

CREE INC  
Form 10-Q  
January 22, 2014  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q  
(Mark One)

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

For the quarterly period ended December 29, 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 0-21154

CREE, INC.

(Exact name of registrant as specified in its charter)

North Carolina

(State or other jurisdiction of incorporation or organization)

56-1572719

(I.R.S. Employer Identification No.)

4600 Silicon Drive

Durham, North Carolina

(Address of principal executive offices)

(919) 407-5300

27703

(Zip Code)

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

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

Large accelerated filer

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

Accelerated filer

Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

The number of shares outstanding of the registrant's common stock, par value \$0.00125 per share, as of January 15, 2014, was 121,670,615.



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## PART I - FINANCIAL INFORMATION

## Item 1. Financial Statements

## CREE, INC.

## CONSOLIDATED BALANCE SHEETS

|   | December 29,<br>2013<br>(unaudited)<br>(In thousands, except par value) | June 30,<br>2013 |
|---|---|------------------|
| <b>ASSETS</b>   |   |                  |
| Current assets:   |   |                  |
| Cash and cash equivalents   | \$269,388   | \$190,069        |
| Short-term investments  | 915,063   | 833,846          |
| Total cash, cash equivalents and short-term investments   | 1,184,451   | 1,023,915        |
| Accounts receivable, net  | 213,536   | 192,507          |
| Inventories   | 234,455   | 197,001          |
| Deferred income taxes   | 25,912  | 26,125           |
| Prepaid expenses and other current assets   | 75,603  | 76,218           |
| Total current assets  | 1,733,957   | 1,515,766        |
| Property and equipment, net   | 569,162   | 542,833          |
| Intangible assets, net  | 348,079   | 357,525          |
| Goodwill  | 616,345   | 616,345          |
| Other assets  | 49,114  | 19,941           |
| Total assets  | \$3,316,657   | \$3,052,410      |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>   |   |                  |
| Current liabilities:  |   |                  |
| Accounts payable, trade   | \$166,740   | \$121,441        |
| Accrued salaries and wages  | 46,962  | 41,407           |
| Income taxes payable  | 10,093  | 1,315            |
| Other current liabilities   | 51,248  | 43,248           |
| Total current liabilities   | 275,043   | 207,411          |
| Long-term liabilities:  |   |                  |
| Deferred income taxes   | 27,244  | 25,504           |
| Other long-term liabilities   | 45,409  | 12,843           |
| Total long-term liabilities   | 72,653  | 38,347           |
| Commitments and contingencies (Note 11)   |   |                  |
| Shareholders' equity:   |   |                  |
| Preferred stock, par value \$0.01; 3,000 shares authorized at December 29, 2013 and June 30, 2013; none issued and outstanding  | —   | —                |
| Common stock, par value \$0.00125; 200,000 shares authorized at December 29, 2013 and June 30, 2013; 121,613 and 119,623 shares issued and outstanding at December 29, 2013 and June 30, 2013, respectively | 151   | 148              |
| Additional paid-in-capital  | 2,128,563   | 2,025,764        |
| Accumulated other comprehensive income, net of taxes  | 10,089  | 8,244            |
| Retained earnings   | 830,158   | 772,496          |
| Total shareholders' equity  | 2,968,961   | 2,806,652        |
| Total liabilities and shareholders' equity  | \$3,316,657   | \$3,052,410      |
| The accompanying notes are an integral part of the consolidated financial statements.   |   |                  |



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CREE, INC.  
(UNAUDITED)  
CONSOLIDATED STATEMENTS OF INCOME

|  | Three Months Ended                       |                      | Six Months Ended     |                      |
|--|--|----------------------|----------------------|----------------------|
|  | December 29,<br>2013                     | December 30,<br>2012 | December 29,<br>2013 | December 30,<br>2012 |
|  | (In thousands, except per share amounts) |                      |                      |                      |
| Revenue, net   | \$415,086                                | \$346,286            | \$806,092            | \$662,039            |
| Cost of revenue, net                                   | 259,308                                  | 212,810              | 499,557              | 412,514              |
| Gross profit   | 155,778                                  | 133,476              | 306,535              | 249,525              |
| Operating expenses:                                    |  |                      |                      |                      |
| Research and development                               | 44,436                                   | 39,941               | 86,179               | 77,488               |
| Sales, general and administrative                      | 67,943                                   | 60,100               | 132,221              | 112,745              |
| Amortization of acquisition-related intangibles        | 7,256                                    | 7,719                | 14,543               | 15,389               |
| Loss on disposal or impairment of long-lived assets    | 760                                      | 624                  | 1,417                | 1,522                |
| Total operating expenses                               | 120,395                                  | 108,384              | 234,360              | 207,144              |
| Operating income                                       | 35,383                                   | 25,092               | 72,175               | 42,381               |
| Non-operating income, net                              | 3,403                                    | 2,481                | 6,221                | 5,866                |
| Income before income taxes                             | 38,786                                   | 27,573               | 78,396               | 48,247               |
| Income tax expense                                     | 3,105                                    | 7,170                | 12,218               | 11,721               |
| Net income   | \$35,681                                 | \$20,403             | \$66,178             | \$36,526             |
| Earnings per share:                                    |  |                      |                      |                      |
| Basic  | \$0.30                                   | \$0.18               | \$0.55               | \$0.32               |
| Diluted  | \$0.29                                   | \$0.18               | \$0.54               | \$0.31               |
| Weighted average shares used in per share calculation: |  |                      |                      |                      |
| Basic  | 120,932                                  | 115,965              | 120,248              | 115,760              |
| Diluted  | 123,204                                  | 116,410              | 122,821              | 116,249              |

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

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CREE, INC.

(UNAUDITED)

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

|  | Three Months Ended   |                      | Six Months Ended     |                      |
|--|----------------------|----------------------|----------------------|----------------------|
|  | December 29,<br>2013 | December 30,<br>2012 | December 29,<br>2013 | December 30,<br>2012 |
|  | (In thousands)       |                      |                      |                      |
| Net income   | \$35,681             | \$20,403             | \$66,178             | \$36,526             |
| Other comprehensive income:  |                      |                      |                      |                      |
| Currency translation (loss) gain, net of tax<br>benefit (expense) of \$0, \$20, \$0 and (\$91),<br>respectively  | (125                 | ) (33                | ) 135                | 149                  |
| Net unrealized gain (loss) on available-for-sale<br>securities, net of tax (expense) benefit of (\$283),447<br>\$376, (\$1,065) and \$54, respectively |                      | (617                 | ) 1,710              | (83                  |
| Other comprehensive income (loss)  | 322                  | (650                 | ) 1,845              | 66                   |
| Comprehensive income   | \$36,003             | \$19,753             | \$68,023             | \$36,592             |

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



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CREE, INC.  
(UNAUDITED)  
CONSOLIDATED STATEMENTS OF CASH FLOWS

|   | Six Months Ended     |                      |
|---|----------------------|----------------------|
|   | December 29,<br>2013 | December 30,<br>2012 |
|   | (In thousands)       |                      |
| Cash flows from operating activities:   |                      |                      |
| Net income  | \$66,178             | \$36,526             |
| Adjustments to reconcile net income to net cash provided by operating activities:     |                      |                      |
| Depreciation and amortization   | 79,611               | 76,395               |
| Stock-based compensation  | 30,250               | 27,029               |
| Excess tax benefit from share-based payment arrangements                              | (14,853)             | (117)                |
| Loss on disposal or impairment of long-lived assets                                   | 1,417                | 1,522                |
| Amortization of premium/discount on investments                                       | 5,043                | 4,744                |
| Changes in operating assets and liabilities:  |                      |                      |
| Accounts receivable   | (21,029)             | 7,683                |
| Inventories   | (36,632)             | 3,854                |
| Prepaid expenses and other assets   | (6,148)              | (3,644)              |
| Accounts payable, trade   | 40,501               | 14,581               |
| Accrued salaries and wages and other liabilities                                      | 23,649               | 9,721                |
| Net cash provided by operating activities   | 167,987              | 178,294              |
| Cash flows from investing activities:   |                      |                      |
| Purchases of property and equipment   | (83,450)             | (30,430)             |
| Purchases of available-for-sale investments   | (346,799)            | (364,027)            |
| Proceeds from maturities of available-for-sale investments                            | 251,020              | 194,754              |
| Proceeds from sale of property and equipment  | 94                   | 301                  |
| Proceeds from sale of available-for-sale investments                                  | 12,295               | 23,825               |
| Purchases of patent and licensing rights  | (10,046)             | (10,021)             |
| Net cash used in investing activities   | (176,886)            | (185,598)            |
| Cash flows from financing activities:   |                      |                      |
| Net proceeds from issuance of common stock  | 73,079               | 8,177                |
| Excess tax benefit from share-based payment arrangements                              | 14,853               | 117                  |
| Repurchases of common stock   | (107)                | (638)                |
| Net cash provided by financing activities   | 87,825               | 7,656                |
| Effects of foreign exchange changes on cash and cash equivalents                      | 393                  | 371                  |
| Net increase in cash and cash equivalents   | 79,319               | 723                  |
| Cash and cash equivalents:  |                      |                      |
| Beginning of period   | 190,069              | 178,885              |
| End of period   | \$269,388            | \$179,608            |
| The accompanying notes are an integral part of the consolidated financial statements. |                      |                      |

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CREE, INC.  
(UNAUDITED)  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Basis of Presentation and Changes in Significant Accounting Policies

Overview

Cree, Inc. (the Company) is a leading innovator of lighting-class light emitting diode (LED) products, lighting products and semiconductor products for power and radio-frequency (RF) applications. The Company's products are targeted for applications such as indoor and outdoor lighting, video displays, transportation, electronic signs and signals, power supplies, inverters and wireless systems.

The Company develops and manufactures semiconductor materials and devices primarily based on silicon carbide (SiC), gallium nitride (GaN) and related compounds. In many cases, the properties of SiC and GaN offer technical advantages over traditional silicon, gallium arsenide (GaAs) and other materials used for electronic applications. The Company's LED products consist of LED components, LED chips and SiC materials. As LED technology improves, the Company believes the potential market for LED lighting will continue to expand. The Company's success in selling LED products depends upon the ability to offer innovative products and its ability to enable its customers to develop and market LED-based products that successfully compete against other LED-based products and drive LED adoption against traditional lighting products.

The Company's lighting products consist of both LED and traditional lighting systems. The Company designs, manufactures and sells lighting fixtures and lamps for the commercial, industrial and consumer markets.

In addition, the Company develops, manufactures and sells power and RF devices. The Company's power products are made from SiC and provide increased efficiency, faster switching speeds and reduced system size and weight over comparable silicon-based power devices. The Company's RF devices are made from GaN and provide improved efficiency, bandwidth and frequency of operation as compared to silicon or GaAs.

The majority of the Company's products are manufactured at its production facilities located in North Carolina, Wisconsin and China. The Company also uses contract manufacturers for certain aspects of product fabrication, assembly and packaging. The Company operates research and development facilities in North Carolina, California, Wisconsin, India and China (including Hong Kong).

Cree, Inc. is a North Carolina corporation established in 1987 and is headquartered in Durham, North Carolina.

As of December 29, 2013, the Company has three reportable segments:

LED Products

Lighting Products

Power and RF Products

For financial results by reportable segment, please refer to Note 12 "Reportable Segments."

Basis of Presentation

The consolidated balance sheet at December 29, 2013, the consolidated statements of income for the three and six months ended December 29, 2013 and December 30, 2012, the consolidated statements of comprehensive income for the three and six months ended December 29, 2013 and December 30, 2012, and the consolidated statements of cash flows for the six months ended December 29, 2013 and December 30, 2012 (collectively, the consolidated financial statements) have been prepared by the Company and have not been audited. In the opinion of management, all normal and recurring adjustments necessary to present fairly the consolidated financial position, results of operations and cash flows at December 29, 2013, and for all periods presented, have been made. All intercompany accounts and transactions have been eliminated. The consolidated balance sheet at June 30, 2013 has been derived from the audited financial statements as of that date. The three and six month periods ended December 29, 2013 include one less week as compared to the three and six month periods ended December 30, 2012.

Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP) have been condensed or omitted pursuant to such rules and regulations. These financial statements should be read in conjunction with the consolidated financial statements

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and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2013 (fiscal 2013). The results of operations for the three and six months ended December 29, 2013 are not necessarily indicative of the operating results that may be attained for the entire fiscal year ending June 29, 2014 (fiscal 2014). The preparation of consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, and the disclosure of contingent assets and liabilities. Actual amounts could differ materially from those estimates. Certain fiscal 2013 amounts in the accompanying consolidated financial statements have been reclassified to conform to the fiscal 2014 presentation. These reclassifications had no effect on previously reported consolidated net income or shareholders' equity.

New Accounting Standards

Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward or Tax Credit Carryforward Exists

In July 2013, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2013-11, Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward or Tax Credit Carryforward Exists. The ASU provides guidance regarding the presentation in the statement of financial position of an unrecognized tax benefit when a net operating loss carryforward or a tax credit carryforward exists. The ASU generally provides that an entity's unrecognized tax benefit, or a portion of its unrecognized tax benefit, should be presented in its financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward. The ASU applies prospectively to all entities that have unrecognized tax benefits when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists at the reporting date, and is effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. The Company early adopted this guidance beginning with the first quarter of fiscal 2014. The Company's adoption of this guidance did not have a significant impact on its consolidated financial statements.

Note 2. Acquisitions

On August 17, 2011, the Company entered into a Stock Purchase Agreement with all of the shareholders of Ruud Lighting, Inc. (Ruud Lighting). Pursuant to the terms of the Stock Purchase Agreement and concurrently with the execution of the Stock Purchase Agreement, the Company acquired all of the outstanding share capital of Ruud Lighting in exchange for consideration consisting of 6.1 million shares of the Company's common stock valued at approximately \$211.0 million and \$372.2 million cash, subject to certain post-closing adjustments. Following the acquisition, the Company recorded certain post-closing purchase price adjustments resulting in a \$2.3 million reduction to the purchase price and a total purchase price of approximately \$666.0 million. See Note 11 "Commitments and Contingencies" for a discussion of the amounts receivable from the Stock Purchase Agreement escrow funds. The acquisition allowed the Company to expand its product portfolio into outdoor LED lighting.

Prior to the Company completing its acquisition of Ruud Lighting, Ruud Lighting completed the re-acquisition of its e-conolight business by purchasing all of the membership interests of E-conolight LLC (E-conolight). Ruud Lighting previously sold its e-conolight business in March 2010 and had been providing operational services to E-conolight since that date. In connection with the stock purchase transaction with Ruud Lighting, the Company funded Ruud Lighting's re-acquisition of E-conolight and repaid Ruud Lighting's outstanding debt in the aggregate amount of approximately \$85.0 million.

The assets, liabilities and operating results of Ruud Lighting have been included in the Lighting Products segment of the Company's consolidated financial statements from the date of acquisition and are reflected in all periods presented in the accompanying unaudited consolidated financial statements.

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## Note 3. Financial Statement Details

## Accounts receivable, net

The following table summarizes the components of accounts receivable, net (in thousands):

|   | December 29, 2013 | June 30, 2013 |   |
|---|-------------------|---------------|---|
| Billed trade receivables                                    | \$244,136         | \$220,307     |   |
| Unbilled contract receivables                               | 1,282             | 1,171         |   |
|   | 245,418           | 221,478       |   |
| Allowance for sales returns, discounts and other incentives | (28,849           | ) (26,500     | ) |
| Allowance for bad debts                                     | (3,033            | ) (2,471      | ) |
| Total accounts receivable, net                              | \$213,536         | \$192,507     |   |

## Inventories

The following table summarizes the components of inventories (in thousands):

|                   | December 29, 2013 | June 30, 2013 |
|-------------------|-------------------|---------------|
| Raw material      | \$79,602          | \$62,253      |
| Work-in-progress  | 71,432            | 68,146        |
| Finished goods    | 83,421            | 66,602        |
| Total inventories | \$234,455         | \$197,001     |

## Other current liabilities

The following table summarizes the components of other current liabilities (in thousands):

|                                 | December 29, 2013 | June 30, 2013 |
|---------------------------------|-------------------|---------------|
| Accrued taxes                   | \$21,533          | \$21,436      |
| Accrued professional fees       | 6,340             | 4,493         |
| Accrued warranty                | 5,294             | 5,259         |
| Accrued other                   | 18,081            | 12,060        |
| Total other current liabilities | \$51,248          | \$43,248      |

## Accumulated other comprehensive income, net of taxes

The following table summarizes the components of accumulated other comprehensive income, net of taxes (in thousands):

|   | December 29, 2013 | June 30, 2013 |   |
|---|-------------------|---------------|---|
| Currency translation gain                                   | \$8,627           | \$8,492       |   |
| Net unrealized gain (loss) on available-for-sale securities | 1,462             | (248          | ) |
| Total accumulated other comprehensive income, net of taxes  | \$10,089          | \$8,244       |   |

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## Non-operating income, net

The following table summarizes the components of non-operating income, net (in thousands):

|                                  | Three Months Ended |                   | Six Months Ended  |                   |
|----------------------------------|--------------------|-------------------|-------------------|-------------------|
|                                  | December 29, 2013  | December 30, 2012 | December 29, 2013 | December 30, 2012 |
| Foreign currency gain, net       | \$213              | \$301             | \$477             | \$128             |
| Gain on sale of investments, net | —                  | 8                 | 10                | 36                |
| Interest income, net             | 2,806              | 1,946             | 5,147             | 3,738             |
| Other, net                       | 384                | 226               | 587               | 1,964             |
| Total non-operating income, net  | \$3,403            | \$2,481           | \$6,221           | \$5,866           |

## Reclassifications out of accumulated other comprehensive income

The following table summarizes the amounts reclassified out of accumulated other comprehensive income (in thousands):

| Accumulated Other Comprehensive Income Component                         | Amount Reclassified from Accumulated Other Comprehensive Income |                   |                   |                   | Affected Line Item in the Statement of Income |
|--|---|-------------------|-------------------|-------------------|---|
|  | Three Months Ended  |                   | Six Months Ended  |                   |   |
|  | December 29, 2013   | December 30, 2012 | December 29, 2013 | December 30, 2012 |   |
| Net unrealized gain on available-for-sale securities, net of tax expense | \$—   | \$8               | \$10              | \$36              | Non-operating income, net                     |
|  | —   | 8                 | 10                | 36                | Income before income taxes                    |
|  | —   | 2                 | 2                 | 9                 | Income tax expense                            |
|  | \$—   | \$6               | \$8               | \$27              | Net income                                    |

## Note 4. Investments

Short-term investments consist of municipal bonds, corporate bonds, U.S. agency securities, non-U.S. certificates of deposit and non-U.S. government securities. All marketable investments are classified as available-for-sale.

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The following tables summarize marketable investments (in thousands):

|                                  | December 29, 2013 |                        |                         |                      |
|----------------------------------|-------------------|------------------------|-------------------------|----------------------|
|                                  | Amortized Cost    | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| Municipal bonds                  | \$278,331         | \$1,604                | (\$151 )                | \$279,784            |
| Corporate bonds                  | 208,636           | 1,660                  | (957 )                  | 209,339              |
| U.S. agency securities           | 31,157            | 199                    | —                       | 31,356               |
| Non-U.S. certificates of deposit | 386,000           | —                      | —                       | 386,000              |
| Non-U.S. government securities   | 8,566             | 20                     | (2 )                    | 8,584                |
| Total                            | \$912,690         | \$3,483                | (\$1,110 )              | \$915,063            |

|                                  | June 30, 2013  |                        |                         |                      |
|----------------------------------|----------------|------------------------|-------------------------|----------------------|
|                                  | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| Municipal bonds                  | \$250,206      | \$817                  | (\$1,314 )              | \$249,709            |
| Corporate bonds                  | 192,147        | 1,678                  | (1,765 )                | 192,060              |
| U.S. agency securities           | 39,288         | 186                    | —                       | 39,474               |
| Non-U.S. certificates of deposit | 345,000        | —                      | —                       | 345,000              |
| Non-U.S. government securities   | 7,608          | 14                     | (19 )                   | 7,603                |
| Total                            | \$834,249      | \$2,695                | (\$3,098 )              | \$833,846            |

The following tables present the gross unrealized losses and estimated fair value of the Company's investment securities, aggregated by investment type and the length of time that individual investment securities have been in a continuous unrealized loss position (in thousands, except numbers of securities):

|  | December 29, 2013   |                 |                        |                 |            |                 |
|--|---------------------|-----------------|------------------------|-----------------|------------|-----------------|
|  | Less than 12 Months |                 | Greater than 12 Months |                 | Total      |                 |
|  | Fair Value          | Unrealized Loss | Fair Value             | Unrealized Loss | Fair Value | Unrealized Loss |
| Municipal bonds                              | \$46,896            | (\$151 )        | \$—                    | \$—             | \$46,896   | (\$151 )        |
| Corporate bonds                              | 73,821              | (906 )          | 2,967                  | (51 )           | 76,788     | (957 )          |
| Non-U.S. government securities               | 2,034               | (2 )            | —                      | —               | 2,034      | (2 )            |
| Total  | \$122,751           | (\$1,059 )      | \$2,967                | (\$51 )         | \$125,718  | (\$1,110 )      |
| Number of securities with an unrealized loss |                     | 61              |                        | 2               |            | 63              |

|  | June 30, 2013       |                 |                        |                 |            |                 |
|--|---------------------|-----------------|------------------------|-----------------|------------|-----------------|
|  | Less than 12 Months |                 | Greater than 12 Months |                 | Total      |                 |
|  | Fair Value          | Unrealized Loss | Fair Value             | Unrealized Loss | Fair Value | Unrealized Loss |
| Municipal bonds                              | \$126,926           | (\$1,314 )      | \$—                    | \$—             | \$126,926  | (\$1,314 )      |
| Corporate bonds                              | 102,010             | (1,765 )        | —                      | —               | 102,010    | (1,765 )        |
| Non-U.S. government securities               | 5,534               | (19 )           | —                      | —               | 5,534      | (19 )           |
| Total  | \$234,470           | (\$3,098 )      | \$—                    | \$—             | \$234,470  | (\$3,098 )      |
| Number of securities with an unrealized loss |                     | 123             |                        | —               |            | 123             |

The Company utilizes specific identification in computing realized gains and losses on the sale of investments. Realized gains from the sale of investments for the six months ended December 29, 2013 of approximately \$10 thousand were included in "Non-





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operating income, net" and unrealized gains and losses are included as a separate component of equity, net of tax, unless the loss is determined to be other-than-temporary.

The Company evaluates its investments for possible impairment or a decline in fair value below cost basis that is deemed to be other-than-temporary on a periodic basis. It considers such factors as the length of time and extent to which the fair value has been below the cost basis, the financial condition of the investee, and its ability and intent to hold the investment for a period of time that may be sufficient for an anticipated full recovery in market value.

Accordingly, the Company considers declines in its securities to be temporary in nature, and does not consider its securities to be impaired as of December 29, 2013 and June 30, 2013.

The contractual maturities of marketable investments as of December 29, 2013 were as follows (in thousands):

|                                     | December 29, 2013  |                                    |                                    |                    |           |
|-------------------------------------|--------------------|------------------------------------|------------------------------------|--------------------|-----------|
|                                     | Within One<br>Year | After One,<br>Within Five<br>Years | After Five,<br>Within Ten<br>Years | After Ten<br>Years | Total     |
| Municipal bonds                     | \$58,779           | \$221,005                          | \$—                                | \$—                | \$279,784 |
| Corporate bonds                     | 36,499             | 172,840                            | —                                  | —                  | 209,339   |
| U.S. agency securities              | 12,110             | 19,246                             | —                                  | —                  | 31,356    |
| Non-U.S. certificates of<br>deposit | 386,000            | —                                  | —                                  | —                  | 386,000   |
| Non-U.S. government<br>securities   | 5,574              | 3,010                              | —                                  | —                  | 8,584     |
| Total                               | \$498,962          | \$416,101                          | \$—                                | \$—                | \$915,063 |

#### Note 5. Fair Value of Financial Instruments

Under U.S. GAAP, fair value is defined as the price that would be received to sell an asset or paid to transfer a liability (i.e., the exit price) in an orderly transaction between market participants at the measurement date. In determining fair value, the Company uses various valuation approaches, including quoted market prices. U.S. GAAP also establishes a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available. Observable inputs are obtained from independent sources and can be validated by a third party, whereas unobservable inputs reflect assumptions regarding what a third party would use in pricing an asset or liability. The fair value hierarchy is categorized into three levels based on the reliability of inputs as follows:

Level 1 - Valuations based on quoted prices in active markets for identical instruments that the Company is able to access. Since valuations are based on quoted prices that are readily and regularly available in an active market, valuation of these products does not entail a significant degree of judgment.

Level 2 - Valuations based on quoted prices in active markets for instruments that are similar, or quoted prices in markets that are not active for identical or similar instruments, and model-derived valuations in which all significant inputs and significant value drivers are observable in active markets.

Level 3 - Valuations based on inputs that are unobservable and significant to the overall fair value measurement.

The financial assets for which the Company performs recurring fair value remeasurements are cash equivalents and short-term investments. As of December 29, 2013, financial assets utilizing Level 1 inputs included money market funds. Financial assets utilizing Level 2 inputs included municipal bonds, corporate bonds, U.S. agency securities, non-U.S. certificates of deposit and non-U.S. government securities. Level 2 assets are valued using a third-party pricing services consensus price, which is a weighted average price based on multiple sources. These sources determine prices utilizing market income models which factor in, where applicable, transactions of similar assets in active markets, transactions of identical assets in infrequent markets, interest rates, bond or credit default swap spreads and volatility. The Company does not have any significant financial assets requiring the use of Level 3 inputs. There were no transfers between Level 1 and Level 2 during the six months ended December 29, 2013.



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The following table sets forth financial instruments carried at fair value within the U.S. GAAP hierarchy (in thousands):

|                                  | December 29, 2013 |           |         |           | June 30, 2013 |           |         |           |
|----------------------------------|-------------------|-----------|---------|-----------|---------------|-----------|---------|-----------|
|                                  | Level 1           | Level 2   | Level 3 | Total     | Level 1       | Level 2   | Level 3 | Total     |
| Assets:                          |                   |           |         |           |               |           |         |           |
| Cash equivalents:                |                   |           |         |           |               |           |         |           |
| Non-U.S. certificates of deposit | \$—               | \$25,063  | \$—     | \$25,063  | \$—           | \$—       | \$—     | \$—       |
| Municipal bonds                  | —                 | —         | —       | —         | —             | 2,009     | —       | 2,009     |
| Money market funds               | 34,818            | —         | —       | 34,818    | 12,589        | —         | —       | 12,589    |
| Total cash equivalents           | 34,818            | 25,063    | —       | 59,881    | 12,589        | 2,009     | —       | 14,598    |
| Short-term investments:          |                   |           |         |           |               |           |         |           |
| Municipal bonds                  | —                 | 279,784   | —       | 279,784   | —             | 249,709   | —       | 249,709   |
| Corporate bonds                  | —                 | 209,339   | —       | 209,339   | —             | 192,060   | —       | 192,060   |
| U.S. agency securities           | —                 | 31,356    | —       | 31,356    | —             | 39,474    | —       | 39,474    |
| Non-U.S. certificates of deposit | —                 | 386,000   | —       | 386,000   | —             | 345,000   | —       | 345,000   |
| Non-U.S. government securities   | —                 | 8,584     | —       | 8,584     | —             | 7,603     | —       | 7,603     |
| Total short-term investments     | —                 | 915,063   | —       | 915,063   | —             | 833,846   | —       | 833,846   |
| Total assets                     | \$34,818          | \$940,126 | \$—     | \$974,944 | \$12,589      | \$835,855 | \$—     | \$848,444 |

## Note 6. Intangible Assets

The following table presents the components of intangible assets, net (in thousands):

|   | December 29, 2013 |                          |           | June 30, 2013 |                          |           |
|---|-------------------|--------------------------|-----------|---------------|--------------------------|-----------|
|   | Gross             | Accumulated Amortization | Net       | Gross         | Accumulated Amortization | Net       |
| Intangible assets with finite lives:      |                   |                          |           |               |                          |           |
| Customer relationships                    | \$137,440         | (\$63,291)               | \$74,149  | \$137,440     | (\$59,611)               | \$77,829  |
| Developed technology                      | 162,760           | (63,342)                 | 99,418    | 162,760       | (53,476)                 | 109,284   |
| Non-compete agreements                    | 10,244            | (5,017)                  | 5,227     | 10,244        | (4,037)                  | 6,207     |
| Trade names, finite-lived                 | 520               | (504)                    | 16        | 520           | (493)                    | 27        |
| Patent and license rights                 | 124,865           | (38,476)                 | 86,389    | 116,147       | (34,849)                 | 81,298    |
| Total intangible assets with finite lives | 435,829           | (170,630)                | 265,199   | 427,111       | (152,466)                | 274,645   |
| Trade names, indefinite-lived             | 82,880            |                          | 82,880    | 82,880        |                          | 82,880    |
| Total intangible assets                   | \$518,709         | (\$170,630)              | \$348,079 | \$509,991     | (\$152,466)              | \$357,525 |

Total amortization of intangible assets recognized during the three and six months ended December 29, 2013 was \$9.4 million and \$18.8 million, respectively. For the three and six months ended December 30, 2012, total amortization of intangible assets recognized was \$9.5 million and \$18.7 million, respectively.

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Total future amortization expense of definite-lived intangible assets is estimated to be as follows (in thousands):

| Fiscal Year Ending                       |           |
|--|-----------|
| June 29, 2014 (remainder of fiscal 2014) | \$18,251  |
| June 28, 2015                            | 33,829    |
| June 26, 2016                            | 33,545    |
| June 25, 2017                            | 31,566    |
| June 24, 2018                            | 30,400    |
| Thereafter                               | 117,608   |
| Total                                    | \$265,199 |

#### Note 7. Shareholders' Equity

As of December 29, 2013, pursuant to an extension of the stock repurchase program authorized by the Board of Directors, the Company is authorized to repurchase shares of its common stock having an aggregate purchase price not exceeding \$200.0 million for all purchases from June 20, 2013 through the expiration of the program on June 29, 2014. During the six months ended December 29, 2013, there were no repurchases of common stock by the Company under the share repurchase program.

#### Note 8. Earnings Per Share

The following presents the computation of basic earnings per share (in thousands, except per share amounts):

|                                | Three Months Ended   |                      | Six Months Ended     |                      |
|--------------------------------|----------------------|----------------------|----------------------|----------------------|
|                                | December 29,<br>2013 | December 30,<br>2012 | December 29,<br>2013 | December 30,<br>2012 |
| Net income                     | \$35,681             | \$20,403             | \$66,178             | \$36,526             |
| Weighted average common shares | 120,932              | 115,965              | 120,248              | 115,760              |
| Basic earnings per share       | \$0.30               | \$0.18               | \$0.55               | \$0.32               |

The following computation reconciles the differences between the basic and diluted earnings per share presentations (in thousands, except per share amounts):

|   | Three Months Ended   |                      | Six Months Ended     |                      |
|---|----------------------|----------------------|----------------------|----------------------|
|   | December 29,<br>2013 | December 30,<br>2012 | December 29,<br>2013 | December 30,<br>2012 |
| Net income  | \$35,681             | \$20,403             | \$66,178             | \$36,526             |
| Weighted average common shares - basic                                      | 120,932              | 115,965              | 120,248              | 115,760              |
| Dilutive effect of stock options, nonvested shares and ESPP purchase rights | 2,272                | 445                  | 2,573                | 489                  |
| Weighted average common shares - diluted                                    | 123,204              | 116,410              | 122,821              | 116,249              |
| Diluted earnings per share  | \$0.29               | \$0.18               | \$0.54               | \$0.31               |

Potential common shares that would have the effect of increasing diluted earnings per share are considered to be anti-dilutive and as such, these shares are not included in calculating diluted earnings per share. For the three and six months ended December 29, 2013, there were 3.1 million and 2.1 million, respectively, of potential common shares not included in the calculation of diluted earnings per share because their effect was anti-dilutive. For the three and six months December 30, 2012, there were 10.2 million and 9.1 million, respectively, of potential common shares not included in the calculation of diluted earnings per share because their effect was anti-dilutive.

#### Note 9. Stock-Based Compensation

Prior to the second quarter of fiscal 2014, the Company had one equity-based compensation plan, the 2004 Long-Term Incentive Compensation Plan (2004 LTIP), from which stock-based compensation awards could be granted to employees and directors. The Company's 2013 Long-Term Incentive Compensation Plan (2013 LTIP) became effective in the second quarter of fiscal 2014,



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and replaced the 2004 LTIP as the sole plan for providing stock-based compensation awards to employees and directors on January 1, 2014. Outstanding awards under the 2004 LTIP will continue to be governed by the 2004 LTIP. In addition, the Company has equity-based compensation plans that have been terminated so that no future grants can be made under these plans, but under which options are currently outstanding.

Prior to fiscal 2013, the Company's stock-based awards had been service-based only. Beginning in fiscal 2013, the Company issued grants of awards that also contain performance-based conditions. Performance-based conditions are generally tied to future financial and/or operating performance of the Company. The compensation expense with respect to performance-based grants is recognized if the Company believes it is probable that the performance condition will be achieved. The Company reassesses the probability of the achievement of the performance condition at each reporting period, and adjusts the compensation expense for subsequent changes in the estimate or actual outcome.

The Company also has an Employee Stock Purchase Plan (ESPP) that provides employees with the opportunity to purchase common stock at a discount. The ESPP limits employee contributions to 15% of each employee's compensation (as defined in the plan). The ESPP allows employees to purchase shares at a 15% discount to the fair market value of common stock on the purchase date during the twelve-month participation period, divided into two equal six-month purchase periods, and provides a look-back feature. At the end of each six-month period in April and October, employees participating in the plan purchase the Company's common stock through the ESPP at a 15% discount to the fair market value of the common stock on the first day of the twelve-month participation period or the purchase date, whichever is lower. The plan also provides for an automatic reset feature to start participants on a new twelve-month participation period if the stock price declines during the first six-month purchase period.

**Stock Option Awards**

The following table summarizes option activity during the six months ended December 29, 2013 (shares in thousands):

|                                  | Number of Shares | Weighted-Average<br>Exercise Price |
|----------------------------------|------------------|------------------------------------|
| Outstanding at June 30, 2013     | 8,657            | \$35.67                            |
| Granted                          | 2,870            | 55.03                              |
| Exercised                        | (1,795           | ) 36.57                            |
| Forfeited or expired             | (158             | ) 38.64                            |
| Outstanding at December 29, 2013 | 9,574            | \$41.26                            |

**Restricted Stock Awards**

A summary of nonvested restricted stock awards (RSAs) and restricted stock unit awards (RSUs) outstanding under the Company's 2004 LTIP as of December 29, 2013 and changes during the six months then ended, are as follows (in thousands, except per share data):

|                                | Number of<br>RSAs/RSUs | Weighted-Average<br>Grant-Date Fair Value |
|--------------------------------|------------------------|---|
| Nonvested at June 30, 2013     | 647                    | \$33.80                                   |
| Granted                        | 516                    | 54.62                                     |
| Vested                         | (250                   | ) 32.95                                   |
| Forfeited                      | (7                     | ) 35.45                                   |
| Nonvested at December 29, 2013 | 906                    | \$45.88                                   |

**Stock-Based Compensation Valuation and Expense**

The Company accounts for its employee stock-based compensation plans using the fair value method. The fair value method requires the Company to estimate the grant date fair value of its stock-based awards and amortize this fair value to compensation expense over the requisite service period or vesting term.

The Company currently uses the Black-Scholes option-pricing model to estimate the fair value of the Company's stock option and ESPP awards. The determination of the fair value of stock-based payment awards on the date of grant using an option-pricing model is affected by the Company's stock price as well as assumptions regarding a number of complex and subjective variables. These variables include the expected stock price volatility over the term of the

awards, actual and projected employee stock option

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exercise behaviors, the risk-free interest rate and expected dividends. Due to the inherent limitations of option-valuation models, future events that are unpredictable and the estimation process utilized in determining the valuation of the stock-based awards, the ultimate value realized by award holders may vary significantly from the amounts expensed in the Company's financial statements.

For RSAs and RSUs, the grant date fair value is based upon the market price of the Company's common stock on the date of the grant. This fair value is then amortized to compensation expense over the requisite service period or vesting term.

Stock-based compensation expense is recognized net of estimated forfeitures such that expense is recognized only for those stock-based awards that are expected to vest. A forfeiture rate is estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from initial estimates.

Total stock-based compensation expense was as follows (in thousands):

|                                   | Three Months Ended   |                      | Six Months Ended     |                      |
|-----------------------------------|----------------------|----------------------|----------------------|----------------------|
|                                   | December 29,<br>2013 | December 30,<br>2012 | December 29,<br>2013 | December 30,<br>2012 |
| Income Statement Classification:  |                      |                      |                      |                      |
| Cost of goods sold                | \$2,849              | \$2,257              | \$5,228              | \$4,541              |
| Research and development          | 3,829                | 3,947                | 7,541                | 7,003                |
| Sales, general and administrative | 8,994                | 8,340                | 17,481               | 15,485               |
| Total                             | \$15,672             | \$14,544             | \$30,250             | \$27,029             |

#### Note 10. Income Taxes

The variation between the Company's effective income tax rate and the U.S. statutory rate of 35% is due to a percentage of the Company's projected income for the full year being derived from international locations with lower tax rates than the U.S. and the impact of tax credits available in the current year. A change in the mix of pretax income of the Company's various tax jurisdictions can have a material impact on the Company's periodic effective tax rate. During the second quarter of fiscal 2014, the Company was notified by the Internal Revenue Service that it had been allocated up to \$30 million of federal tax credits as part of the American Recovery and Reinvestment Act of 2009 - Phase II (Internal Revenue Code Section 48C). This \$30 million allocation is in addition to the \$39 million previously allocated to the Company in the third quarter of fiscal 2010. The \$30 million allocation was based upon the Company's plan to place into service approximately \$100 million of qualified equipment at its U.S. manufacturing locations from fiscal 2013 through fiscal 2017. Property placed into service during fiscal 2013 generated \$15 million of the potential \$30 million Internal Revenue Code Section 48C credit. The Company anticipates that the remaining \$15 million Internal Revenue Code Section 48C credit will be generated during fiscal 2014. The tax benefit (net of related basis adjustments) will be amortized into income over the useful life (five years) of the underlying equipment that was placed in service to generate these credits. In fiscal 2014, the Company anticipates it will recognize an income tax benefit of approximately \$5.2 million related to this award; of this amount, \$3.7 million has been recorded as a tax benefit in the second quarter of fiscal 2014.

U.S. GAAP requires a two-step approach to recognizing and measuring uncertain tax positions. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates that it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount that is cumulatively more than 50% likely to be realized upon ultimate settlement.

As of June 30, 2013, the Company's liability for unrecognized tax benefits was \$2.7 million. The Company recognized an \$18.0 million increase to the liability for unrecognized tax benefits due to uncertainty regarding a change in tax depreciation methodology adopted in the first quarter of fiscal 2014. In addition, there was a \$0.7 million decrease to the amount of unrecognized tax benefits following the settlement of prior year tax audits. As a result, the total liability for unrecognized tax benefits as of December 29, 2013 was \$20.0 million. If any portion of this \$20.0 million is recognized, the Company will then include that portion in the computation of its effective tax rate. Although the ultimate timing of the resolution and/or closure of audits is highly uncertain, the Company believes it is reasonably possible that approximately \$1.4 million of gross unrecognized tax benefits will change in the next 12 months as a



result of pending audit settlements or statute requirements.

The Company files U.S. federal, U.S. state and foreign tax returns. For U.S. federal purposes, the Company is generally no longer subject to tax examinations for fiscal years ended June 28, 2009 and prior. For U.S. state tax returns, the Company is generally no longer subject to tax examinations for fiscal years prior to 2010. For foreign purposes, the Company is generally no longer

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subject to examination for tax periods 2003 and prior. Certain carryforward tax attributes generated in prior years remain subject to examination and adjustment. The Company is currently under audit by the German Federal Central Tax Office for the fiscal year ended June 29, 2008 (fiscal 2008) through the fiscal year ended June 27, 2010 (fiscal 2010).

## Note 11. Commitments and Contingencies

## Warranties

The following table summarizes the changes in the Company's product warranty liabilities (in thousands):

|  | Six Months Ended<br>December 29, 2013 |
|--|---------------------------------------|
| Balance at beginning of period                   | \$6,171                               |
| Warranties accrued in current period             | 1,249                                 |
| Changes in estimates for pre-existing warranties | 907                                   |
| Expenditures                                     | (2,037 )                              |
| Balance at end of period                         | \$6,290                               |

Product warranties are estimated and recognized at the time the Company recognizes revenue. The warranty periods range from 90 days to 10 years. The Company accrues warranty liabilities at the time of sale, based on historical and projected incident rates and expected future warranty costs. The warranty reserves, which are primarily related to Lighting Products, are evaluated on a quarterly basis based on various factors including historical warranty claims, assumptions about the frequency of warranty claims, and assumptions about the frequency of product failures derived from quality testing, field monitoring and the Company's reliability estimates. As of December 29, 2013, \$996 thousand of the Company's product warranty liabilities were classified as long-term.

## Litigation

The Company is currently a party to various legal proceedings, including those described in the Company's Annual Report on Form 10-K for fiscal 2013. The following is provided as an update to the Company's legal proceedings as contained in that report. Unless otherwise indicated, the potential losses for claims against the Company in these matters are not reasonably estimable.

## Cooper Lighting Litigation

Ruud Lighting, Inc. filed a complaint for patent infringement against Cooper Lighting, LLC in the U.S. District Court for the Eastern District of Wisconsin on April 2, 2010. The complaint as amended seeks injunctive relief and damages for infringement of two U.S. patents owned by Ruud Lighting: No. 7,686,469, entitled "LED Lighting Fixture"; and No. 7,891,835, entitled "Light-Directed Apparatus with Protected Reflector-Shield and Lighting Fixture Utilizing Same." On May 23, 2012, Ruud Lighting filed a second complaint for patent infringement against Cooper Lighting, LLC in the U.S. District Court for the Eastern District of Wisconsin. The complaint seeks injunctive relief and damages for infringement of a third U.S. patent owned by Ruud Lighting, No. 7,952,262, entitled "Modular LED Unit Incorporating Interconnected Heat Sinks Configured To Mount and Hold Adjacent LED Modules." In each of these actions Cooper Lighting has filed an answer and counterclaims in which it denies any infringement and seeks a declaratory judgment that the asserted claims of the patents are invalid. On February 19, 2013, the Company, as successor-in-interest to Ruud Lighting, Inc., filed a third complaint for patent infringement against Cooper Lighting in the U.S. District Court for the Eastern District of Wisconsin. The complaint seeks injunctive relief and damages for infringement of two U.S. patents owned by the Company, No. 8,282,239, entitled "Light-Directing Apparatus with Protected Reflector-Shield and Lighting Fixture Utilizing Same" and No. 8,070,306, entitled "LED Lighting Fixture." Cooper Lighting, LLC filed a complaint for patent infringement against the Company and Ruud Lighting, Inc. in the U.S. District Court for the Northern District of Georgia on September 7, 2012. The complaint seeks injunctive relief and damages for infringement of one U.S. patent owned by Cooper Lighting, LLC: No. 8,210,722, entitled "LED Device for Wide Beam Generation." The Company has filed an answer in which it denies any infringement and asserts that the patent is invalid as well as other defenses.

Illumination Management Solutions, Inc., a subsidiary of Cooper Lighting, LLC, filed a complaint for patent infringement against Ruud Lighting in the U.S. District Court for the Eastern District of Texas on June 7, 2010. The action was later transferred to the U.S. District Court for the Eastern District of Wisconsin. As amended in January

2012, the complaint alleged that Ruud Lighting is infringing two U.S. patents owned by Illumination Management Solutions, No. 7,674,018 and No. 7,993,036, each entitled "LED Device for Wide Beam Generation." It also alleged that Ruud Lighting and its then president, Alan Ruud, who served on the plaintiff's board of directors in 2006 and 2007 when Ruud Lighting was a shareholder of the plaintiff, conspired to misuse confidential information obtained from the plaintiff to file patent applications and to obtain patents assigned to Ruud Lighting. The complaint sought injunctive relief, damages and ownership of the patent applications and patents alleged to have been

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wrongfully filed and obtained. The court in October 2012 granted partial summary judgment in favor of Ruud Lighting, finding that most of the accused products did not infringe either of the asserted patents. The court in February 2013 entered final judgment in which the court 1) dismissed the claims relating to most of the accused products, finding that they did not infringe either of the asserted patents; 2) dismissed with prejudice and with the consent of the parties the claims with respect to the remaining accused products; 3) severed the conspiracy claim, which was subsequently voluntarily dismissed; and 4) dismissed the remaining claims and counterclaims without prejudice. In March 2013, the plaintiffs filed a notice of appeal from this judgment to the U.S. Court of Appeals for the Federal Circuit.

Ruud Lighting is a defendant in an action commenced by Illumination Management Solutions in the U.S. District Court for the Central District of California on June 8, 2010 and later transferred to the U.S. District Court for the Eastern District of Wisconsin. As amended in January 2013, the complaint names as defendants Ruud Lighting and two of its employees, Alan Ruud and Christopher Ruud, and asserts that the defendants engaged in wrongful acts arising out of the relationship between the plaintiff and Ruud Lighting in 2006 and 2007 when Ruud Lighting was a shareholder of the plaintiff and Alan Ruud served on the plaintiff's board of directors. The complaint alleges that the defendants breached fiduciary duties and otherwise acted improperly by pursuing a plan to compete with the plaintiff and that the defendants misused information obtained from the plaintiff as fiduciaries and subject to a non-disclosure agreement. These allegedly wrongful acts included filing patent applications and obtaining patents assigned to Ruud Lighting on inventions claimed by the plaintiff. The complaint also alleges that Ruud Lighting: 1) marketed its LED products without reference to certain optical technology claimed by the plaintiff, thereby breaching a marketing agreement with the plaintiff and engaging in unfair competition and false advertising; and 2) breached the marketing agreement by failing to give the plaintiff a right of first refusal to integrate the plaintiff's optical technology into Ruud Lighting LED products. The complaint further alleges that the plaintiff is entitled to a correction of the inventors named in one or more patents to add a founder of the plaintiff as an inventor. The complaint seeks to recover damages, all profits and other gains realized by defendants as a result of the acts complained of, attorneys' fees, ownership of any interest in the patent applications and patents alleged to have been wrongfully filed and obtained, and correction of the named inventors on one or more patents.

In September 2013, the Company and the Cooper Lighting and Illumination Management Solutions parties reached a binding term sheet agreement to settle all six cases. This non-cash settlement agreement provides for a royalty-free cross license of all of the patents-in-suit in the six cases for the life of the patents; a royalty-free cross license of each of the Company's and Cooper Lighting's LED luminaire patent portfolios for seven years (with carve-outs of the Company's LED chip, LED component and LED replacement lamp patents from the cross license, as well as carve-outs for certain LED luminaires of Cooper Lighting that are not for general illumination); and a supply agreement, with no minimum purchase commitment and with a seven year term, whereby the Company may sell Cooper Lighting LED components and modules. The parties are negotiating the terms of the definitive agreements to effect this binding agreement. The Company recorded a \$17.4 million non-cash litigation settlement charge in the first quarter of fiscal 2014, representing the current estimated fair value of the patent licenses to be provided to the Cooper Lighting and Illumination Management Solutions parties in excess of the fair value patent license rights to be received by the Company under the terms of the proposed cross license agreement. This \$17.4 million obligation will be amortized into income over the remainder of the seven year license period.

In conjunction with the September 2013 settlement with the Cooper Lighting and Illumination Management Solutions parties, the Company also recorded a \$17.4 million offset to the non-cash litigation charge to reflect the amount receivable by the Company from the Stock Purchase Agreement escrow funds, including cash and common stock consideration, pursuant to a letter agreement approved by the Audit Committee, which the Company entered into during September 2013 with Christopher Ruud, acting as the Seller Representative for the former Ruud Lighting shareholders. The escrow consideration will be provided to the Company upon the execution of the final settlement agreement with the Cooper Lighting and Illumination Management Solutions parties.

Dynacraft Industries Litigation

On April 29, 2009, Dynacraft Industries Sdn Bhd commenced an action against the Company and Cree Malaysia Sdn Bhd, a subsidiary of the Company, in Malaysia in a filing with the High Court of Malaysia at Pulau Pinang (Penang).

The statement of claim alleged that the Cree defendants breached an agreement to purchase from Dynacraft certain real property in Malaysia for a contract price of 38,000,000 Malaysia ringgit (approximately \$12 million) and sought an award of damages in an unspecified amount. The Cree defendants filed defenses denying liability for damages. The case was tried before a judge and on November 28, 2012 and all claims against the Cree defendants were dismissed. Dynacraft initially filed a notice of appeal, which Dynacraft then dismissed in December 2013, thereby exhausting Dynacraft's appeals in this matter.

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Note 12. Reportable Segments

The Company's operating and reportable segments are:

LED Products

Lighting Products

Power and RF Products

Reportable Segments Description

The Company's LED Products segment includes LED chips, LED components and SiC materials. The Company's Lighting Products segment consists of both LED and traditional lighting systems, with its primary focus on LED lighting. The Company's Power and RF Products segment includes power devices and RF devices.

Financial Results by Reportable Segment

The table below reflects the results of the Company's reportable segments as reviewed by the Chief Operating Decision Maker (CODM) for the three and six months ended December 29, 2013 and December 30, 2012. The Company's CODM is the Chief Executive Officer. The Company uses substantially the same accounting policies to derive the segment results reported below as those used in the Company's consolidated financial statements.

The Company's CODM does not review inter-segment revenue when evaluating segment performance and allocating resources to each segment. Thus, inter-segment revenue is not included in the segment revenues presented in the table below. As such, total segment revenue in the table below is equal to the Company's consolidated revenue.

The Company's CODM reviews gross profit as the lowest and only level of segment profit. As such, all items below gross profit in the consolidated statements of income must be included to reconcile the consolidated gross profit presented in the table below to the Company's consolidated income before income taxes.

In order to determine gross profit for each reportable segment, the Company allocates direct costs and indirect costs to each segment's cost of revenue. The Company allocates indirect costs, such as employee benefits for manufacturing employees, shared facilities services, information technology, purchasing, and customer service, when the costs are identifiable and beneficial to the reportable segment. The Company allocates these indirect costs based on a reasonable measure of utilization that considers the specific facts and circumstances of the costs being allocated.

Unallocated costs in the table below consist primarily of manufacturing employees' stock-based compensation, expenses for profit sharing and quarterly or annual incentive plans, matching contributions under the Company's 401(k) plan and acquisition related costs. These costs are not allocated to the reportable segments' gross profit because the Company's CODM does not review them regularly when evaluating segment performance and allocating resources.

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Revenues, gross profit and gross margin for each of the Company's segments were as follows (in thousands, except percentages):

|                                    | Three Months Ended   |                      | Six Months Ended     |                      |  |   |
|------------------------------------|----------------------|----------------------|----------------------|----------------------|--|---|
|                                    | December 29,<br>2013 | December 30,<br>2012 | December 29,<br>2013 | December 30,<br>2012 |  |   |
| Revenues:                          |                      |                      |                      |                      |  |   |
| LED Products                       | \$215,022            | \$200,962            | \$433,045            | \$388,509            |  |   |
| Lighting Products                  | 173,656              | 122,714              | 321,574              | 230,787              |  |   |
| Power and RF Products              | 26,408               | 22,610               | 51,473               | 42,743               |  |   |
| Total revenue                      | \$415,086            | \$346,286            | \$806,092            | \$662,039            |  |   |
| Gross Profit and Gross Margin:     |                      |                      |                      |                      |  |   |
| LED Products gross profit          | \$97,644             | \$84,186             | \$199,297            | \$159,653            |  |   |
| LED Products gross margin          | 45.4                 | % 41.9               | % 46.0               | % 41.1               |  | % |
| Lighting Products gross profit     | 48,426               | 41,383               | 88,244               | 75,483               |  |   |
| Lighting Products gross margin     | 27.9                 | % 33.7               | % 27.4               | % 32.7               |  | % |
| Power and RF Products gross profit | 15,321               | 12,798               | 28,777               | 23,220               |  |   |
| Power and RF Products gross margin | 58.0                 | % 56.6               | % 55.9               | % 54.3               |  | % |
| Total segment reporting            | 161,391              | 138,367              | 316,318              | 258,356              |  |   |
| Unallocated costs                  | (5,613               | ) (4,891             | ) (9,783             | ) (8,831             |  | ) |
| Consolidated gross profit          | \$155,778            | \$133,476            | \$306,535            | \$249,525            |  |   |
| Consolidated gross margin          | 37.5                 | % 38.5               | % 38.0               | % 37.7               |  | % |

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

Information set forth in this Quarterly Report on Form 10-Q contains various "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended (the Securities Act), and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act). All information contained in this report relative to future markets for our products and trends in and anticipated levels of revenue, gross margins and expenses, as well as other statements containing words such as "believe," "project," "may," "will," "anticipate," "target," "plan," "estimate," "expect," "intend" and other similar expressions constitute forward-looking statements. These forward-looking statements are subject to business, economic and other risks and uncertainties, both known and unknown, and actual results may differ materially from those contained in the forward-looking statements. Any forward-looking statements we make are as of the date made, and except as required under the U.S. federal securities laws and the rules and regulations of the Securities and Exchange Commission (the SEC), we have no duty to update them if our views later change. These forward-looking statements should not be relied upon as representing our views as of any date subsequent to the date of this Quarterly Report. Examples of risks and uncertainties that could cause actual results to differ materially from historical performance and any forward-looking statements include, but are not limited to, those described in "Risk Factors" in Part II, Item 1A of this Quarterly Report.

The following discussion is designed to provide a better understanding of our unaudited consolidated financial statements, including a brief discussion of our business and products, key factors that impacted our performance and a summary of our operating results. The following discussion should be read in conjunction with the unaudited condensed consolidated financial statements and the notes thereto included in Part I, Item 1 of this Quarterly Report on Form 10-Q, and the consolidated financial statements and notes thereto and Management's Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report on Form 10-K for the year ended June 30, 2013. Historical results and percentage relationships among any amounts in the financial statements are not necessarily indicative of trends in operating results for any future periods.

Overview

Cree, Inc. (Cree, we, our, or us) is a leading innovator of lighting-class light emitting diode (LED) products, lighting products and semiconductor products for power and radio-frequency (RF) applications. Our products are targeted for applications such as indoor and outdoor lighting, video displays, transportation, electronic signs and signals, power supplies, inverters and wireless systems.

We develop and manufacture semiconductor materials and devices primarily based on silicon carbide (SiC), gallium nitride (GaN) and related compounds. In many cases, the properties of SiC and GaN offer technical advantages over traditional silicon, gallium arsenide (GaAs) and other materials used for electronic applications.

Our LED products consist of LED components, LED chips and SiC materials. As LED technology improves, we believe the potential market for LED lighting will continue to expand. Our success in selling LED products depends upon our ability to offer innovative products and our ability to enable our customers to develop and market LED-based products that successfully compete against other LED-based products and drive LED adoption against traditional lighting products.

Our lighting products consist of both LED and traditional lighting systems. We design, manufacture and sell lighting fixtures and lamps for the commercial, industrial and consumer markets.

In addition, we develop, manufacture and sell power and RF devices. Our power products are made from SiC and provide increased efficiency, faster switching speeds and reduced system size and weight over comparable silicon-based power devices. Our RF devices are made from GaN and provide improved efficiency, bandwidth and frequency of operation as compared to silicon or GaAs.

The majority of our products are manufactured at our production facilities located in North Carolina, Wisconsin and China. We also use contract manufacturers for certain aspects of product fabrication, assembly and packaging. We operate research and development facilities in North Carolina, California, Wisconsin, India and China (including Hong Kong).

Cree, Inc. is a North Carolina corporation established in 1987, and our headquarters are in Durham, North Carolina.

Reportable Segments

As of December 29, 2013, we have three reportable segments:



LED Products  
Lighting Products  
Power and RF Products

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Reportable segments are components of an entity that have separate financial data that the entity's Chief Operating Decision Maker (CODM) regularly reviews when allocating resources and assessing performance. Our CODM is the Chief Executive Officer.

For financial results by reportable segment, please refer to Note 12 "Reportable Segments."

### Industry Dynamics and Trends

There are a number of industry factors that affect our business which include, among others:

**Overall Demand for Products and Applications using LEDs.** Our potential for growth depends significantly on the adoption of LEDs within the general lighting market and our ability to affect this rate of adoption. Although the market for LED lighting has grown in recent years, adoption of LEDs for general lighting is relatively new, still limited, and faces significant challenges before widespread adoption. Demand also fluctuates based on various market cycles, a continuously evolving LED industry supply chain, and demand dynamics in the market. These uncertainties make demand difficult to forecast for us and our customers.

**Intense and Constantly Evolving Competitive Environment.** Competition in the LED and lighting industry is intense. Many companies have made significant investments in LED development and production equipment. Traditional lighting companies and new entrants are investing in LED-based lighting products as LED adoption has gained momentum. Traditional lighting companies have taken steps to try and limit access to their sales channels, including lighting agents and distributors. Product pricing pressures exist as market participants often undertake pricing strategies to gain or protect market share, increase the utilization of their production capacity and open new applications to LED-based solutions. To remain competitive, market participants must continuously increase product performance and reduce costs. To address these competitive pressures, we have invested in R&D activities to support new product development to deliver higher levels of performance and lower costs to differentiate our products in the market.

**Technological Innovation and Advancement.** Innovations and advancements in LED, power and RF technologies continue to expand the potential commercial application for our products, particularly in the general illumination, power electronics and wireless markets. However, new technologies or standards could emerge, or improvements could be made in existing technologies, that could reduce or limit the demand for our products in certain markets.

**Regulatory Actions Concerning Energy Efficiency.** Many countries have already instituted or have announced plans to institute government regulations and programs designed to encourage or mandate increased energy efficiency, even in some cases banning forms of incandescent lighting, which are advancing the adoption of more energy efficient lighting solutions such as LEDs. Government agencies are also involved in setting standards for LED lighting, which can affect market acceptance and the availability of rebates from government agencies or third parties such as utilities. While this trend is generally positive, these regulations are affected by changing political priorities and evolving technical standards which can modify or limit the effectiveness of these new regulations.

**Intellectual Property Issues.** Market participants rely on patented and non-patented proprietary information relating to product development, manufacturing capabilities and other core competencies of their business. Protection of intellectual property is critical. Therefore, steps such as additional patent applications, confidentiality and non-disclosure agreements, as well as other security measures are generally taken. To enforce or protect intellectual property rights, litigation or threatened litigation commonly occurs.

### Financial Results

The following is a summary of our financial results for the six months ended December 29, 2013:

Revenues increased to \$806.1 million for the six months ended December 29, 2013 from \$662.0 million for the six months ended December 30, 2012.

For the six months ended December 29, 2013, gross margins improved to 38.0% from 37.7% for the six months ended December 30, 2012. For the six months ended December 29, 2013, gross profit increased to \$306.5 million from \$249.5 million for the six months ended December 30, 2012.

Operating income increased to \$72.2 million for the six months ended December 29, 2013 from \$42.4 million for the six months ended December 30, 2012. Net income per diluted share increased to \$0.54 for the six months ended December 29, 2013 from \$0.31 for the six months ended December 30, 2012.



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Combined cash, cash equivalents and short-term investments increased to \$1.2 billion at December 29, 2013 compared to \$1.0 billion at June 30, 2013. Cash provided by operating activities was \$168.0 million for the six months ended December 29, 2013, compared to \$178.3 million for the six months ended December 30, 2012. Inventory increased to \$234.5 million at December 29, 2013 compared to \$197.0 million at June 30, 2013.

Business Outlook

We project that the markets for our products will remain highly competitive during fiscal 2014. We anticipate focusing on the following key areas, among others, in response to this competitive environment:

Lead with innovation and drive to cost parity. We continue to work on developing new LEDs, LED lighting systems, and Power and RF devices to deliver improved value that approaches cost parity with existing technology and solutions. We believe that as our technology approaches cost parity, the market for these products will expand significantly.

Build the Cree brand. We are working to build the Cree brand in both the commercial and consumer lighting segments by expanding our product offerings and continuing to invest in marketing the value of the Cree LED bulb and LED lighting directly to the end user. The level of investment will vary from quarter to quarter to optimize new product introductions, utility rebates, channel opportunities and seasonal trends.

Focus on select market segments to drive LED adoption. In addition to our broad sales strategies, we are focused on a number of market segments where we can upgrade existing lighting and drive LED adoption with a combination of new product offerings, short payback, expanded services and innovative channel approaches.

Translate product innovation into revenue and profit growth. We target revenue growth from new products and increased LED adoption and profit growth from the combination of higher sales, lower cost products and operating expense leverage.

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## Results of Operations

The following table sets forth certain consolidated statement of income data for the periods indicated (in thousands, except per share amounts and percentages):

|   | Three Months Ended |              |                   |              | Six Months Ended  |              |                   |              |
|---|--------------------|--------------|-------------------|--------------|-------------------|--------------|-------------------|--------------|
|   | December 29, 2013  |              | December 30, 2012 |              | December 29, 2013 |              | December 30, 2012 |              |
|   | Dollars            | % of Revenue | Dollars           | % of Revenue | Dollars           | % of Revenue | Dollars           | % of Revenue |
| Revenue, net  | \$415,086          | 100 %        | \$346,286         | 100 %        | \$806,092         | 100 %        | \$662,039         | 100 %        |
| Cost of revenue, net                                | 259,308            | 62 %         | 212,810           | 61 %         | 499,557           | 62 %         | 412,514           | 62 %         |
| Gross profit  | 155,778            | 38 %         | 133,476           | 39 %         | 306,535           | 38 %         | 249,525           | 38 %         |
| Research and development                            | 44,436             | 11 %         | 39,941            | 12 %         | 86,179            | 11 %         | 77,488            | 12 %         |
| Sales, general and administrative                   | 67,943             | 16 %         | 60,100            | 17 %         | 132,221           | 16 %         | 112,745           | 17 %         |
| Amortization of acquisition-related intangibles     | 7,256              | 2 %          | 7,719             | 2 %          | 14,543            | 2 %          | 15,389            | 2 %          |
| Loss on disposal or impairment of long-lived assets | 760                | — %          | 624               | — %          | 1,417             | — %          | 1,522             | — %          |
| Operating income                                    | 35,383             | 9 %          | 25,092            | 7 %          | 72,175            | 9 %          | 42,381            | 6 %          |
| Non-operating income, net                           | 3,403              | 1 %          | 2,481             | 1 %          | 6,221             | 1 %          | 5,866             | 1 %          |
| Income before income taxes                          | 38,786             | 9 %          | 27,573            | 8 %          | 78,396            | 10 %         | 48,247            | 7 %          |
| Income tax expense                                  | 3,105              | 1 %          | 7,170             | 2 %          | 12,218            | 2 %          | 11,721            | 2 %          |
| Net income  | \$35,681           | 9 %          | \$20,403          | 6 %          | \$66,178          | 8 %          | \$36,526          | 6 %          |
| Basic earnings per share                            | \$0.30             |              | \$0.18            |              | \$0.55            |              | \$0.32            |              |
| Diluted earnings per share                          | \$0.29             |              | \$0.18            |              | \$0.54            |              | \$0.31            |              |

## Revenues

Revenues for the three and six months ended December 29, 2013 and December 30, 2012 were comprised of the following (in thousands, except percentages):

|                       | Three Months Ended |                   |          | Six Months Ended  |                   |           |
|-----------------------|--------------------|-------------------|----------|-------------------|-------------------|-----------|
|                       | December 29, 2013  | December 30, 2012 | Change   | December 29, 2013 | December 30, 2012 | Change    |
| LED Products          | \$215,022          | \$200,962         | \$14,060 | \$433,045         | \$388,509         | \$44,536  |
| Percent of revenue    | 52 %               | 58 %              | 7 %      | 54 %              | 59 %              | 11 %      |
| Lighting Products     | 173,656            | 122,714           | 50,942   | 321,574           | 230,787           | 90,787    |
| Percent of revenue    | 42 %               | 35 %              | 42 %     | 40 %              | 35 %              | 39 %      |
| Power and RF Products | 26,408             | 22,610            | 3,798    | 51,473            | 42,743            | 8,730     |
| Percent of revenue    | 6 %                | 7 %               | 17 %     | 6 %               | 6 %               | 20 %      |
| Total revenue         | \$415,086          | \$346,286         | \$68,800 | \$806,092         | \$662,039         | \$144,053 |
|                       |                    |                   | 20 %     |                   |                   | 22 %      |

Our consolidated revenue increased 20% to \$415.1 million for the three months ended December 29, 2013 from \$346.3 million for the three months ended December 30, 2012. For the six months ended December 29, 2013, our consolidated revenue increased 22% to \$806.1 million from \$662.0 million for the six months ended December 30, 2012. This year-over-year increase is due to higher sales across all three of our business segments, but driven primarily by strong sales in the Lighting Products segment.

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LED Products Segment Revenue

LED Products revenue represents the largest portion of our revenue with 52% and 58% of our total revenues for the three months ended December 29, 2013 and December 30, 2012, respectively.

LED Products revenue increased 7% to \$215.0 million for the three months ended December 29, 2013 from \$201.0 million for the three months ended December 30, 2012, and 11% to \$433.0 million for the six months ended December 29, 2013 from \$388.5 million for the six months ended December 30, 2012. The increase in revenue was the result of an overall increase in the number of units sold, primarily from our newer products, partially offset by a decline in selling prices. The average selling prices for our LED products decreased for the three and six months ended December 29, 2013 as compared to the three and six months ended December 30, 2012 due primarily to market downward pricing pressure and sales of new lower cost products.

Lighting Products Segment Revenue

Lighting Products revenue represents 42% and 35% of our total revenues for the three months ended December 29, 2013 and December 30, 2012, respectively.

Lighting Products revenue increased 42% to \$173.7 million for the three months ended December 29, 2013 from \$122.7 million for the three months ended December 30, 2012, and 39% to \$321.6 million for the six months ended December 29, 2013 from \$230.8 million for the six months ended December 30, 2012. The increase in revenue was the result of an overall increase in the number of units sold. The increased volume was partially offset by a reduction in selling prices primarily due to sales of new lower cost products.

Power and RF Products Segment Revenue

Power and RF Products revenue represents 6% and 7% of our total revenues for the three months ended December 29, 2013 and December 30, 2012, respectively.

Power and RF Products revenue increased 17% to \$26.4 million for the three months ended December 29, 2013 from \$22.6 million for the three months ended December 30, 2012, and 20% to \$51.5 million for the six months ended December 29, 2013 from \$42.7 million for the six months ended December 30, 2012. The increase in revenue was mainly the result of higher sales of RF products. The increased volume was partially offset by a reduction in selling prices primarily due to sales of new lower cost products.

Unallocated Revenue

All of our revenue is allocated to our reportable segments. Our CODM does not review inter-segment revenue when evaluating performance and allocating resources to each segment, and inter-segment revenue is not included in the segment revenues presented above. As such, total segment revenue in the table above is equal to our consolidated revenue.

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## Gross Profit and Gross Margin

Gross profit and gross margin for the three and six months ended December 29, 2013 and December 30, 2012 were comprised of the following (in thousands, except percentages):

|                                    | Three Months Ended |                   |          | Six Months Ended  |                   |           |          |      |
|------------------------------------|--------------------|-------------------|----------|-------------------|-------------------|-----------|----------|------|
|                                    | December 29, 2013  | December 30, 2012 | Change   | December 29, 2013 | December 30, 2012 | Change    |          |      |
| LED Products gross profit          | \$97,644           | \$84,186          | \$13,458 | 16 %              | \$199,297         | \$159,653 | \$39,644 | 25 % |
| LED Products gross margin          | 45.4 %             | 41.9 %            |          |                   | 46.0 %            | 41.1 %    |          |      |
| Lighting Products gross profit     | 48,426             | 41,383            | 7,043    | 17 %              | 88,244            | 75,483    | 12,761   | 17 % |
| Lighting Products gross margin     | 27.9 %             | 33.7 %            |          |                   | 27.4 %            | 32.7 %    |          |      |
| Power and RF Products gross profit | 15,321             | 12,798            | 2,523    | 20 %              | 28,777            | 23,220    | 5,557    | 24 % |
| Power and RF Products gross margin | 58.0 %             | 56.6 %            |          |                   | 55.9 %            | 54.3 %    |          |      |
| Unallocated costs                  | (5,613 )           | (4,891 )          | (722 )   | 15 %              | (9,783 )          | (8,831 )  | (952 )   | 11 % |
| Consolidated gross profit          | \$155,778          | \$133,476         | \$22,302 | 17 %              | \$306,535         | \$249,525 | \$57,010 | 23 % |
| Consolidated gross margin          | 37.5 %             | 38.5 %            |          |                   | 38.0 %            | 37.7 %    |          |      |

Our consolidated gross profit increased 17% to \$155.8 million for the three months ended December 29, 2013 from \$133.5 million for the three months ended December 30, 2012. Our consolidated gross margin decreased to 37.5% for the three months ended December 29, 2013 from 38.5% for the three months ended December 30, 2012.

## LED Products Segment Gross Profit and Gross Margin

LED Products gross profit increased 16% to \$97.6 million for the three months ended December 29, 2013 from \$84.2 million for the three months ended December 30, 2012 and gross margin increased to 45.4% for the three months ended December 29, 2013 from 41.9% for the three months ended December 30, 2012. For the six months ended December 29, 2013, LED Products gross profit increased \$39.6 million to \$199.3 million from \$159.7 million for the six months ended December 30, 2012, and gross margin increased to 46.0% for the six months ended December 29, 2013 from 41.1% for the six months ended December 30, 2012. LED Products gross profit and gross margin increased due to higher revenue, factory cost reductions, the introduction of new lower cost products and higher factory utilization. These benefits more than offset the decline in the average selling prices for the three and six months ended December 29, 2013 as compared to the three and six months ended December 30, 2012.

## Lighting Products Segment Gross Profit and Gross Margin

Lighting Products gross profit increased 17% to \$48.4 million for the three months ended December 29, 2013 from \$41.4 million for the three months ended December 30, 2012, and increased 17% to \$88.2 million for the six months ended December 29, 2013 from \$75.5 million for the six months ended December 30, 2012. Lighting Products gross margin decreased to 27.9% for the three months ended December 29, 2013 from 33.7% for the three months ended December 30, 2012, and decreased to 27.4% for the six months ended December 29, 2013 from 32.7% for the six months ended December 30, 2012. Lighting Products gross profit increased for both the three and six months ended December 29, 2013 as compared to the three and six months ended December 30, 2012 due to growth in LED lighting products sales. Lighting Products gross margin decreased for both the three and six months ended December 29, 2013 as compared to the three and six months ended December 30, 2012 primarily due to sales of our consumer LED bulb products, which had no sales in the comparable fiscal 2013 periods, and which have gross margins at the lower end of the range of our Lighting Products segment products' gross margins.

## Power and RF Products Segment Gross Profit and Gross Margin



Power and RF Products gross profit increased 20% to \$15.3 million for the three months ended December 29, 2013 from \$12.8 million for the three months ended December 30, 2012, and increased 24% to \$28.8 million for the six months ended December 29, 2013 from \$23.2 million for the six months ended December 30, 2012. Power and RF Products gross margin increased to 58.0% for the three months ended December 29, 2013 from 56.6% for the three months ended December 30, 2012 and increased to 55.9% for the six months ended December 29, 2013 from 54.3% for the six months ended December 30, 2012. These gross profit and gross margin increases were due primarily to higher revenue, factory cost reductions, increased factory utilization and introduction of new lower cost products. These benefits more than offset the decline in the average selling prices for the three and six months ended December 29, 2013 as compared to the three and six months ended December 30, 2012.

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## Unallocated Costs

Unallocated costs were \$5.6 million and \$4.9 million for the three months ended December 29, 2013 and December 30, 2012, respectively. For the six months ended December 29, 2013 and December 30, 2012, unallocated costs were \$9.8 million and \$8.8 million, respectively. These costs consist primarily of manufacturing employees' stock-based compensation, expenses for profit sharing and quarterly or annual incentive plans and matching contributions under our 401(k) plan. These costs are not allocated to the reportable segments' gross profit because our CODM does not review them regularly when evaluating segment performance and allocating resources. The increase of \$0.7 million for the three months ended December 29, 2013 and \$1.0 million for the six months ended December 29, 2013 is primarily attributable to higher incentive and stock-based compensation incurred as a result of improved business performance in fiscal 2014 as compared to fiscal 2013.

For further information on the allocation of costs to segment gross profit, refer to Note 12 "Reportable Segments" in our consolidated financial statements included in Item 1 of this Quarterly Report.

## Research and Development

Research and development expenses include costs associated with the development of new products, enhancements of existing products and general technology research. These costs consist primarily of employee salaries and related compensation costs, occupancy costs, consulting costs and the cost of development equipment and supplies.

The following sets forth our research and development expenses in dollars and as a percentage of revenues (in thousands, except percentages):

|                          | Three Months Ended   |                      |         | Six Months Ended     |                      |         |
|--------------------------|----------------------|----------------------|---------|----------------------|----------------------|---------|
|                          | December 29,<br>2013 | December 30,<br>2012 | Change  | December 29,<br>2013 | December 30,<br>2012 | Change  |
| Research and development | \$44,436             | \$39,941             | \$4,495 | \$86,179             | \$77,488             | \$8,691 |
| Percent of revenues      | 11                   | % 12                 | %       | 11                   | % 12                 | %       |

Research and development expenses for the three months ended December 29, 2013 increased 11% to \$44.4 million from \$39.9 million for the three months ended December 30, 2012. For the six months ended December 29, 2013, research and development expenses increased 11% to \$86.2 million from \$77.5 million for the six months ended December 30, 2012. These increases were primarily due to increased spending on research and development activities focused on new LED lighting products. Our research and development expenses vary significantly from quarter to quarter based on a number of factors, including the timing of new product introductions and the number and nature of our ongoing research and development activities. We anticipate that in general our research and development expenses will continue to increase over time to support future growth.

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## Sales, General and Administrative

Sales, general and administrative expenses were comprised primarily of costs associated with our sales and marketing personnel and our executive and administrative personnel (for example, finance, human resources, information technology and legal) and consist of 1) salaries and related compensation costs, 2) consulting and other professional services (such as litigation and other outside legal counsel fees, audit and other compliance costs), 3) marketing and advertising expenses, 4) facilities and insurance costs and 5) travel and other costs. The following table sets forth our sales, general and administrative expenses in dollars and as a percentage of revenues (in thousands, except percentages):

|                                   | Three Months Ended |                   |         | Six Months Ended  |                   |          |
|-----------------------------------|--------------------|-------------------|---------|-------------------|-------------------|----------|
|                                   | December 29, 2013  | December 30, 2012 | Change  | December 29, 2013 | December 30, 2012 | Change   |
| Sales, general and administrative | \$67,943           | \$60,100          | \$7,843 | \$132,221         | \$112,745         | \$19,476 |
| Percent of revenues               | 16 %               | 17 %              | 13 %    | 16 %              | 17 %              | 17 %     |

Sales, general and administrative expenses for the three months ended December 29, 2013 increased 13% to \$67.9 million from \$60.1 million for the three months ended December 30, 2012. For the six months ended December 29, 2013, sales, general and administrative expenses increased 17% to \$132.2 million from \$112.7 million for the six months ended December 30, 2012. These increases were primarily due to an increase in spending on sales and marketing for lighting products, including commissions, trade shows and advertising, as we continue to expand our direct sales resources and channels and invest in building and promoting the Cree brand.

## Amortization of Acquisition Related Intangibles

As a result of our acquisitions, we have recognized various intangible assets, including customer relationships and developed technologies. During fiscal 2012, we acquired Ruud Lighting, resulting in \$206.0 million of amortizable intangible assets, principally composed of developed technology, customer relationships and trade names. In fiscal 2008, we acquired LED Lighting Fixtures, Inc. (LLF), resulting in an additional \$41.2 million of amortizable intangible assets. These intangible assets are principally composed of developed technologies that specifically relate to technologies underlying the development of LED lighting products for the general illumination market. During fiscal 2007, we acquired INTRINSIC Semiconductor Corporation and COTCO Luminant Device Limited (now Cree Hong Kong Limited) (COTCO), resulting in \$63.7 million of amortizable intangible assets principally composed of customer relationships and developed technology.

Amortization of intangible assets related to our acquisitions is as follows (in thousands, except percentages):

|               | Three Months Ended |                   |         | Six Months Ended  |                   |         |
|---------------|--------------------|-------------------|---------|-------------------|-------------------|---------|
|               | December 29, 2013  | December 30, 2012 | Change  | December 29, 2013 | December 30, 2012 | Change  |
| Ruud Lighting | \$5,746            | \$5,742           | \$4     | \$11,492          | \$11,437          | \$55    |
| COTCO         | 753                | 1,041             | (288)   | 1,506             | 2,081             | (575)   |
| LLF           | 749                | 750               | (1)     | 1,499             | 1,499             | —       |
| INTRINSIC     | 8                  | 186               | (178)   | 46                | 372               | (326)   |
| Total         | \$7,256            | \$7,719           | (\$463) | \$14,543          | \$15,389          | (\$846) |

## Loss on Disposal or Impairment of Long-Lived Assets

We operate a capital intensive business. As such, we dispose of a certain level of our equipment in the normal course of business as our production process changes due to production improvement initiatives or product mix changes. Due to the risk of technological obsolescence or changes in our production process, we regularly review our equipment and capitalized patent costs for possible impairment. The following table sets forth our loss on disposal or impairment of long-lived assets (in thousands, except percentages):

|  | Three Months Ended |                   |        | Six Months Ended  |                   |        |
|--|--------------------|-------------------|--------|-------------------|-------------------|--------|
|  | December 29, 2013  | December 30, 2012 | Change | December 29, 2013 | December 30, 2012 | Change |
|  |                    |                   |        |                   |                   |        |

|  |       |       |       |    |   |         |         |          |       |
|--|-------|-------|-------|----|---|---------|---------|----------|-------|
| Loss on disposal or<br>impairment of long-lived<br>assets, net | \$760 | \$624 | \$136 | 22 | % | \$1,417 | \$1,522 | (\$105 ) | (7 )% |
|--|-------|-------|-------|----|---|---------|---------|----------|-------|

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We recognized a net loss of \$0.8 million on the disposal of long-lived assets for the three months ended December 29, 2013 compared to a net loss of \$0.6 million for the three months ended December 30, 2012. For the six months ended December 29, 2013, we recognized a net loss of \$1.4 million compared to \$1.5 million for the six months ended December 30, 2012. These net losses resulted from the disposal of equipment due to manufacturing process changes and the abandonment of certain patent assets.

## Non-Operating Income, Net

The following table sets forth our non-operating income, net (in thousands, except percentages):

|                                  | Three Months Ended |                   |         | Six Months Ended  |                   |         |          |        |   |
|----------------------------------|--------------------|-------------------|---------|-------------------|-------------------|---------|----------|--------|---|
|                                  | December 29, 2013  | December 30, 2012 | Change  | December 29, 2013 | December 30, 2012 | Change  |          |        |   |
| Foreign currency gain, net       | \$213              | \$301             | (\$88 ) | (29 )%            | \$477             | \$128   | \$349    | 273    | % |
| Gain on sale of investments, net | —                  | 8                 | (8 )    | (100 )%           | 10                | 36      | (26 )    | (72 )% |   |
| Interest income, net             | 2,806              | 1,946             | 860     | 44 %              | 5,147             | 3,738   | 1,409    | 38     | % |
| Other, net                       | 384                | 226               | 158     | 70 %              | 587               | 1,964   | (1,377 ) | (70 )% |   |
| Total non-operating income, net  | \$3,403            | \$2,481           | \$922   | 37 %              | \$6,221           | \$5,866 | \$355    | 6      | % |

We have no debt or active lines of credit and we are in a net interest income position. Our investments consist of municipal bonds, corporate bonds, U.S. agency securities, non-U.S. certificates of deposit and non-U.S. government securities. The primary objective of our investment policy is preservation of principal.

Foreign currency gain, net. Foreign currency gain, net consists primarily of remeasurement adjustments resulting from consolidating our international subsidiaries. The changes in foreign currency gain (loss), net are primarily due to fluctuations in the exchange rate between the Chinese Yuan and the United States Dollar.

Gain on sale of investments, net. Gain on sale of investments, net was zero for the three months ended December 29, 2013 compared to \$8 thousand for the three months ended December 30, 2012. For the six months ended December 29, 2013, gain on sale of investments, net was \$10 thousand compared to \$36 thousand for the six months ended December 30, 2012.

Interest income, net. Interest income, net was \$2.8 million for the three months ended December 29, 2013 compared to \$1.9 million for the three months ended December 30, 2012. For the six months ended December 29, 2013, interest income, net was \$5.1 million compared to \$3.7 million for the six months ended December 30, 2012. The increase in interest income for the three and six months ended December 29, 2013 was primarily due to having higher balances of invested cash and short-term investments compared to the three and six months ended December 30, 2012.

Other, net. Other, net was \$0.4 million for the three months ended December 29, 2013 compared to \$0.2 million for the three months ended December 30, 2012. For the six months ended December 29, 2013, other, net was \$0.6 million compared to \$2.0 million for the six months ended December 30, 2012. The decrease for the six months ended December 29, 2013 is due primarily to a one-time payment received in connection with the SemiLEDs patent litigation settlement which occurred in the first quarter of fiscal 2013.

## Income Tax Expense

The following table sets forth our income tax expense in dollars and our effective tax rate (in thousands, except percentages):

|                    | Three Months Ended |                   |            | Six Months Ended  |                   |          |       |   |   |
|--------------------|--------------------|-------------------|------------|-------------------|-------------------|----------|-------|---|---|
|                    | December 29, 2013  | December 30, 2012 | Change     | December 29, 2013 | December 30, 2012 | Change   |       |   |   |
| Income tax expense | \$3,105            | \$7,170           | (\$4,065 ) | (57 )%            | \$12,218          | \$11,721 | \$497 | 4 | % |
| Effective tax rate | 8.0                | % 26.0            | %          |                   | 15.6              | % 24.3   | %     |   |   |

The variation between our effective income tax rate and the U.S. statutory rate of 35 percent is due to a percentage of our projected income for the full year being derived from international locations with lower tax rates than the U.S. and the impact of tax credits available in the current year. A change in the mix of pretax income of our various tax jurisdictions can have a material impact on our periodic effective tax rate.

We recognized income tax expense of \$3.1 million for an effective tax rate of 8.0% for the three months ended December 29, 2013 as compared to income tax expense of \$7.2 million for an effective tax rate of 26.0% for the three months ended December 30,

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2012. For the six months ended December 29, 2013, we recognized income tax expense of \$12.2 million for an effective tax rate of 15.6% compared to \$11.7 million for an effective tax rate of 24.3% for the six months ended December 30, 2012. These decreases in our effective tax rate were due to an increased percentage of our income being earned in lower tax jurisdictions and the tax benefit related to the receipt of U.S. federal tax credits awarded on November 15, 2013 as part of Phase II of the American Recovery and Reinvestment Act of 2009 (Internal Revenue Code Section 48C).

## Liquidity and Capital Resources

## Overview

We require cash to fund our operating expenses and working capital requirements, including outlays for research and development, capital expenditures, strategic acquisitions and investments. Our principal sources of liquidity are cash and cash equivalents, marketable investments and cash generated from operations. Our ability to generate cash from operations has been one of our fundamental strengths and has provided us with substantial flexibility in meeting our operating, financing and investing needs. We have no debt or active lines of credit and have minimal lease commitments.

Based on past performance and current expectations, we believe our cash and cash equivalents, investments, cash generated from operations and our ability to access capital markets will satisfy our working capital needs, capital expenditures, investment requirements, stock repurchases, contractual obligations, commitments and other liquidity requirements associated with our operations through at least the next 12 months.

From time to time, we evaluate strategic opportunities, including potential acquisitions, divestitures or investments in complementary businesses and we anticipate continuing to make such evaluations. We may also access capital markets through the issuance of debt or additional shares of common stock in connection with the acquisition of complementary businesses or other significant assets or for other strategic opportunities.

We may use a portion of our available cash and cash equivalents, or funds underlying our marketable securities, to repurchase shares of our common stock pursuant to repurchase programs authorized by our Board of Directors. With our strong working capital position, we believe that we have the ability to continue to invest in further development of our products and, when necessary or appropriate, make selective acquisitions or other strategic investments to strengthen our product portfolio, secure key intellectual properties, or expand our production capacity.

## Liquidity

Our liquidity and capital resources depend on our cash flows from operations and our working capital. The significant components of our working capital are liquid assets such as cash and cash equivalents, short-term investments, accounts receivable and inventories, reduced by trade accounts payable, accrued salaries and wages, and other accrued expenses. Our working capital increased to \$1.5 billion as of December 29, 2013 from \$1.3 billion as of June 30, 2013, primarily due to \$168.0 million cash provided by operating activities and \$73.1 million cash provided by the net issuances of common stock from employee option exercises. These cash inflows were partially offset by payments for patent and licensing rights and purchases of property and equipment of \$93.5 million.

The following table presents the components of our cash conversion cycle for the three months ended December 29, 2013 and June 30, 2013:

|  | December 29,<br>2013 | June 30,<br>2013 | Change |      |    |
|--|----------------------|------------------|--------|------|----|
| Days of sales outstanding <sup>(a)</sup>   | 46                   | 46               | —      | —    | %  |
| Days of supply in inventory <sup>(b)</sup> | 81                   | 76               | 5      | 7    | %  |
| Days in accounts payable <sup>(c)</sup>    | (58)                 | (47)             | (11    | ) 23 | %  |
| Cash conversion cycle                      | 69                   | 75               | (6     | ) (8 | )% |

Days of sales outstanding (DSO) measures the average collection period of our receivables. DSO is based on the ending net trade receivables and the revenue for the quarter then ended. DSO is calculated by dividing ending accounts receivable, net of applicable allowances and reserves, by the average net revenue per day for the respective 90 day period.





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Days of supply in inventory (DSI) measures the average number of days from procurement to sale of our product. b) DSI is based on ending inventory and cost of revenue, net sold for the quarter then ended. DSI is calculated by dividing ending inventory by average cost of revenue, net per day for the respective 90 day period.

Days in accounts payable (DPO) measures the average number of days our payables remain outstanding before payment. DPO is based on ending accounts payable and cost of revenue, net for the quarter then ended. c) DPO is calculated by dividing ending accounts payable by the average cost of revenue, net per day for the respective 90 day period.

The decrease in the cash conversion cycle was primarily driven by an increase in days in accounts payable, partially offset by an increase in days of inventory.

As of December 29, 2013, we had unrealized losses on our investments of \$1.1 million. All of our investments had investment grade ratings, and any such investments that were in an unrealized loss position at December 29, 2013 were in such position due to interest rate changes, sector credit rating changes or company-specific rating changes. As we intend and believe that we have the ability to hold such investments for a period of time that will be sufficient for anticipated recovery in market value, we currently expect to receive the full principal or recover our cost basis in these securities. The declines in value of the securities in our portfolio are considered to be temporary in nature and, accordingly, we do not believe these securities are impaired as of December 29, 2013.

**Cash Flows**

In summary, our cash flows were as follows (in thousands, except percentages):

|   | Six Months Ended     |                      |             | Change |    |
|---|----------------------|----------------------|-------------|--------|----|
|   | December 29,<br>2013 | December 30,<br>2012 |             |        |    |
| Cash provided by operating activities     | \$167,987            | \$178,294            | (\$10,307 ) | (6     | )% |
| Cash used in investing activities         | (176,886 )           | (185,598 )           | 8,712       | (5     | )% |
| Cash provided by financing activities     | 87,825               | 7,656                | 80,169      | 1,047  | %  |
| Effects of foreign exchange changes       | 393                  | 371                  | 22          | 6      | %  |
| Net increase in cash and cash equivalents | \$79,319             | \$723                | \$78,596    | 10,871 | %  |

The following is a discussion of our primary sources and uses of cash in our operating, investing and financing activities.

**Cash Flows from Operating Activities**

Net cash provided by operating activities was \$168.0 million for the six months ended December 29, 2013 compared to \$178.3 million for the six months ended December 30, 2012. This decrease was primarily due to changes in our working capital offset by an increase in net income.

**Cash Flows from Investing Activities**

Our investing activities primarily relate to transactions within our investments, purchase of property, plant and equipment and payments for patent and license rights. Net cash used in investing activities was \$176.9 million for the six months ended December 29, 2013 compared to \$185.6 million for the six months ended December 30, 2012. For the six months ended December 29, 2013, our purchases of property and equipment were \$83.5 million as compared to \$30.4 million for the six months ended December 30, 2012. Our capital spending increased as we continued to make investments in capacity to support our future growth. This increase was offset by lower net purchases of investments for the six months ended December 29, 2013 compared to the six months ended December 30, 2012. We continue to actively manage our capital spending. For fiscal 2014, we target approximately \$145.0 million of capital investment to support our strategic priorities.

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### Cash Flows from Financing Activities

Net cash provided by financing activities was \$87.8 million for the six months ended December 29, 2013 and \$7.7 million for the six months ended December 30, 2012. For the six months ended December 29, 2013 and December 30, 2012, our financing activities primarily consisted of proceeds of \$87.9 million and \$8.3 million, respectively, from net issuances of common stock pursuant to the exercise of employee stock options, including the excess tax benefit on those exercises.

### Off-Balance Sheet Arrangements

We do not use off-balance sheet arrangements with unconsolidated entities or related parties, nor do we use any other forms of off-balance sheet arrangements. Accordingly, our liquidity and capital resources are not subject to off-balance sheet risks from unconsolidated entities. As of December 29, 2013, we did not have any off-balance sheet arrangements, as defined in Item 303(a)(4)(ii) of SEC Regulation S-K.

We have entered into operating leases primarily for certain of our U.S. and international facilities in the normal course of business. Please refer to Part II, Item 7 of our Annual Report on Form 10-K for the fiscal year ended June 30, 2013, in the section entitled “Contractual Obligations” for the future minimum lease payments due under our operating leases as of June 30, 2013. There have been no significant changes to the contractual obligations discussed therein.

### Critical Accounting Policies and Estimates

For information about our critical accounting policies and estimates, see the “Critical Accounting Policies and Estimates” section of “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations” in our Annual Report on Form 10-K for the fiscal year ended June 30, 2013.

### New Accounting Standards

See Note 1, “Basis of Presentation and Changes in Significant Accounting Policies,” to our unaudited consolidated financial statements in Part I, Item 1 of this Quarterly Report for a description of new accounting standards, including the effects, if any, on our consolidated financial statements.

### Item 3. Quantitative and Qualitative Disclosures About Market Risk

For quantitative and qualitative disclosures about our market risks, see “Part II. Item 7A. Quantitative and Qualitative Disclosures About Market Risk” of our Annual Report on Form 10-K for the fiscal year ended June 30, 2013. There have been

no material changes to the amounts presented therein.

### Item 4. Controls and Procedures

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

We routinely review our internal control over financial reporting and from time to time make changes intended to enhance the effectiveness of our internal control over financial reporting. We will continue to evaluate the effectiveness of our disclosure controls and procedures and internal control over financial reporting on an ongoing basis and will take action as appropriate. There have been no changes to our internal control over financial reporting, as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act, during the second quarter of fiscal 2014 that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II – OTHER INFORMATION

Item 1. Legal Proceedings

The information required by this item is set forth under Note 11, “Commitments and Contingencies,” to our unaudited financial statements in Part I, Item 1 of this Quarterly Report and is incorporated herein by reference.

Item 1A. Risk Factors

Described below are various risks and uncertainties that may affect our business. The descriptions below include any material changes to and supersede the description of the risk factors affecting our business previously disclosed in “Part I, Item 1A. Risk Factors” of our Annual Report on Form 10-K for the fiscal year ended June 30, 2013 and any subsequent periodic reports. If any of the risks described below actually occurs, our business, financial condition or results of operations could be materially and adversely affected.

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

Our future success may depend on our ability to develop new, higher performing and lower cost solutions for existing and new markets and for customers to accept those solutions. We must introduce new products in a timely and cost-effective manner, and we must secure production orders for those products from our customers. The development of new products is a highly complex process, and we have in some instances experienced delays in completing the development and introduction of new products. Our research and development efforts are aimed at solving increasingly complex problems, and we do not expect that all of our projects will be successful. The successful development, introduction and acceptance of new products depends on a number of factors, including the following:

- achievement of technology breakthroughs required to make commercially viable devices;
- the accuracy of our predictions for market requirements beyond near term visibility;
- our ability to predict, influence, and/or react to evolving standards;
- acceptance of our new product designs;
- acceptance of new technology in certain markets;
- the availability of qualified research and development personnel;
- our timely completion of product designs and development;
- our ability to develop repeatable processes to manufacture new products in sufficient quantities, with the desired specifications and at competitive costs;
- our ability to effectively transfer products and technology from development to manufacturing;
- our customers' ability to develop competitive products incorporating our products; and
- acceptance of our customers' products by the market.

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

If we are unable to effectively develop, manage and expand our sales channels for our products, our operating results may suffer.

We have expanded into business channels that are different from those in which we have historically operated as we grow our business and sell more LED and lighting products. Lighting sales agents have in the past and may in the future choose to drop our product lines from their portfolio to avoid losing access to our competitors' lighting products, resulting in a disruption in the project pipeline and lower than targeted sales for our lighting products. We sell an increasing portion of our products through retailers who may alter their promotional pricing or inventory strategies, which could impact our targeted sales of lighting products. If we are unable to effectively penetrate these channels or develop alternate channels to ensure our products are reaching the intended customer base, our financial results may be adversely impacted. In addition, if we successfully penetrate or develop

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these channels, we cannot guarantee that customers will accept our products or that we will be able to manufacture and deliver them in the timeline established by our customers.

We sell a substantial portion of our products to distributors. We rely on distributors to develop and expand their customer base as well as anticipate demand from their customers. If they are not successful, our growth and profitability may be adversely impacted. Distributors must balance the need to have enough products in stock in order to meet their customers' needs against their internal target inventory levels and the risk of potential inventory obsolescence. The risks of inventory obsolescence are especially true with technological products. The distributors' internal target inventory levels vary depending on market cycles and a number of factors within each distributor over which we have very little, if any, control.

We typically recognize revenue on products sold to distributors when the item is shipped and title passes to the distributor (sell-in method). Certain distributors have limited rights to return inventory under stock rotation programs and have limited price protection rights for which we make estimates. We evaluate inventory levels in the distribution channel, current economic trends and other related factors in order to account for these factors in our judgments and estimates. As inventory levels and product return trends change, we may have to revise our estimates and incur additional costs, and our gross margins and operating results could be adversely impacted.

We face significant challenges managing our growth as the market adopts LEDs for general lighting.

Our potential for growth depends significantly on the adoption of LEDs within the general lighting market and our ability to affect this rate of adoption. Although the market for LED lighting has grown rapidly in recent years, adoption of LEDs for general lighting is relatively new, still limited and faces significant challenges before widespread adoption. In order to manage our growth and business strategy effectively in light of uncertainty related to the pace of adoption, we must continue to:

- maintain, expand and purchase adequate manufacturing facilities and equipment to meet customer demand;
- maintain a sufficient supply of raw materials to support our growth;
- expand research and development, sales and marketing, technical support, distribution capabilities and administrative functions;
- manage organizational complexity and communication;
- expand the skills and capabilities of our current management team;
- add experienced senior level managers; and
- attract and retain qualified employees.

While we intend to focus on managing our costs and expenses, over the long term we expect to invest substantially to support our growth and may have additional unexpected costs. For example, in 2013, we expanded our facilities in Wisconsin and North Carolina. Such investments take time to become fully operational, and we may not be able to expand quickly enough to exploit targeted market opportunities. There are also inherent execution risks in starting up a new factory or expanding production capacity that could increase costs and reduce our operating results, including design and construction cost overruns, poor production process yields and reduced quality control during the start-up phase.

We are also increasingly dependent on information technology to enable us to improve the effectiveness of our operations and to maintain financial accuracy and efficiency. If we do not allocate and effectively manage the resources necessary to build, implement, upgrade, integrate and sustain the proper technology infrastructure, we could be subject to transaction errors, processing inefficiencies, loss of customers, business disruptions or loss of or damage to intellectual property through security breach.

In connection with our efforts to cost-effectively manage our growth, we have increasingly relied on contractors for production capacity, logistics support and certain administrative functions including hosting of certain information technology software applications. If these service providers do not perform effectively, we may not be able to achieve the expected cost savings and may incur additional costs to correct errors or fulfill customer demand. Depending on the function involved, such errors may also lead to business disruption, processing inefficiencies or the loss of or damage to intellectual property through security breach, or impact employee morale. Our operations may also be negatively impacted if any of these service providers do not have the financial capability to meet our growing needs.



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The markets in which we operate are highly competitive and have evolving technical requirements. The markets for our products are highly competitive. In the LED market, we compete with companies that manufacture and sell LED chips and LED components. In the lighting market, we compete with companies that manufacture and sell traditional and LED lighting products, many of which have larger and more established sales channels. Competitors continue to offer new products with aggressive pricing and improved performance. Competitive pricing pressures may change and could accelerate the rate of decline of our average sales prices. With the growth potential for LEDs, we may face increased competition in the future. If the investment in new capacity exceeds the growth in demand, the LED market is likely to become more competitive with additional pricing pressures. Additionally, new technologies could emerge or improvements could be made in existing technologies that may also reduce the demand for LEDs in certain markets. There are also new technologies, such as organic LEDs (OLEDs), which could potentially have the same impact on LED demand for backlighting, which could impact the overall LED market.

As competition increases, in order to continue to grow our business, we need to continue to develop new products that meet or exceed the needs of our customers. Therefore, our ability to continually produce more efficient, higher brightness and lower cost LEDs and lighting products that meet the evolving needs of our customers will be critical to our success. Competitors may also try to align with some of our strategic customers. This could mean lower prices for our products, reduced demand for our products and a corresponding reduction in our ability to recover development, engineering and manufacturing costs. Any of these developments could have an adverse effect on our business, results of operations or financial condition.

We rely on a number of key sole source and limited source suppliers, and are subject to high price volatility on certain commodity inputs, variations in parts quality, and raw material consistency and availability.

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

We generally purchase these sole or limited source items with purchase orders, and we have limited guaranteed supply arrangements with such suppliers. Some of our sources can have variations in attributes and availability which can affect our ability to produce products in sufficient volume or quality. We do not control the time and resources that these suppliers devote to our business, and we cannot be sure that these suppliers will perform their obligations to us. Additionally, general shortages in the marketplace of certain raw materials or key components may adversely impact our business. In the past, we have experienced decreases in our production yields when suppliers have varied from previously agreed upon specifications, which impacted our cost of revenue.

Additionally, the inability of our suppliers to access capital efficiently could cause disruptions in their businesses, thereby negatively impacting ours. This risk may increase if an economic downturn negatively affects key suppliers or a significant number of our other suppliers. Any delay in product delivery or other interruption or variation in supply from these suppliers could prevent us from meeting commercial demand for our products. If we were to lose key suppliers, if our key suppliers were unable to support our demand for any reason, or if we were unable to identify and qualify alternative suppliers, our manufacturing operations could be interrupted or hampered significantly.

We rely on arrangements with independent shipping companies for the delivery of our products from vendors and to customers in both the United States and abroad. The failure or inability of these shipping companies to deliver products, or the unavailability of their shipping services, even temporarily, could have a material adverse effect on our business. We may also be adversely affected by an increase in freight surcharges due to rising fuel costs and added security.

In our fabrication process we consume a number of precious metals and other commodities, which are subject to high price volatility. Our operating margins could be significantly affected if we are not able to pass along price increases to our customers. In addition, production could be disrupted by the unavailability of the resources used in production such as water, silicon, electricity and gases. Future environmental regulations could restrict supply or increase the cost of certain of those materials.

We operate in an industry that is subject to significant fluctuation in supply and demand that affects our revenue and profitability.

The LED lighting industry is in the early stages of adoption and is characterized by constant and rapid technological change, rapid product obsolescence and price erosion, evolving standards, short product life-cycles and fluctuations in product supply and demand. The industry has experienced significant fluctuations, often in connection with, or in anticipation of, product cycles and changes in general economic conditions. As the markets for our products mature, additional fluctuations may result from variability

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and consolidations within the industry's customer base. These fluctuations have been characterized by lower product demand, production overcapacity, higher inventory levels and increased pricing pressure. We have experienced these conditions in our business in the past and may experience such conditions in the future, which could have a material negative impact on our business, results of operations or financial condition.

In addition, as we diversify our product offerings and as pricing differences in the average selling prices among our product lines widen, a change in the mix of sales among our product lines may increase volatility in our revenue and gross margin from period to period.

As a result of our continued expansion into new markets, we may compete with existing customers who may reduce their orders.

Through acquisitions and organic growth, we continue to expand into new markets and new market segments. Many of our existing customers who purchase our LED products develop and manufacture products using those chips and components that are offered into the same lighting markets. As a result, some of our current customers perceive us as a competitor in these market segments. In response, our customers may reduce or discontinue their orders for our LED products. This reduction in or discontinuation of orders could occur faster than our sales growth in these new markets, which could adversely affect our business, results of operations or financial condition.

We depend on a limited number of customers, including distributors and retailers, for a substantial portion of our revenues, and the loss of, or a significant reduction in purchases by, one or more of these customers could adversely affect our operating results.

We receive a significant amount of our revenues from a limited number of customers, including distributors, one of which represented greater than 10% of our consolidated revenues in fiscal 2013. Most of our customer orders are made on a purchase order basis, which does not generally require any long-term customer commitments. Therefore, these customers may alter their purchasing behavior with little or no notice to us for various reasons, including: developing, or, in the case of our distributors, their customers developing, their own product solutions; choosing to purchase product from our competitors; incorrectly forecasting end market demand for their products; or experiencing a reduction in their market share in the markets for which they purchase our products. In the case of retailers, these customers may alter their promotional pricing or inventory strategies. If our customers alter their purchasing behavior, if our customers' purchasing behavior does not match our expectations, or if we encounter any problems collecting amounts due from them, our financial condition and results of operations could be negatively impacted.

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

As customer demand for our products changes, we must be able to ramp up or adjust our production capacity to meet demand. We are continually taking steps to address our manufacturing capacity needs for our products. If we are not able to increase our production capacity at our targeted rate, or if there are unforeseen costs associated with adjusting our capacity levels, we may not be able to achieve our financial targets.

Conversely, due to the proportionately high fixed cost nature of our business (such as facility costs), if demand does not increase at the rate forecasted, we may not be able to scale our manufacturing expenses or overhead costs to correspond to the demand. This could result in lower margins and adversely impact our business and results of operations. Additionally, if product demand decreases or we fail to forecast demand accurately, we may be required to recognize impairments on our long-lived assets or recognize excess inventory write off charges. We have in the past and may in the future be required to recognize excess capacity charges, which would have a negative impact on our results of operations.

In addition, our efforts to improve quoted delivery lead-time performance may result in corresponding reductions in order backlog. A decline in backlog levels could result in more variability and less predictability in our quarter-to-quarter net sales and operating results.

If our products fail to perform or fail to meet customer requirements or expectations, we could incur significant additional costs, including costs associated with the recall of those items.

The manufacture of our products involves highly complex processes. Our customers specify quality, performance and reliability standards that we must meet. If our products do not meet these standards, we may be required to replace or rework the products. In some cases, our products may contain undetected defects or flaws that only become evident



after shipment. Even if our products meet standard specifications, our customers may attempt to use our products in applications they were not designed for or in products that were not designed or manufactured properly, resulting in product failures and creating customer satisfaction issues.

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We have experienced product quality, performance or reliability problems from time to time and defects or failures may occur in the future. If failures or defects occur, we may need to recall our products. These recalls could result in significant losses due to:

- costs associated with the removal, collection and destruction of the product recalled;
- payments made to replace recalled product;
- the write down or destruction of existing inventory subject to the recall;
- lost sales due to the unavailability of product for a period of time;
- delays, cancellations or rescheduling of orders for our products; or
- increased product returns.

A significant product recall could also result in adverse publicity, damage to our reputation, and a loss of customer or consumer confidence in our products. We also may be the target of product liability lawsuits or regulatory proceedings by the Consumer Product Safety Commission (CPSC), and could suffer losses from a significant product liability judgment or adverse CPSC finding against us if the use of our products at issue is determined to have caused injury or contained a substantial product hazard.

We provide warranty periods ranging from ninety days to ten years on our products. The standard warranty on nearly all of our new LED lighting products, which represent an increasing portion of our sales, is ten years. Although we believe our reserves are appropriate, we are making projections about the future reliability of new products and technologies. We may experience increased variability in warranty claims. Increased warranty claims could result in significant losses due to a rise in warranty expense and costs associated with customer support.

Variations in our production yields could impact our ability to reduce costs and could cause our margins to decline and our operating results to suffer.

All of our products are manufactured using technologies that are highly complex. The number of usable items, or yield, from our production processes may fluctuate as a result of many factors, including but not limited to the following:

- variability in our process repeatability and control;
- contamination of the manufacturing environment;
- equipment failure, power outages, information or other system failures or variations in the manufacturing process;
- lack of consistency and adequate quality and quantity of piece parts and other raw materials, and other bill of materials items;
- inventory shrinkage or human errors;
- defects in production processes (including system assembly) either within our facilities or at our suppliers; and
- any transitions or changes in our production process, planned or unplanned.

In the past, we have experienced difficulties in achieving acceptable yields on certain products, which has adversely affected our operating results. We may experience similar problems in the future, and we cannot predict when they may occur or their severity.

In addition, our ability to convert volume manufacturing to larger diameter substrates can be an important factor in providing a more cost effective manufacturing process. If we are unable to make this transition in a timely or cost effective manner, our results could be negatively impacted.

In some instances, we may offer products for future delivery at prices based on planned yield improvements or increased cost efficiencies from other production advances. Failure to achieve these planned improvements or advances could have a significant impact on our margins and operating results.

Our results may be negatively impacted if customers do not maintain their favorable perception of our brand and products.

We have a developing brand with increasing value. Maintaining and continually enhancing the value of this brand is critical to the success of our business. Brand value is based in large part on customer perceptions. Success in promoting and enhancing brand value depends in large part on our ability to provide high-quality products. Brand value could diminish significantly due



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to a number of factors, including adverse publicity about our products (whether or not valid), a failure to maintain the quality of our products (whether alleged or real), the failure of our products to deliver consistently positive consumer experiences, the products becoming unavailable to consumers or consumer perception that we have acted in an irresponsible manner in some way. Damage to our brand, reputation or loss of customer confidence in our brand or products could result in decreased demand for our products and have a negative impact on our business, results of operations or financial condition.

Global economic conditions could materially adversely impact demand for our products and services.

Our operations and performance depend significantly on worldwide economic conditions. Uncertainty about global economic conditions could result in customers postponing purchases of our products and services in response to tighter credit, unemployment, negative financial news and/or declines in income or asset values and other macroeconomic factors, which could have a material negative effect on demand for our products and services and accordingly, on our business, results of operations or financial condition.

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

From time to time, we evaluate strategic opportunities available to us for product, technology or business transactions, such as business acquisitions or divestitures. If we choose to enter into such transactions, we face certain risks, such as the failure of an acquired business to meet our performance expectations, diversion of management attention, identification of additional liabilities relating to the acquired business, loss of existing customers of our current and acquired businesses due to concerns that new product lines may be in competition with the customers' existing product lines, and difficulty integrating an acquired business's operations, personnel and financial and operating systems into our current business.

We may not be able to adequately address these risks or any other problems that arise from our recent or future acquisitions or divestitures. Any failure to successfully evaluate strategic opportunities and address risks or other problems that arise related to any such business transaction could adversely affect our business, results of operations or financial condition.

Our revenue is highly dependent on our customers' ability to produce, market and sell more integrated products. Our revenue in our LED Products and Power and RF Products segments depends on getting our products designed into a larger number of our customers' products and in turn, our customers' ability to produce, market and sell their products. For example, we have current and prospective customers that create, or plan to create, lighting systems using our LED components. However, the traditional lighting industry is still developing technical expertise with LED-related designs, which may limit the success of our customers' products. Even if our customers are able to develop and produce LED lighting products and products that incorporate our Power and RF products, there can be no assurance that our customers will be successful in marketing and selling these products in the marketplace.

The adoption of or changes in government and/or industry policies, standards or regulations relating to the efficiency, performance, use or other aspects of lighting could impact the demand for our products.

The adoption of or changes in government and/or industry policies, standards or regulations relating to the efficiency, performance or other aspects of LED lighting may impact the demand for our products. Demand for our products may also be impacted by changes in government and/or industry policies, standards or regulations that discourage the use of certain traditional lighting technologies. These constraints may be eliminated or delayed by legislative action, which could have a negative impact on demand for our products.

If governments, their agencies or utilities reduce their demand for our products or discontinue or curtail their funding, our business may suffer.

Changes in governmental budget priorities could adversely affect our business and results of operations. U.S. and foreign government agencies have purchased products directly from us and products from our customers, and U.S. government agencies have historically funded a portion of our research and development activities. When the government changes budget priorities, such as in times of war or financial crisis, our research and development funding and our product sales to government entities and government-funded customers are at risk. For example, demand and payment for our products and our customers' products may be affected by public sector budgetary cycles, funding authorizations, or utility rebates. Funding reductions or delays could negatively impact demand for our products. If government or utility funding is discontinued or significantly reduced, our business and results of

operations could be adversely affected.

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Our operations in foreign countries expose us to certain risks inherent in doing business internationally, which may adversely affect our business, results of operations or financial condition.

As a result of acquisitions and organic growth, we have operations, manufacturing facilities and contract manufacturing arrangements in foreign countries that expose us to certain risks. For example, fluctuations in exchange rates may affect our revenues, expenses and results of operations as well as the value of our assets and liabilities as reflected in our financial statements. We are also subject to other types of risks, including the following:

- protection of intellectual property and trade secrets;
- tariffs, customs and other barriers to importing/exporting materials and products in a cost effective and timely manner;
- timing and availability of export licenses;
- rising labor costs;
- disruptions in or inadequate infrastructure of the countries where we operate;
- difficulties in accounts receivable collections;
- difficulties in staffing and managing international operations;
- the burden of complying with foreign and international laws and treaties; and
- the burden of complying with and changes in international taxation policies.

In some instances, we have been provided and may continue to receive incentives from foreign governments to encourage our investment in certain countries, regions, or areas outside of the United States. In particular, we have received and may continue to receive such incentives in connection with our operations in Asia, as Asian national and local governments seek to encourage the development of the technology industry. Government incentives may include tax rebates, reduced tax rates, favorable lending policies and other measures, some or all of which may be available to us due to our foreign operations. Any of these incentives could be reduced or eliminated by governmental authorities at any time. Any reduction or elimination of incentives currently provided to our operations could adversely affect our business and results of operations. These same governments also may provide increased incentives to or require production processes that favor local companies, which could further negatively impact our business and results of operations.

Abrupt political change, terrorist activity and armed conflict pose a risk of general economic disruption in affected countries, which could also result in an adverse effect on our business and results of operations.

Litigation could adversely affect our operating results and financial condition.

We are often involved in litigation, primarily patent litigation, as described in more detail in Note 12 "Commitments and Contingencies" to our consolidated financial statements included in "Item 8, Financial Statements and Supplementary Data" of our Annual Report on Form 10-K for fiscal 2013 and in Note 11, "Commitments and Contingencies," to our unaudited financial statements in Part I, Item 1 of this Quarterly Report. Defending against existing and potential litigation will likely require significant attention and resources and, regardless of the outcome, result in significant legal expenses, which could adversely affect our results unless covered by insurance or recovered from third parties. If our defenses are ultimately unsuccessful, or if we are unable to achieve a favorable resolution, we could be liable for damage awards that could materially affect our results of operations and financial condition.

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

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

- pay substantial damages;
- indemnify our customers;
- stop the manufacture, use and sale of products found to be infringing;
- incur asset impairment charges;
- discontinue the use of processes found to be infringing;
- expend significant resources to develop non-infringing products or processes; or
- obtain a license to use third party technology.

There can be no assurance that third parties will not attempt to assert infringement claims against us, or our customers, with respect to our products. In addition, our customers may face infringement claims directed to the customer's products that incorporate our products, and an adverse result could impair the customer's demand for our products. We have also promised certain of our customers that we will indemnify them in the event they are sued by our competitors for infringement claims directed to the products we supply. Under these indemnification obligations, we may be responsible for future payments to resolve infringement claims against them.

From time to time, we receive correspondence asserting that our products or processes are or may be infringing patents or other intellectual property rights of others. If we believe the assertions may have merit or in other appropriate circumstances, we may take steps to seek to obtain a license or to avoid the infringement. We cannot predict, however, whether a license will be available; that we would find the terms of any license offered acceptable; or that we would be able to develop an alternative solution. Failure to obtain a necessary license or develop an alternative solution could cause us to incur substantial liabilities and costs and to suspend the manufacture of affected products.

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

Our intellectual property position is based in part on patents owned by us and patents licensed to us. We intend to continue to file patent applications in the future, where appropriate, and to pursue such applications with U.S. and certain foreign patent authorities.

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

We periodically discover products that are counterfeit reproductions of our products or that otherwise infringe on our intellectual property rights. The actions we take to establish and protect trademarks, patents, and other intellectual property rights may not be adequate to prevent imitation of our products by others, and therefore, may adversely affect our sales and our brand and result in the shift of customer preference away from our products. Further, the actions we take to establish and protect trademarks, patents and other intellectual property rights could result in significant legal expense and divert the efforts of our technical personnel and management, even if the litigation or other action results in a determination favorable to us.

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





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We may be required to recognize a significant charge to earnings if our goodwill or other intangible assets become impaired.

Goodwill and purchased intangible assets with indefinite lives are not amortized, but are reviewed for impairment annually and more frequently when events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. We assess the recoverability of the unamortized balance of our definite-lived intangible assets when indicators of potential impairment are present. Factors that may indicate that the carrying value of our goodwill or other intangible assets may not be recoverable include a decline in our stock price and market capitalization and slower growth rates in our industry. The recognition of a significant charge to earnings in our consolidated financial statements resulting from any impairment of our goodwill or other intangible assets could adversely impact our results of operations.

We may be subject to confidential information theft or misuse, which could harm our business and results of operations.

We face attempts by others to gain unauthorized access to our information technology systems on which we maintain proprietary and other confidential information. Our security measures may be breached as the result of industrial or other espionage actions of outside parties, employee error, malfeasance, or otherwise, and, as a result, an unauthorized party may obtain access to our systems. Additionally, outside parties may attempt to access our confidential information through other means, for example by fraudulently inducing our employees to disclose confidential information. We actively seek to prevent, detect and investigate any unauthorized access, which sometimes occurs. We might be unaware of any such access or unable to determine its magnitude and effects. The theft and/or unauthorized use or publication of our trade secrets and other confidential business information as a result of such an incident could adversely affect our competitive position and the value of our investment in research and development could be reduced. Our business could be subject to significant disruption, and we could suffer monetary or other losses.

We are subject to risks related to international sales and purchases.

We expect that revenue from international sales will continue to represent a significant portion of our total revenue. As such, a significant slowdown or instability in relevant foreign economies, including economic instability in Europe, or lower investments in new infrastructure could have a negative impact on our sales. We also purchase a portion of the materials included in our products from overseas sources.

Our international sales and purchases are subject to numerous U.S. and foreign laws and regulations, including, without limitation, tariffs, trade barriers, regulations relating to import-export control, technology transfer restrictions, the International Traffic in Arms Regulation promulgated under the Arms Export Control Act, the Foreign Corrupt Practices Act and the anti-boycott provisions of the U.S. Export Administration Act. If we fail to comply with these laws and regulations, we could be liable for administrative, civil or criminal liabilities, and in the extreme case, we could be suspended or debarred from government contracts or have our export privileges suspended, which could have a material adverse effect on our business.

International sales and purchases are also subject to a variety of other risks, including risks arising from currency fluctuations, collection issues and taxes. Our international sales are subject to variability as our selling prices become less competitive in countries with currencies that are declining in value against the U.S. Dollar and more competitive in countries with currencies that are increasing in value against the U.S. Dollar. In addition, our international purchases can become more expensive if the U.S. Dollar weakens against the foreign currencies in which we are billed.

We have entered and may in the future enter into foreign currency derivative financial instruments in an effort to manage or hedge some of our foreign exchange rate risk. We may not be able to engage in hedging transactions in the future, and even if we do, foreign currency fluctuations may still have a material adverse effect on our results of operations.

Our business may be adversely affected by uncertainties in the global financial markets and our or our customers' or suppliers' ability to access the capital markets.

Global financial markets continue to reflect uncertainty about a sustained global economic recovery. Given these uncertainties, there could be future disruptions in the global economy, financial markets and consumer confidence. If

economic conditions deteriorate unexpectedly, our business and results of operations could be materially and adversely affected. For example, our customers, including our distributors and their customers, may experience difficulty obtaining the working capital and other financing necessary to support historical or projected purchasing patterns, which could negatively affect our results of operations.

Although we believe we have adequate liquidity and capital resources to fund our operations internally, our inability to access the capital markets on favorable terms in the future, or at all, may adversely affect our financial performance. The inability to obtain adequate financing from debt or capital sources in the future could force us to self-fund strategic initiatives or even forego certain opportunities, which in turn could potentially harm our performance.

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Changes in our effective tax rate may affect our results.

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

- the jurisdiction in which profits are determined to be earned and taxed;
- changes in government administrations, such as the Presidency and Congress of the U.S. as well as in the states and countries in which we operate;
- changes in tax laws or interpretation of such tax laws and changes in generally accepted accounting principles;
- the resolution of issues arising from tax audits with various authorities;
- changes in the valuation of our deferred tax assets and liabilities;
- adjustments to estimated taxes upon finalization of various tax returns;
- increases in expenses not deductible for tax purposes, including write-offs of acquired in-process research and development and impairment of goodwill in connection with acquisitions;
- changes in available tax credits;
- the recognition and measurement of uncertain tax positions;
- the lack of sufficient excess tax benefits (credits) in our additional paid in capital pool in situations where our realized tax deductions for certain stock-based compensation awards (such as non-qualified stock options and restricted stock) are less than those originally anticipated; and
- the repatriation of non-U.S. earnings for which we have not previously provided for U.S. taxes, or any changes in legislation that may result in these earnings being taxed within the U.S., regardless of our decision regarding repatriation of funds.

Any significant increase or decrease in our future effective tax rates could impact net income for future periods. In addition, the determination of our income tax provision requires complex estimations, significant judgments and significant knowledge and experience concerning the applicable tax laws. To the extent our income tax liability materially differs from our income tax provisions due to factors, including the above, which were not anticipated at the time we estimated our tax provision, our net income or cash flows could be affected.

In order to compete, we must attract, motivate and retain key employees, and our failure to do so could harm our results of operations.

Hiring and retaining qualified executives, scientists, engineers, technical staff and sales personnel is critical to our business, and competition for experienced employees in our industry can be intense. As a global company, this issue is not limited to the United States, but includes our other locations such as Europe and China. For example, there is substantial competition in China for qualified and capable personnel, particularly experienced engineers and technical personnel, which may make it difficult for us to recruit and retain qualified employees. Also, within Huizhou, China, there are other large companies building manufacturing plants that will likely compete for qualified employees. If we are unable to staff sufficient and adequate personnel at our China facilities, we may experience lower revenues or increased manufacturing costs, which would adversely affect our results of operations.

To help attract, motivate and retain key employees, we use benefits such as stock-based compensation awards. If the value of such awards does not appreciate, as measured by the performance of the price of our common stock, or if our share-based compensation otherwise ceases to be viewed as a valuable benefit, our ability to attract, retain and motivate employees could be weakened, which could harm our business and results of operations.

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Failure to comply with applicable environmental laws and regulations worldwide could harm our business and results of operations.

The manufacturing, assembling and testing of our products require the use of hazardous materials that are subject to a broad array of environmental, health and safety laws and regulations. Our failure to comply with any of these applicable laws or regulations could result in:

- regulatory penalties, fines, legal liabilities, and the forfeiture of certain tax benefits;
- suspension of production;
- alteration of our fabrication, assembly and test processes; and
- curtailment of our operations or sales.

In addition, our failure to manage the use, transportation, emission, discharge, storage, recycling or disposal of hazardous materials could subject us to increased costs or future liabilities. Existing and future environmental laws and regulations could also require us to acquire pollution abatement or remediation equipment, modify our product designs or incur other expenses, such as permit costs, associated with such laws and regulations. Many new materials that we are evaluating for use in our operations may be subject to regulation under existing or future environmental laws and regulations that may restrict our use of one or more of such materials in our manufacturing, assembly and test processes or products. Any of these restrictions could harm our business and results of operations by increasing our expenses or requiring us to alter our manufacturing processes.

Our results could vary as a result of the methods, estimates and judgments that we use in applying our accounting policies, including changes in the accounting standards to be applied.

The methods, estimates and judgments that we use in applying our accounting policies have a significant impact on our results (see “Critical Accounting Policies and Estimates” in “Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations” in our Annual Report on Form 10-K for fiscal 2013). Such methods, estimates and judgments are, by their nature, subject to substantial risks, uncertainties and assumptions, and factors may arise over time that lead us to change our methods, estimates and judgments. Changes in those methods, estimates and judgments could significantly affect our results of operations or financial condition.

Likewise, our results may be impacted due to changes in the accounting standards to be applied, such as the increased use of fair value measurement standards and proposed changes in revenue recognition requirements.

Catastrophic events may disrupt our business.

A disruption or failure of our systems or operations in the event of a natural disaster, health pandemic, such as an influenza outbreak within our workforce, or man-made catastrophic event could cause delays in completing sales, continuing production or performing other critical functions of our business, particularly if a catastrophic event occurred at our primary manufacturing locations in the U.S. and China. This could severely affect our ability to conduct normal business operations and, as a result, our operating results could be adversely affected. There may also be secondary impacts that are unforeseeable as well, such as impacts to our customers, which could cause delays in new orders, delays in completing sales or even order cancellations.

New regulations related to conflict-free minerals may force us to incur additional expenses.

The Dodd-Frank Wall Street Reform and Consumer Protection Act contains provisions to improve transparency and accountability concerning the supply of minerals originating from the conflict zones of the Democratic Republic of Congo (DRC) and adjoining countries. As a result, in August 2012 the SEC established new annual disclosure and reporting requirements for those companies who may use “conflict” minerals mined from the DRC and adjoining countries in their products. These new requirements required us to undertake due diligence efforts beginning in the 2013 calendar year, with initial disclosure requirements beginning in May 2014. These new requirements could affect the sourcing and availability of certain minerals used in the manufacture of our products. As a result, we may not be able to obtain the relevant minerals at competitive prices and there will likely be additional costs associated with complying with the new due diligence procedures as required by the SEC. In addition, as our supply chain is complex, we may face reputational challenges with our customers and other stakeholders if we are unable to sufficiently verify the origins of all minerals used in our products through the due diligence procedures that we implement, and we may incur additional costs as a result of changes to product, processes or sources of supply as a consequence of these new requirements.



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We are exposed to fluctuations in the market value of our investment portfolio and in interest rates, and therefore, impairment of our investments or lower investment income could harm our earnings.

We are exposed to market value and inherent interest rate risk related to our investment portfolio. We have historically invested portions of our available cash in fixed interest rate securities such as high-grade corporate debt, commercial paper, government securities and other fixed interest rate investments. The primary objective of our investment policy is preservation of principal. However, our investments are generally not FDIC insured and may lose value and/or become illiquid regardless of their credit rating.

Our stock price may be volatile.

Historically, our common stock has experienced substantial price volatility, particularly as a result of significant fluctuations in our revenue, earnings and margins over the past few years, and variations between our actual financial results and the published expectations of analysts. For example, the closing price per share of our common stock on the NASDAQ Global Select Market ranged from a low of \$31.44 to a high of \$75.76 during calendar year 2013. If our future operating results or margins are below the expectations of stock market analysts or our investors, our stock price will likely decline.

Speculation and opinions in the press or investment community about our strategic position, financial condition, results of operations, or significant transactions can also cause changes in our stock price. In particular, speculation around our market opportunities for energy efficient lighting may have a dramatic effect on our stock price, especially as various government agencies announce their planned investments in energy efficient technology, including lighting.

#### Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

There were no sales of unregistered securities during the second quarter of fiscal 2014. The following table summarizes our stock repurchase activity for the second quarter of fiscal 2014 (in thousands, except price per share data):

| Period   | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as a Part of Publicly Announced Program | Maximum Dollar Value of Shares that May Yet be Purchased Under the Program <sup>3</sup> |
|--|----------------------------------|------------------------------|--|---|
| Shares repurchased outside our Stock Repurchase Program in connection with our indemnification rights <sup>1</sup> |                                  |                              |  |   |
| September 30, 2013 to October 27, 2013   | —                                | \$—                          | —  | \$200,000   |
| October 28, 2013 to November 24, 2013  | 3                                | 40.85                        | —  | 200,000   |
| November 25, 2013 to December 29, 2013   | —                                | —                            | —  | 200,000   |
| Total  | 3                                | \$40.85                      | —  | \$200,000   |
| Shares repurchased outside our Stock Repurchase Program to satisfy tax withholding obligations <sup>2</sup>        |                                  |                              |  |   |
| September 30, 2013 to October 27, 2013   | 17                               | \$74.32                      | —  | \$200,000   |
| October 28, 2013 to November 24, 2013  | —                                | —                            | —  | 200,000   |
| November 25, 2013 to December 29, 2013   | —                                | —                            | —  | 200,000   |
| Total  | 17                               | \$74.32                      | —  | \$200,000   |

(1) Represents shares of our common stock returned to us in connection with the exercise of our indemnification rights under the stock purchase agreement pursuant to which we acquired Ruud Lighting. The average price per share represents the deemed value of the shares as specified in the stock purchase agreement.

(2) Represents shares repurchased to satisfy tax withholding obligations that arose on the vesting of shares of restricted stock.

(3) On January 18, 2001, we announced the authorization by our Board of Directors of a program to repurchase shares of our outstanding common stock. Several times since then, the Board of Directors has renewed the program and increased the number of shares that can be repurchased under the program. As of December 29, 2013, pursuant to an extension of

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the stock repurchase program by the Board of Directors, we are authorized to repurchase shares of our common stock having an aggregate purchase price not exceeding \$200 million for all purchases from June 20, 2013 through the June 29, 2014 expiration of the program. During the three months ended December 29, 2013, we repurchased zero shares of common stock under the repurchase program.

Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

Not applicable.

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Item 6. Exhibits

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

| Exhibit No. | Description  |
|-------------|--|
| 10.1        | 2013 Long-Term Incentive Compensation Plan (incorporated herein by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K, dated October 29, 2013, filed with the Securities and Exchange Commission on October 29, 2013)   |
| 10.2        | Cree, Inc. Severance Plan for Section 16 Officers, as amended (incorporated herein by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K, dated October 28, 2013, filed with the Securities and Exchange Commission on October 31, 2013)  |
| 10.3        | Schedule of Compensation for Non-Employee Directors (incorporated herein by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K, dated November 25, 2013, filed with the Securities and Exchange Commission on December 2, 2013)   |
| 10.4        | Form of Non-Qualified Stock Option Award Agreement for 2013 Long-Term Incentive Compensation Plan  |
| 10.5        | Form of Restricted Stock Unit Award Agreement for 2013 Long-Term Incentive Compensation Plan (Time-Based)  |
| 31.1        | Certification by Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  |
| 31.2        | Certification by Chief Financial Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002  |
| 32.1        | Certification by Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  |
| 32.2        | Certification by Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  |
| 101         | The following materials from Cree Inc.'s Quarterly Report on Form 10-Q for the fiscal quarter ended December 29, 2013 formatted in XBRL (eXtensible Business Reporting Language): (i) Consolidated Balance Sheets; (ii) Consolidated Statements of Income; (iii) Consolidated Statements of Comprehensive Income; (iv) Consolidated Statements of Cash Flows; and (v) Notes to Consolidated Financial Statements |

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SIGNATURE

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

CREE, INC.

January 22, 2014

/s/ MICHAEL E. MCDEVITT  
Michael E. McDevitt  
Executive Vice President and Chief Financial Officer  
(Authorized Officer and Principal Financial and Chief Accounting Officer)

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EXHIBIT INDEX

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