefits on stock based compensation	—	2,913	
Proceeds from exercises of stock options	8,328	2,413	
Repurchase of outstanding common stock	—	(269)	)
Payment of long term debt	(359,125)	(5,625)	)
Net cash (used in) provided by financing activities	(26,434)	336,370	)
Effect of exchange rate increase on cash and cash equivalents	—	(66)	)
Net increase (decrease) in cash and cash equivalents	13,868	(61,164)	)
Cash and cash equivalents at beginning of period	223,192	227,022	
Cash and cash equivalents at end of period	\$237,060	\$165,858	



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

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

Note 1: Organization and Basis of Presentation

Semtech Corporation (together with its subsidiaries, the “Company” or “Semtech”) 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, 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, cable modems, signal conditioners, wireless LAN and other communication infrastructure equipment.

High-End Consumer: handheld products, set-top boxes, digital televisions, tablet computers, digital video recorders, wired and fiberless high-speed interfaces 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 second quarter of fiscal years 2014 and 2013 each consisted of 13 weeks.

Principles of Consolidation

The accompanying interim unaudited consolidated condensed financial statements of Semtech Corporation and its subsidiaries 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 Corporation and its subsidiaries 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 (“U.S. 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 consolidated financial statements and the notes thereto included in the Company’s Annual Report on Form 10-K for the year ended January 27, 2013. 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 five 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 has been identified as the Chief Operating Decision Maker as defined by guidance regarding segment disclosures.

Use of Estimates

The preparation of financial statements in conformity with U.S. 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:

(in thousands, except per share amounts)	Three Months Ended		Six Months Ended	
	July 28, 2013	July 29, 2012	July 28, 2013	July 29, 2012
Net income	\$19,112	\$10,022	\$33,889	\$12,231
Weighted average common shares outstanding - basic	67,614	65,587	67,285	65,435
Dilutive effect of employee equity incentive plans	1,476	1,578	1,527	1,772
Weighted average common shares outstanding - diluted	69,090	67,165	68,812	67,207
Basic earnings per common share	\$0.28	\$0.15	\$0.50	\$0.19
Diluted earnings per common share	\$0.28	\$0.15	\$0.49	\$0.18

Anti-dilutive shares not included in the above calculations	352	1,472	392	1,190
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Basic earnings per common share is computed by dividing income available to common shareholders 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 unaudited 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 second quarter of fiscal year 2014 or fiscal year 2013.

## Note 4: Acquisitions

## Gennum Corporation (“Gennum”)

On March 20, 2012, the Company, through its wholly-owned subsidiary Semtech Canada Inc., completed the acquisition of all outstanding equity interests of Gennum (TSX: GND), a leading supplier of high speed analog and mixed-signal semiconductors for the optical communications and video broadcast markets.

Upon consummation of the business acquisition, which constituted a change in control of Gennum, Gennum’s stock option awards and restricted shares became fully vested. Semtech acquired 100% of the outstanding shares and vested stock options, restricted shares, and deferred share units of Gennum for CDN \$13.55 per share for a total purchase price of \$506.5 million. The acquisition was financed with a combination of cash from Semtech’s international cash reserves and \$347.0 million of five-year secured term loans, net of original issuance debt discount of \$3.0 million (see Note 10).

The Gennum assets acquired and liabilities assumed are recorded at their acquisition-date fair values.

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 assets acquired and liabilities assumed is 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, and is not deductible for tax purposes. The acquired in-process research and development is recorded at fair value as an indefinite-lived intangible asset at the acquisition date until the completion or abandonment of the associated research and development efforts.

In connection with the acquisition, certain Gennum employees became entitled to payments upon a change in control and their subsequent termination. These payments, which totaled approximately \$9.6 million, have been recognized as a post-acquisition compensation expense and included in the unaudited consolidated condensed statements of income for the six months ended July 29, 2012 under “Selling, general and administrative.”

The Company’s allocation of the total purchase price as of March 20, 2012 is summarized below:

(in thousands)	At March 20, 2012
Cash	\$ 19,664
Accounts receivable, less allowances	14,032
Inventories	62,941
Prepaid expenses	3,832
Income taxes receivable	1,467
Deferred tax assets - current	8,590
Other current assets	7,804
Property, plant and equipment	25,702
Amortizable intangible assets	129,863
In-process research and development	29,100
Goodwill	261,891
Deferred tax assets - non-current	31,235
Other non-current assets	8
Deferred tax liabilities	(47,077 )
Accounts payable	(18,232 )
Accrued liabilities	(24,274 )
Total acquisition consideration	\$ 506,546

(in thousands)	At March 20, 2012
Amortizable intangible assets:	
Developed technology	\$ 95,100
Customer relationships	28,000

Other intangible assets	6,763
Total amortizable intangible assets	\$ 129,863

The Company completed the purchase price allocation for its acquisition of Gennum in fiscal year 2013.

The Company recorded the following transaction and integration related costs in the three and six months ended July 28, 2013 and July 29, 2012:

(in thousands)	Three Months Ended		Six Months Ended	
	July 28, 2013	July 29, 2012	July 28, 2013	July 29, 2012
Transaction and integration related costs	\$386	\$1,763	\$987	\$20,389

These costs are included in the unaudited consolidated condensed statements of income for the respective periods under "Selling, general and administrative."

For the three and six months ended July 28, 2013 and July 29, 2012 (for the period after acquisition), the Company recognized the following net revenues and corresponding net income (loss) attributable to Gennum:

(in thousands)	Three Months Ended		Six Months Ended	
	July 28, 2013	July 29, 2012	July 28, 2013	July 29, 2012
Net revenue - Gennum	\$47,376	\$35,346	\$87,657	\$47,340
Net income (loss) - Gennum	5,130	(22,741)	4,320	(51,274)

#### Pro Forma Financial Information

The results of operations of Gennum have been included in the Company's consolidated statements of income since the acquisition date of March 20, 2012. The following table reflects the unaudited consolidated pro forma information as if the acquisition had been completed on January 29, 2011, after giving effect to certain adjustments including the following for the three and six months ended July 29, 2012:

• decrease in cost of goods sold associated with fair value adjustment related to acquired inventory of \$17.7 million and \$30.6 million for the three and six months ended July 29, 2012, respectively;

• increase in operating expense as a result of the settlement of two pre-acquisition contingencies related to legal matters of \$4.2 million for the six months ended July 29, 2012;

• decrease in amortization expense as a result of acquired intangible assets of \$1.2 million for the three months ended July 29, 2012 and increase of \$0.8 million for the six months ended July 29, 2012;

• decrease in tax benefit of \$23.4 million associated with the releasing of prior accrued taxes on foreign earnings for the six months ended July 29, 2012;

• decrease in interest expense of \$0.2 million associated with the \$350 million term loans entered into to finance the acquisition for the three months ended July 29, 2012 and increase of \$2.0 million for the six months ended July 29, 2012; and

• the related tax effects.

Unaudited Consolidated Pro forma Information:

(in thousands)	Three Months Ended	Six Months Ended
	July 29, 2012	July 29, 2012
	(unaudited)	(unaudited)
Revenue	\$150,704	\$291,586
Net income	\$26,020	\$16,637

The unaudited pro forma information presented does not purport to be indicative of the results that would have been achieved had the acquisition been consummated on January 29, 2011 nor of the results which may occur in the future. The pro forma adjustments are based upon available information and certain assumptions that the Company believes are reasonable. The unaudited pro forma information does not include any adjustments for any restructuring activities, operating efficiencies or cost savings.

#### Cycleo SAS ("Cycleo")

On March 7, 2012, the Company completed the acquisition of Cycleo, a privately held company based in France that develops intellectual property ("IP") for wireless long-range semiconductor products used in smart metering and other industrial and consumer markets. Under the terms of the agreement, Semtech paid the stockholders of Cycleo \$5.0 million in cash at closing.

Total acquisition consideration is allocated to the acquired tangible and intangible assets and assumed liabilities of Cycleo based on their respective estimated fair values as of the acquisition date. Any excess of the acquisition consideration over the fair value of assets acquired and liabilities assumed is allocated to goodwill. The Company expects that all such goodwill will not be deductible for tax purposes.

The Company completed the purchase price allocation for its acquisition of Cycleo in fiscal year 2013.

Additionally, pursuant to the earn-out arrangement with Cycleo stockholders, the Company potentially may make payments totaling up to approximately \$16.0 million based on the achievement of a combination of certain revenue and operating income milestones by Cycleo over the period of four years beginning on April 30, 2012. For certain of the Cycleo stockholders, payment of the earn-out liability is contingent upon employment on the payout date and is accounted for as post-acquisition compensation expense over the service period. The portion of the earn-out liability that is not dependent on continued employment is included in the purchase price allocation at March 7, 2012.

As of July 28, 2013, the Company does not expect to make any earn-out payments related to the year 1 and year 2 milestones. The potential earn-out payments for the year 1 and year 2 milestones were \$1.8 million and \$3.0 million, respectively.

Net revenues and earnings attributable to Cycleo since the acquisition date were not material. Pro forma results of operations have not been presented as the acquisition was not material to the Company's consolidated financial statements.

## Note 5: 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 and six months ended July 28, 2013 and July 29, 2012.

(in thousands)	Three Months Ended		Six Months Ended	
	July 28, 2013	July 29, 2012	July 28, 2013	July 29, 2012
Cost of sales	\$405	\$297	\$733	\$528
Selling, general and administrative	3,548	2,657	8,430	5,881
Product development and engineering	2,203	1,965	5,619	3,836
Stock-based compensation, pre-tax	\$6,156	\$4,919	\$14,782	\$10,245
Net change in stock-based compensation capitalized into inventory	\$8	\$16	\$85	\$82

## 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 compensation. As of July 28, 2013, the Company has granted options and restricted stock under the plans and has also issued some stock-based compensation outside of the plans, including options and restricted stock 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 options. 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 options granted in the three and six months ended July 28, 2013 and July 29, 2012:

	Three Months Ended		Six Months Ended	
	July 28, 2013	July 29, 2012	July 28, 2013	July 29, 2012
Expected lives, in years	4.7	4.4 - 4.6	4.2 - 4.7	4.4 - 4.6
Estimated volatility	33%	40%	33% - 35%	40% - 41%
Dividend yield	—	—	—	—
Risk-free interest rate	1.3%	0.70%	0.65% - 1.3%	0.70%
Weighted average fair value on grant date	\$10.59	\$8.31	\$9.33	\$9.68

The estimated fair value of restricted stock awards was calculated based on the market price of the Company's common stock on the date of grant. Some of the restricted stock units awarded in the second quarter of fiscal year 2014 and prior years are classified as liabilities rather than equity. For awards classified as liabilities, the value of these awards is re-measured at the end of each quarter.

Stock Option Awards. The Company has historically granted stock option awards 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 six months of fiscal year 2014 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 27, 2013	2,579	\$18.29	\$29,789	\$ 3,817	1,937	
Options granted	240	32.04				
Options exercised	(790 )	16.71	13,982			
Options cancelled/forfeited	(12 )	23.56				
Balance at July 28, 2013	2,017	\$20.28	\$22,092	\$ 4,651	1,370	
Exercisable at July 28, 2013	1,370	\$17.28	\$19,262			2.4

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 July 28, 2013.

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 condition generally relates to the Company's revenue and operating income measured against internal goals. 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 412,500 shares and 402,500 shares settled in cash. The Company would have a liability accrued in the unaudited consolidated condensed balance sheet equal to the value of 402,500 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 July 28, 2013, the performance metrics associated with the outstanding awards issued in fiscal years 2014, 2013 and 2012 are expected to be met at a level which would result in a grant at 100%, 80%, and 97% of target, respectively.

The following table summarizes the activity for performance units for the first six months of fiscal year 2014:

(in thousands, except for per share amounts)	Total Units	Subject to Share Settlement Units	Subject to Cash Settlement Units	Recorded Liability	Weighted Average Grant Fair Value (per share)	Aggregate Unrecognized Compensation	Period Over Which Expected to be Recognized (in years)
Balance at January 27, 2013	353	181	172	\$4,422	\$ 23.50	\$ 4,754	1.1
Performance units granted	186	93	93		30.82		
Performance units vested	(114 )	(57 )	(57 )		16.68		
Performance units cancelled/forfeited	(13 )	(7 )	(6 )		25.70		
Change in liability				(2,405 )			
Balance at July 28, 2013	412	210	202	\$2,017	\$ 28.62	\$ 7,646	1.8

Stock Units, Employees. The Company issues 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 stock unit award activity for the first six months of fiscal year 2014:

(in thousands, except per share amount)	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 27, 2013	2,558	\$ 23.41		\$ 49,374	2.5
Stock units granted	308	32.50			
Stock units vested	(504 )	22.59	\$16,317		
Stock units forfeited	(97 )	24.60			
Balance at July 28, 2013	2,265	\$ 24.78		\$ 45,996	2.3

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

Stock Units, Non-Employee Directors. The Company grants stock unit awards to non-employee directors. These restricted stock units are accounted for as liabilities and accrued in the unaudited 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 six months of fiscal year 2014:

(in thousands, except per share amount)	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 27, 2013	20	\$4,557	\$ 24.46	\$253	0.4
Stock units granted	18		35.17		
Stock units vested	(20 )		24.46		
Stock units forfeited	—		—		
Change in liability		537			
Balance at July 28, 2013	18	\$5,094	\$ 35.17	\$518	0.9

As of July 28, 2013, the total number of vested but unsettled stock units for Non-Employee Directors is 161,182 units which are included in the recorded liability.

## Note 6: 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 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 "Interest income and other 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.

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

(in thousands)	July 28, 2013			January 27, 2013		
	Market Value	Adjusted Cost	Gross Unrealized Loss	Market Value	Adjusted Cost	Gross Unrealized Gain
Agency securities	\$4,923	\$4,924	\$(1 )	\$7,907	\$7,900	\$7
Bank time deposits	—	—	—	4,973	4,973	—
Total investments	\$4,923	\$4,924	\$(1 )	\$12,880	\$12,873	\$7

Agency securities are specific securities that are issued by United States 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:

(in thousands)	July 28, 2013		January 27, 2013	
	Market Value	Adjusted Cost	Market Value	Adjusted Cost
Within 1 year	\$—	\$—	\$4,973	\$4,973
After 1 year through 5 years	4,923	4,924	7,907	7,900
Total investments	\$4,923	\$4,924	\$12,880	\$12,873

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 unaudited 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:

(in thousands)	Three Months Ended		Six Months Ended	
	July 28, 2013	July 29, 2012	July 28, 2013	July 29, 2012
Unrealized loss, net of tax	\$(4 )	\$(7 )	\$(5 )	\$(27 )
Decrease to deferred tax liability	(3 )	(2 )	(3 )	(6 )

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

(in thousands)	Three Months Ended		Six Months Ended	
	July 28, 2013	July 29, 2012	July 28, 2013	July 29, 2012
Interest income	\$91	\$60	\$191	\$252

During the third quarter of fiscal year 2013, the Company acquired an investment in a privately traded company for total cash consideration of \$2.5 million. The Company accounts for the investment in equity interests under the cost method of accounting since it does not have the ability to exercise significant influence over the investee. The investment in equity interests is included in “Other assets” on the unaudited consolidated condensed balance sheet as of July 28, 2013.

#### Note 7: 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:

(in thousands)	Fair Value as of July 28, 2013				Fair Value as of January 27, 2013			
	Total	(Level 1)	(Level 2)	(Level 3)	Total	(Level 1)	(Level 2)	(Level 3)
Agency securities	\$4,923	\$—	\$4,923	\$—	\$7,907	\$—	\$7,907	\$—
Bank time deposits	—	—	—	—	4,973	—	4,973	—
Total available-for-sale securities	4,923	—	4,923	—	12,880	—	12,880	—
Interest rate cap	591	—	591	—	544	—	544	—
Total financial assets	\$5,514	\$—	\$5,514	\$—	\$13,424	\$—	\$13,424	\$—

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 July 28, 2013 is estimated as described in Note 11 and is included in “Other assets” on the unaudited consolidated condensed balance sheet.

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

(in thousands)	Fair Value as of July 28, 2013				Fair Value as of January 27, 2013			
	Total	(Level 1)	(Level 2)	(Level 3)	Total	(Level 1)	(Level 2)	(Level 3)
Temporary investments	\$—	\$—	\$—	\$—	\$4,973	\$—	\$4,973	\$—
Long-term investments	4,923	—	4,923	—	7,907	—	7,907	—
Other assets	591	—	591	—	544	—	544	—
Total financial assets	\$5,514	\$—	\$5,514	\$—	\$13,424	\$—	\$13,424	\$—

During the six months ended July 28, 2013, the Company had no transfers of financial assets or liabilities between Level 1, Level 2 or Level 3. As of July 28, 2013 and January 27, 2013, 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) of \$123.3 million and Revolving Commitments (as defined herein) of \$177.2 million at July 28, 2013 approximate their carrying amounts based on the variable nature of the rates and their proximity to the May 2, 2013 issuance date. See Note 10 for details.



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 six months of fiscal year 2014.

Note 8: 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)	July 28, 2013	January 27, 2013
Raw materials	\$4,393	\$1,970
Work in progress	55,986	52,669
Finished goods	17,835	20,239
Inventories	\$78,214	\$74,878

## Note 9: Goodwill and Intangible Assets

Goodwill – There were no changes to goodwill during the first six months of fiscal year 2014.

Goodwill is not amortized, but is tested for impairment using a two-step method on an annual basis and whenever events or changes in circumstances indicate that the carrying value may not be recoverable. The recoverability of goodwill is measured at the reporting unit level by comparing the reporting unit's carrying amount, including goodwill, to the fair market value of the reporting unit.

The fair value of goodwill is tested for impairment on a non-recurring basis in the accompanying unaudited consolidated condensed financial statements using Level 3 inputs. The Company concluded that there were no indicators of impairment as of July 28, 2013.

Purchased Intangibles – The following table sets forth the Company's finite-lived intangible assets resulting from business acquisitions and technology licenses purchased, which continue to be amortized:

(in thousands)	Estimated Useful Life	July 28, 2013			January 27, 2013		
		Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Core technologies	2-10 years	\$ 178,724	\$ (52,292 )	\$ 126,432	\$ 173,724	\$ (40,867 )	\$ 132,857
Customer relationships	7-10 years	40,130	(10,415 )	29,715	40,130	(7,736 )	32,394
Technology licenses (1)	5-10 years	8,496	(1,864 )	6,632	8,164	(1,056 )	7,108
Other intangibles assets	1-5 years	6,600	(5,563 )	1,037	6,600	(4,601 )	1,999
Total finite-lived intangible assets		\$ 233,950	\$ (70,134 )	\$ 163,816	\$ 228,618	\$ (54,260 )	\$ 174,358

Technology licenses relate to licensing agreements entered into by the Company. Amortization expense related to (1) technology licenses is reported as "Product development and engineering" in the unaudited consolidated condensed statements of income.

During the first six months of fiscal year 2014, acquired finite-lived intangible assets increased by approximately \$5.3 million primarily due to the transfer from indefinite-lived intangible assets to core technologies upon the completion of an in-process research and development project from the Gennum acquisition in March 2012.

For the three months ended July 28, 2013 and July 29, 2012, amortization expense related to acquired finite-lived intangible assets was \$7.2 million and \$8.0 million, respectively. For the six months ended July 28, 2013 and July 29, 2012, amortization expense related to finite-lived intangible assets was \$15.1 million and \$12.9 million, respectively. Amortization expense related to acquired finite-lived intangible assets is reported as "Intangible amortization and impairments" in the unaudited consolidated condensed statements of income.

The estimated annual amount of future amortization expense for all finite-lived intangible assets will be as follows:

(in thousands)	Technology license	Sierra Monolithics	Gennum	Cycleo	Total
To be recognized in:					
Remainder of fiscal year 2014	\$ 843	\$ 4,434	\$ 9,483	\$ 504	\$ 15,264
Fiscal year 2015	1,512	8,870	18,965	1,007	30,354
Fiscal year 2016	1,501	8,870	18,419	1,007	29,797
Fiscal year 2017	1,251	8,870	18,332	1,007	29,460
Fiscal year 2018	842	8,160	18,332	1,007	28,341
Thereafter	683	8,490	21,345	82	30,600
Total expected amortization expense	\$ 6,632	\$ 47,694	\$ 104,876	\$ 4,614	\$ 163,816





The following table sets forth the Company's indefinite-lived intangible assets resulting from business acquisitions:

(in thousands)	July 28, 2013			January 27, 2013		
	Gross Carrying Amount	Accumulated Impairment Loss	Net Carrying Amount	Gross Carrying Amount	Accumulated Impairment Loss	Net Carrying Amount
In-process research and development	\$29,870	\$(5,770)	\$24,100	\$34,870	\$(3,170)	\$31,700
Total indefinite-lived intangible assets	\$29,870	\$(5,770)	\$24,100	\$34,870	\$(3,170)	\$31,700

During the first six months of fiscal year 2014, acquired indefinite-lived intangible assets decreased by approximately \$5.0 million due to the transfer from indefinite-lived intangible assets to core technologies upon the completion of an in-process research and development project ("IPR&D") from the Gennum acquisition in March 2012.

The Company reviews indefinite-lived intangible assets for impairment annually or whenever events or changes in circumstances indicate the carrying value may not be recoverable. Recoverability of indefinite-lived intangible assets is measured by comparing the carrying amount of the asset to the future discounted cash flows the asset is expected to generate.

The fair value of indefinite-lived intangible assets is tested for impairment on a non-recurring basis in the accompanying unaudited consolidated condensed financial statements using Level 3 inputs. During the three month period ending July 28, 2013, the Company made the strategic decision to discontinue development of microwave products which resulted in the Company recording a \$2.6 million impairment to IPR&D from the acquisition of Sierra Monolithics, Inc ("SMI"). Other than this impairment charge, the Company concluded that the fair value of all the continuing acquired in-process research and developments exceeded the carrying value and no impairment existed as of July 28, 2013.

#### Note 10: Credit Facilities

On March 20, 2012, the Company entered into a credit agreement with certain lenders (the “Prior Lenders”) and Jefferies Finance LLC, as administrative and collateral agent (the “Prior Credit Agreement”). Pursuant to the Prior Credit Agreement, the Prior Lenders provided the Company with senior secured first lien credit facilities in an aggregate principal amount of \$350.0 million (the “Prior Credit Facilities”), consisting of term A loans in an aggregate principal amount of \$100.0 million (the “Term A Loans”) and term B loans in an aggregate principal amount of \$250.0 million (the “Term B Loans”). The initial carrying amounts totaled \$99.5 million (net of original issue discount of \$0.5 million) for the Term A Loans and \$247.5 million (net of original issue discount of \$2.5 million) for the Term B Loans.

On May 2, 2013 (the “Closing Date”), the Company, with each of its domestic subsidiaries as guarantors (the “Guarantors”), entered into a new Credit Agreement (the “New Credit Agreement”) with the lenders referred to therein (the “Lenders”) and HSBC Bank USA, National Association, as administrative agent and as swing line lender and letter of credit issuer. Pursuant to the New Credit Agreement, the Lenders provided Semtech with senior secured first lien credit facilities in an aggregate principal amount of \$400.0 million (the “New Facilities”), consisting of term loans in an aggregate principal amount of \$150.0 million (the “Term Loans”) and revolving commitments in an aggregate principal amount of \$250.0 million (the “Revolving Commitments”). Up to \$40.0 million of the Revolving Commitments may be used to obtain letters of credit; up to \$25.0 million of the Revolving Commitments may be used to obtain swing line loans (as defined below); and up to \$40.0 million of the Revolving Commitments may be used to obtain revolving loans and letters of credit in certain currencies other than U.S. Dollars (“Alternative Currencies”). Swing line loans are base rate loans made in immediately available funds denominated in dollars by a swing line lender in its sole and absolute discretion. As of July 28, 2013, there were no amounts outstanding under the letters of credit, swing line loans, and multi-currency subfacility.

At the Closing Date, \$326.5 million of borrowings were outstanding under the New Facilities consisting of \$149.3 million of Term Loans and \$177.2 million of Revolving Commitments, net of \$1.5 million of debt discounts resulting from amounts paid to the Lenders. The debt discounts are amortized using the effective interest method and is included in “Interest expense” in the unaudited consolidated condensed statements of income. The proceeds from the New Facilities were used to repay in full the outstanding obligations of \$327.5 million under the Prior Credit Facilities. The Prior Credit Facilities were terminated and accounted for as a debt extinguishment.

Debt issuance costs incurred in connection with the New Facilities totaled approximately \$2.0 million and are being amortized using the effective interest method over five year terms of the loans, and are included in “Interest expense” in the unaudited consolidated condensed statements of income.

As a result of the debt refinancing, the Company expensed approximately \$8.8 million of unamortized deferred financing costs and original issue discount associated with the Prior Credit Facilities. The expense is included in “Interest expense” in the unaudited consolidated condensed statements of income for the three and six months ended July 28, 2013.

The New Credit Agreement provides that, subject to certain conditions, Semtech may request, at any time and from time to time, the establishment of one or more additional term loan facilities and/or increases to the Revolving Commitments in an aggregate principal amount not to exceed \$100.0 million, the proceeds of which may be used for working capital and general corporate purposes.

Interest on loans made under the New Credit Agreement in U.S. Dollars accrues, at Semtech’s option, at a rate per annum equal to (1) the Base Rate (as defined below) plus a margin ranging from 0.25% to 1.25% depending upon Semtech’s consolidated leverage ratio or (2) LIBOR (determined with respect to deposits in U.S. Dollars) for an interest period to be selected by Semtech plus a margin ranging from 1.25% to 2.25% depending upon Semtech’s consolidated leverage ratio. The “Base Rate” is equal to a fluctuating rate equal to the highest of (a) the prime rate, (b) ½ of 1% above the federal funds effective rate or (c) one-month LIBOR (determined with respect to deposits in U.S. Dollars) plus 1%. The New Credit Agreement includes a multi-currency subfacility where interest on loans made in Alternative Currencies (other than Canadian Dollars) accrues at a rate per annum equal to LIBOR (determined with respect to deposits in the applicable Alternative Currency) for an interest period to be selected by Semtech plus a margin ranging from 1.25% to 2.25% depending upon Semtech’s consolidated leverage ratio. Interest on loans made

under the New Credit Agreement in Canadian Dollars accrues at a rate per annum equal to the CDOR Rate (as defined below) for an interest period to be selected by Semtech plus a margin ranging from 1.25% to 2.25% depending upon Semtech's consolidated leverage ratio. The "CDOR Rate" for any interest period is the rate equal to the sum of: (a) the rate determined by Administrative Agent with reference to the arithmetic average of the discount rate quotations of all institutions listed for CAD Dollar-denominated bankers' acceptances displayed and identified on the "Reuters Screen CDOR Page" and (b) 0.10% per annum. CDOR Commitment fees on the unused portion of the Revolving Commitments accrue at a rate per annum ranging from 0.20% to 0.45% depending upon Semtech's consolidated leverage ratio. Interest is paid monthly for a base rate loan and swing line loan and quarterly for a Euro dollar rate loan. Interest is payable on the revolving credit maturity date in the case of Revolving Commitments and the additional term maturity date in the case of additional term loans,

respectively. As of July 28, 2013, the interest rates payable on both the Term Loans and the Revolving Commitments was 1.95%.

Quarterly principal payments for Term Loans are due beginning on the last day of the Company's fiscal quarter-end months, beginning on October 27, 2013 and ending on April 30, 2018. The quarterly principal payments related to the term loans are due as follows: \$9.4 million in fiscal year 2014; \$18.8 million in fiscal year 2015; \$18.8 million in fiscal year 2016; \$18.8 million in fiscal year 2017; \$24.4 million in fiscal year 2018. The final remaining principal payment is due on the maturity date of May 1, 2018.

There are no scheduled principal payments for the Revolving Commitments. The Company may, upon notice to the administrative agent, at any time or from time to time voluntarily prepay the Term Loans or Revolving Commitments in whole or in part without premium or penalty. On June 3, 2013, the Company made an early prepayment of \$26.0 million against the Term Loans.

All obligations of Semtech under the New Facilities are unconditionally guaranteed by each of the Guarantors. The obligations of Semtech and the Guarantors in respect to the New Facilities are secured by a first priority security interest in substantially all of the assets of Semtech and the Guarantors, subject to certain customary exceptions.

The Company was subject to customary covenants, including the maintenance of a minimum interest ratio of 3.50:1.00 as of July 28, 2013 and a maximum total consolidated leverage ratio of 3.00:1.00 as of July 28, 2013. The Company was in compliance with such financial covenants as of July 28, 2013.

The New Facilities also contain customary events of default. If any event of default occurs, the principal, interest and any other monetary obligations on all the then outstanding amounts under the New Facilities may become due and payable immediately.

#### Note 11: Interest Rate Derivative Agreement

In June 2012, in connection with the Prior Credit Agreement, the Company entered into an interest rate cap agreement (“Cap Agreement”) with a \$175.0 million notional amount and an upfront payment of \$1.1 million. The Cap Agreement matures on February 22, 2016 and caps interest rates on one-month LIBOR at 1.00%. The Company did not have any interest rate derivative agreements outstanding prior to June 2012.

The purpose of the Cap Agreement is to hedge the Company’s exposure to fluctuations in LIBOR-indexed interest payments. Although the Prior Credit Agreement was terminated on May 2, 2013, the New Credit Agreement, in an aggregate principal amount of \$400.0 million (see Note 10), permits the Company to elect LIBOR or Base Rate loans. Since the Company intends to make interest payments based on one-month LIBOR-indexed rates and will not elect interest rates based on alternative indices during the term of the Cap Agreement, the Cap Agreement was re-designated as a hedge of one month LIBOR-indexed interest payments associated with the New Credit Agreement. The effectiveness of the interest rate cap was assessed and the Cap Agreement continues to be an effective cash flow hedge of interest rate risk for the Company. No ineffectiveness was recorded during the six months ended July 28, 2013.

The Cap Agreement is recorded at estimated fair value at the end of each reporting period. The fair value of the Cap Agreement at July 28, 2013 was determined using level 2 inputs, including observable market-based inputs such as interest rate curves and implied volatilities for similar instruments with similar contractual terms.

The Company has determined that the Cap Agreement is highly effective in offsetting future variable interest payments associated with the hedged portion of the Company’s New Credit Agreement. Gains or losses associated with the value of the Cap Agreement are initially reported in other comprehensive income or loss and amortized as an increase to interest expense through the maturity of the Cap Agreement. The amount of unrealized losses on the Cap Agreement recorded in other comprehensive loss at July 28, 2013 that is expected to be reclassified into interest expense in the next twelve months, if interest rates remain unchanged, is approximately \$139,000.

#### Note 12: Income Taxes

The Company’s effective tax rate differs from the statutory federal income tax rate of 35% due primarily to certain undistributed foreign earnings for which no U.S. taxes are provided because such earnings are intended to be indefinitely reinvested outside of the U.S.

The gross unrecognized tax benefit (before federal impact of state items) was \$13.1 million at July 28, 2013 and January 27, 2013. Included in the balance of unrecognized tax benefits at July 28, 2013 and January 27, 2013, is \$11.1 million of net tax benefit (after federal impact of state items), respectively, that, if recognized, would impact the effective tax rate. The liability for uncertain tax positions is reflected on the unaudited consolidated condensed balance sheets as follows:

(in thousands)	July 28, 2013	January 27, 2013
Accrued liabilities	\$188	\$188
Other long-term liabilities	10,887	10,887
Total accrued taxes	\$11,075	\$11,075

The Company’s policy is to include net interest and penalties related to unrecognized tax benefits within the provision (benefit) for taxes on the unaudited consolidated condensed statements of income. The Company had approximately \$293,000 of net interest and penalties accrued at July 28, 2013 and January 27, 2013.

Tax years prior to 2009 (the Company’s fiscal year 2010) are generally not subject to examination by the Internal Revenue Service (“IRS”) except for items involving tax attributes that have been carried forward to tax years whose statute of limitations remains open. The Company is currently under IRS audit for fiscal year 2010 and fiscal year 2011. The Company is also currently under audit by the Canadian Revenue Agency for fiscal years 2010, 2011 and the year ended March 19, 2012. For state returns, the Company is generally not subject to income tax examinations for years prior to 2008 (the Company’s fiscal year 2009). The Company has a primary significant tax presence in Switzerland for which Swiss tax filings have been examined through fiscal year 2010. The Company is also subject to routine examinations by various foreign tax jurisdictions in which it operates.



Note 13: Commitments and Contingencies

Legal Matters

From time to time in the ordinary course of its business, the Company is involved in various claims, litigation, and other legal actions that are normal to the nature of its business, including with respect to intellectual property, contract, product liability, employment, and environmental matters.

In accordance with accounting standards regarding loss contingencies, the Company accrues an undiscounted liability for those contingencies where the incurrence of a loss is probable and the amount can be reasonably estimated, and the Company discloses the amount accrued and the amount of a reasonably possible loss in excess of the amount accrued, if such disclosure is necessary for its financial statements not to be misleading. The Company does not record liabilities when the likelihood that the liability has been incurred is probable but the amount cannot be reasonably estimated, or when the liability is believed to be only reasonably possible or remote.

Because litigation outcomes are inherently unpredictable, the Company's evaluation of legal proceedings often involves a series of complex assessments by management about future events and can rely heavily on estimates and assumptions. While the consequences of certain unresolved proceedings are not presently determinable, and an estimate of the probable and reasonably possible loss or range of loss in excess of amounts accrued for such proceedings cannot be reasonably made, an adverse outcome from such proceedings could have a material adverse effect on the Company's earnings in any given reporting period. However, in the opinion of management, after consulting with legal counsel, and taking into account insurance coverage, any ultimate liability related to current outstanding claims and lawsuits, individually or in the aggregate, is not expected to have a material adverse effect on the Company's consolidated financial statements, as a whole.

The Company's currently pending legal matters of note are discussed below:

**Environmental Matters.** In 2001, the Company was notified by the California Department of Toxic Substances Control ("State") that it may have liability associated with the clean-up of the one-third acre Davis Chemical Company site in Los Angeles, California. The Company has been included in the clean-up program because it was one of the companies that used the Davis Chemical Company site for waste recycling and/or disposal between 1949 and 1990. The Company joined with other potentially responsible parties and entered into a Consent Order with the State that required the group to perform a soils investigation at the site and submit a remediation plan. The State has approved the remediation plan, which completes the group's obligations under the Consent Order. Although the Consent Order does not require the group to remediate the site and the State has indicated it intends to look to other parties for remediation, the State has not yet issued "no further action" letters to the group members. To date, the Company's share of the group's expenses has not been material and has been expensed as incurred.

The Company has used an environmental firm, specializing in hydrogeology, to perform monitoring of the groundwater at the Company's former facility in Newbury Park, California that was leased for approximately forty years. The Company vacated the building in May 2002. Certain contaminants have been found in the local groundwater and site soils. Groundwater monitoring results to date over a number of years indicate that the majority of groundwater contaminants are believed to come, in full or in material part,