

CREE INC  
Form 10-Q  
January 19, 2011  
Table of Contents

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended December 26, 2010

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)

Edgar Filing: CREE INC - Form 10-Q

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

**4600 Silicon Drive**  
**Durham, North Carolina**  
(Address of principal executive offices)

**56-1572719**  
(I.R.S. Employer  
Identification No.)

**27703**  
(Zip Code)

**(919) 313-5300**  
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

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

Large accelerated filer  Accelerated filer   
Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company   
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

The number of shares outstanding of the registrant's common stock, par value \$0.00125 per share, as of January 12, 2011, was 109,369,943.

**Table of Contents**

**CREE, INC.**

**FORM 10-Q**

For the Quarterly Period Ended December 26, 2010

**INDEX**

<b>Description</b>	<b>Page No.</b>
<b><u>PART I FINANCIAL INFORMATION</u></b>	<b>3</b>
Item 1. <u>Financial Statements</u>	3
<u>Consolidated Balance Sheets as of December 26, 2010 (unaudited) and June 27, 2010</u>	3
<u>Consolidated Statements of Income for the three and six months ended December 26, 2010 (unaudited) and December 27, 2009 (unaudited)</u>	4
<u>Consolidated Statements of Cash Flow for the six months ended December 26, 2010 (unaudited) and December 27, 2009 (unaudited)</u>	5
<u>Notes to Consolidated Financial Statements (unaudited)</u>	6
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	16
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	24
Item 4. <u>Controls and Procedures</u>	24
<b><u>PART II OTHER INFORMATION</u></b>	<b>25</b>
Item 1. <u>Legal Proceedings</u>	25
Item 1A. <u>Risk Factors</u>	25
Item 2. <u>Unregistered Sale of Equity Securities and Use of Proceeds</u>	35
Item 3. <u>Defaults Upon Senior Securities</u>	35
Item 4. <u>(Removed and Reserved)</u>	35
Item 5. <u>Other Information</u>	35
Item 6. <u>Exhibits</u>	35
<b><u>SIGNATURE</u></b>	<b>36</b>

**Table of Contents****PART I FINANCIAL INFORMATION****Item 1. Financial Statements****CREE, INC.****CONSOLIDATED BALANCE SHEETS**

	<b>December 26, 2010</b>	<b>June 27, 2010</b>
	<b>(Unaudited)</b>	
	<b>(Thousands, except per share data)</b>	
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 465,557	\$ 397,431
Short-term investments	645,271	668,974
Total cash, cash equivalents, and short-term investments	1,110,828	1,066,405
Accounts receivable, net	135,132	117,535
Income tax receivable	3,645	
Inventories	145,517	112,241
Deferred income taxes	19,435	18,823
Prepaid expenses and other current assets	38,671	40,159
Total current assets	1,453,228	1,355,163
Property and equipment, net	495,928	419,726
Intangible assets, net	103,621	106,109
Goodwill	326,178	313,019
Other assets	4,656	5,159
Total assets	\$ 2,383,611	\$ 2,199,176
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable, trade	\$ 80,595	\$ 63,826
Accrued salaries and wages	19,760	26,247
Income taxes payable		14,375
Other current liabilities	21,414	15,643
Contingent payment due related to LLF acquisition	13,159	
Total current liabilities	134,928	120,091
Long-term liabilities:		
Deferred income taxes	39,398	39,398
Other long-term liabilities	20,469	11,639
Total long-term liabilities	59,867	51,037
Commitments and contingencies (Note 11)		
Shareholders' equity:		
Preferred stock, par value \$0.01; 3,000 shares authorized at December 26, 2010 and June 27, 2010; none issued and outstanding		
Common stock, par value \$0.00125; 200,000 shares authorized at December 26, 2010 and June 27, 2010; 109,308 and 108,002 shares issued and outstanding at December 26, 2010 and June 27, 2010,	136	135

Edgar Filing: CREE INC - Form 10-Q

respectively

Additional paid-in-capital	1,561,402	1,507,435
Accumulated other comprehensive income, net of taxes	11,160	12,171
Retained earnings	616,118	508,307
Total shareholders' equity	2,188,816	2,028,048
Total liabilities and shareholders' equity	\$ 2,383,611	\$ 2,199,176

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

**Table of Contents****CREE, INC.****(UNAUDITED)****CONSOLIDATED STATEMENTS OF INCOME**

	Three Months Ended		Six Months Ended	
	December 26, 2010	December 27, 2009	December 26, 2010	December 27, 2009
	(Thousands, except per share data)			
Revenue, net	\$ 256,983	\$ 199,475	\$ 525,420	\$ 368,605
Cost of revenue, net	135,837	105,405	273,745	200,757
Gross profit	121,146	94,070	251,675	167,848
Operating expenses:				
Research and development	29,233	19,325	53,965	39,499
Sales, general and administrative	33,366	25,560	62,568	49,173
Amortization of acquisition related intangibles	2,706	3,045	5,412	6,090
Loss on disposal or impairment of long-lived assets	429	110	901	403
Total operating expenses	65,734	48,040	122,846	95,165
Operating income	55,412	46,030	128,829	72,683
Non-operating income:				
Gain on sale of investments, net		1	1	1
Other non-operating income (expense)	63	(41)		90
Interest income, net	2,170	2,001	4,186	3,631
Income from operations before income taxes	57,645	47,991	133,016	76,405
Income tax expense	7,870	14,205	25,205	21,593
Net income	\$ 49,775	\$ 33,786	\$ 107,811	\$ 54,812
Earnings per share:				
Basic net income per share	\$ 0.46	\$ 0.32	\$ 1.00	\$ 0.56
Diluted net income per share	\$ 0.45	\$ 0.32	\$ 0.98	\$ 0.55
Shares used in per share calculation:				
Basic	108,364	104,591	108,032	97,876
Diluted	109,976	106,607	109,817	99,836

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

**Table of Contents****CREE, INC.****(UNAUDITED)****CONSOLIDATED STATEMENTS OF CASH FLOW**

	<b>Six Months Ended</b>	
	<b>December 26, 2010</b>	<b>December 27, 2009</b>
	<b>(Thousands)</b>	
<b>Cash flows from operating activities:</b>		
Net income	\$ 107,811	\$ 54,812
<b>Adjustments to reconcile net income to net cash provided by operating activities:</b>		
Depreciation and amortization	50,318	44,578
Stock-based compensation	17,981	11,681
Excess tax benefit from share-based payment arrangements	(9,277)	(15,526)
Loss on disposal or impairment of long-lived assets	901	403
Provision for doubtful accounts	(890)	(49)
Gain on sale of investment in securities	(1)	(1)
Amortization of premium/discount on investments	7,618	2,541
<b>Changes in operating assets and liabilities:</b>		
Accounts receivable	(16,038)	(10,368)
Inventories	(32,871)	(14,352)
Prepaid expenses and other assets	1,991	(2,005)
Accounts payable, trade	22,516	(3,818)
Accrued expenses and other liabilities	(4,303)	14,803
<b>Net cash provided by operating activities</b>	<b>145,756</b>	<b>82,699</b>
<b>Cash flows from investing activities:</b>		
Purchases of property and equipment	(126,387)	(61,826)
Payment of COTCO contingent consideration		(57,050)
Purchases of investments	(194,872)	(356,157)
Proceeds from maturities of investments	147,502	40,317
Proceeds from sale of property and equipment	1	302
Proceeds from sale of available-for-sale investments	61,833	
Purchases of patent and licensing rights	(5,199)	(4,811)
<b>Net cash used in investing activities</b>	<b>(117,122)</b>	<b>(439,225)</b>
<b>Cash flows from financing activities:</b>		
Net proceeds from issuance of common stock	29,977	533,213
Excess tax benefit from share-based payment arrangements	9,277	15,526
<b>Net cash provided by financing activities</b>	<b>39,254</b>	<b>548,739</b>
<b>Effects of foreign exchange changes on cash and cash equivalents</b>	<b>238</b>	<b>190</b>
<b>Net increase in cash and cash equivalents</b>	<b>68,126</b>	<b>192,403</b>
<b>Cash and cash equivalents:</b>		
Beginning of period	\$ 397,431	\$ 290,154
End of period	\$ 465,557	\$ 482,557

## Edgar Filing: CREE INC - Form 10-Q

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

---

**Table of Contents**

**CREE, INC.**

**(UNAUDITED)**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

***Overview***

Cree, Inc. (the Company) develops and manufactures semiconductor materials and devices primarily based on silicon carbide ( SiC ), gallium nitride ( GaN ) and related compounds. The physical and electronic properties of SiC and GaN offer technical advantages over traditional silicon, gallium arsenide ( GaAs ), sapphire and other materials used for certain electronic applications. The Company currently focuses its expertise in SiC and GaN on light emitting diode ( LED ) products. The Company also develops power and radio frequency ( RF ) products. The Company has products commercially available in each of these categories.

The Company derives the largest portion of its revenue from the sales of LED products. These products consist of LED components, LED chips, LED lighting products and SiC wafers. Also included are revenues derived from government agencies to support the development of LED lighting. In addition, the Company generates revenue from sales of power and RF products. These products include power rectifiers made from SiC, which provide faster switching speeds than comparable silicon-based power devices, and also include RF devices made from SiC or GaN, which allow for higher power densities as compared to silicon or gallium arsenide. Also included are revenues derived from government agencies to support the development of SiC- and GaN-based power and RF technology.

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

The Company currently operates its business as one reportable segment.

***Basis of Presentation***

The consolidated balance sheet at December 26, 2010 and the consolidated statements of income for the three and six months ended December 26, 2010 and December 27, 2009, and the consolidated statements of cash flows for the six months ended December 26, 2010 and December 27, 2009 ( 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 26, 2010, and for all periods presented, have been made. The consolidated balance sheet at June 27, 2010 has been derived from the audited financial statements as of that date.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America ( U.S. GAAP ) have been condensed or omitted. It is suggested that these financial statements be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended June 27, 2010 ( fiscal 2010 ). The results of operations for the period ended December 26, 2010 are not necessarily indicative of the operating results that may be attained for the entire fiscal year ending June 26, 2011 ( fiscal 2011 ).

Certain fiscal 2010 amounts in the accompanying Consolidated Financial Statements have been reclassified to conform to the fiscal 2011 presentation. These reclassifications had no effect on previously reported consolidated net income or shareholders' equity.

***Recently Adopted Accounting Pronouncements***

***Transfers of Financial Assets***

In June 2009, the Financial Accounting Standards Board (the FASB) issued new guidance concerning the transfer of financial assets. This guidance amends the criteria for a transfer of a financial asset to be accounted for as a sale, creates more stringent conditions for reporting a transfer of a portion of a financial asset as a sale, changes the initial measurement of a transferor's interest in transferred financial assets, eliminates the qualifying special-purpose entity



---

## **Table of Contents**

concept and provides for new disclosures. This guidance became effective for the Company beginning in the first quarter of fiscal 2011. The Company's adoption of the new accounting guidance did not have a significant impact on its Consolidated Financial Statements.

### *Determining the Primary Beneficiary of a Variable Interest Entity*

In June 2009, the FASB issued new guidance concerning the determination of the primary beneficiary of a variable interest entity ( VIE ). This new guidance amends current U.S. GAAP by: requiring ongoing reassessments of whether an enterprise is the primary beneficiary of a VIE; amending the quantitative approach previously required for determining the primary beneficiary of the VIE; modifying the guidance used to determine whether an entity is a VIE; adding an additional reconsideration event (e.g., troubled debt restructurings) for determining whether an entity is a VIE; and requiring enhanced disclosures regarding an entity's involvement with a VIE. This guidance became effective for the Company beginning in the first quarter of fiscal 2011. The Company's adoption of the new accounting guidance did not have a significant impact on its Consolidated Financial Statements.

### *Interactive Data Filing with the SEC*

On January 30, 2009, the SEC released the final rules requiring all registered companies to use eXtensible Business Reporting Language ( XBRL ) when submitting financial statements to the SEC. The new rules initially require interactive data reporting only by domestic and foreign large accelerated filers (those that prepare their financial statements in accordance with U.S. GAAP and have a worldwide public common equity float above \$5.0 billion) for their first quarterly period ending after June 15, 2009 and all periods thereafter. As the Company did not originally meet this large accelerated filer requirement on the initial measurement date due to its market capitalization at that time, this reporting requirement only became effective for the Company in the first quarter of fiscal 2011. The Company provided its first quarter fiscal 2011 financial statements to the SEC using XBRL in compliance with the new SEC rules.

### *Revenue Recognition with Multiple Deliverables*

In October 2009, the FASB issued new standards for revenue recognition with multiple deliverables. These new standards impact the determination of when the individual deliverables included in a multiple-element arrangement may be treated as separate units of accounting. Additionally, these new standards modify the manner in which the transaction consideration is allocated across the separately identified deliverables by no longer permitting the residual method of allocating arrangement consideration. This guidance became effective for the Company beginning in the first quarter of fiscal 2011. The Company's adoption of the new accounting guidance did not have a significant impact on its Consolidated Financial Statements.

### *Recently Issued Accounting Pronouncements*

#### *Fair Value Disclosures*

In January 2010, the FASB issued amended standards requiring additional fair value disclosures. The amended standards require disclosures of transfers in and out of Levels 1 and 2 of the fair value hierarchy, as well as requiring gross basis disclosures for purchases, sales, issuances and settlements within the Level 3 reconciliation. Additionally, the update clarifies the requirement to determine the level of disaggregation for fair value measurement disclosures and to disclose valuation techniques and inputs used for both recurring and nonrecurring fair value measurements in either Level 2 or Level 3. The Company adopted the new guidance in the third quarter of fiscal 2010, except for the disclosures related to purchases, sales, issuance and settlements, which will be effective for the Company beginning in the first quarter of fiscal 2012. Because these new standards are related primarily to disclosures, their adoption has not had and is not expected to have a significant impact on the Company's Consolidated Financial Statements.

## **Note 2. Acquisitions**

### *Acquisition of LED Lighting Fixtures, Inc.*

On February 29, 2008 the Company acquired LED Lighting Fixtures, Inc. ( LLF ) through a wholly owned subsidiary that merged into Cree, Inc. on June 27, 2010. The Company acquired all of the outstanding share capital of LLF in exchange for total upfront consideration of \$80.8 million, consisting of (1) \$16.5 million in cash, (2) approximately 1.9 million shares of the Company's common stock valued at \$58.8 million, and (3) the assumption of fully vested LLF employee stock options valued at \$4.5 million. The Company incurred transaction costs of approximately \$1.0 million consisting primarily of professional fees incurred relating to attorneys, accountants and valuation advisors. Under the acquisition terms,



**Table of Contents**

additional consideration of up to \$26.4 million would become payable to the former shareholders of LLF if defined product development targets and key employee retention measures were achieved over the three calendar years following the acquisition.

LLF met the conditions necessary for the earn-out payment for the calendar years ended December 31, 2008 and 2009 and as a result, the Company made a cash payment in the amount of \$4.4 million to the former shareholders of LLF in the third quarter of fiscal 2009 and a cash payment in the amount of \$8.8 million to the former shareholders of LLF in the third quarter of fiscal 2010, thus increasing goodwill in the Company's consolidated financial statements. As of December 26, 2010, the final \$13.2 million of contingent consideration to the former shareholders of LLF was accrued based on the Company's review of the status of conditions necessary for the earn-out payment. The Company intends to make a \$13.2 million cash payment to the former shareholders of LLF during its third quarter of fiscal 2011. This additional payment is reflected as a current liability and an increase to goodwill in the Company's consolidated financial statements.

The assets, liabilities, and operating results of LLF have been included in the Company's Consolidated Financial Statements from the date of acquisition and are reflected in all periods presented in the accompanying financial statements.

***Acquisition of COTCO Luminant Device Limited***

On March 30, 2007, the Company acquired COTCO Luminant Device Limited, a Hong Kong company (now Cree Hong Kong Limited) (COTCO), from COTCO Holdings Limited, a Hong Kong company (now United Luminous International (Holdings) Limited) (Holdings). The Company acquired all of the outstanding share capital of COTCO in exchange for consideration consisting of approximately 7.6 million shares of the Company's common stock and \$77.3 million cash. Under the acquisition terms, additional consideration would become payable to Holdings or its designees in the event COTCO achieved specific EBITDA targets over the Company's two full fiscal years following the acquisition. For fiscal 2008 results, the Company made a cash payment in the amount of \$60.0 million in fiscal 2009. For fiscal 2009 results, the Company made a cash payment in the amount of \$57.1 million in fiscal 2010. These incremental payments were treated as additional purchase price and resulted in an increase to goodwill in the Company's consolidated financial statements.

The assets, liabilities, and operating results of COTCO have been included in the Company's Consolidated Financial Statements from the date of acquisition and are reflected in all periods presented in the accompanying financial statements.

**Note 3. Financial Statement Details*****Accounts Receivable, net***

The following is a summary of the components of accounts receivable, net (in thousands):

	<b>December 26, 2010</b>	<b>June 27, 2010</b>
Billed trade receivables	\$ 159,781	\$ 138,642
Unbilled contract receivables	1,712	1,391
	161,493	140,033
Allowance for sales returns and other incentives	(25,509)	(20,551)
Allowance for bad debts	(852)	(1,947)
Total accounts receivable, net	\$ 135,132	\$ 117,535

**Table of Contents****Inventories**

The following is a summary of the components of inventories (in thousands):

	December 26, 2010	June 27, 2010
Raw material	\$ 32,527	\$ 24,858
Work-in-progress	68,520	57,180
Finished goods	44,470	30,203
 Total inventories	 \$ 145,517	 \$ 112,241

**Note 4. Investments**

Short-term investments consist of high grade municipal and corporate bonds and other debt securities. The Company classifies its marketable securities as available-for-sale. This is based upon management's determination that the underlying cash invested in these securities is available for operations as necessary.

The following table provides a summary of marketable investments by type (in thousands):

	Amortized Cost	December 26, 2010		Estimated Fair Value
		Gross Unrealized Gains	Gross Unrealized Losses	
Municipal bonds	\$ 452,891	\$ 2,916	\$ (617)	\$ 455,190
Corporate bonds	112,981	1,251	(213)	114,019
Municipal variable rate demand notes	2,850			2,850
U.S. agency securities	60,556	530	(17)	61,069
U.S. government securities	2,006	9		2,015
Non-U.S. government securities	10,118	10		10,128
 Total	 \$ 641,402	 \$ 4,716	 \$ (847)	 \$ 645,271

	Amortized Cost	June 27, 2010		Estimated Fair Value
		Gross Unrealized Gains	Gross Unrealized Losses	
Municipal bonds	\$ 441,653	\$ 3,502	\$ (117)	\$ 445,038
Corporate bonds	120,991	1,478	(20)	122,449
Municipal variable rate demand notes	15,685		(1)	15,684
U.S. agency securities	72,531	615	(32)	73,114
U.S. government securities	7,533	76		7,609
Non-U.S. government securities	5,091		(11)	5,080
 Total	 \$ 663,484	 \$ 5,671	 \$ (181)	 \$ 668,974

**Table of Contents**

The contractual maturities of marketable investments at December 26, 2010 were as follows (in thousands):

	Within One Year	After One, Within Five Years	After Five, Within Ten Years	After Ten Years	Total
Municipal bonds	\$ 169,086	\$ 286,105	\$	\$	\$ 455,191
Corporate bonds	26,690	87,329			114,019
Municipal variable rate demand notes				2,850	2,850
U.S. agency securities	20,634	40,435			61,069
U.S. government securities	2,015				2,015
Non-U.S. government securities	10,127				10,127
<b>Total</b>	<b>\$ 228,552</b>	<b>\$ 413,869</b>	<b>\$</b>	<b>\$ 2,850</b>	<b>\$ 645,271</b>

**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 and discounted cash flows. 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 broken down 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 26, 2010, financial assets utilizing Level 1 inputs included money market funds and investments traded on active securities exchanges. Financial assets utilizing Level 2 inputs included corporate bonds, municipal bonds and variable rate demand notes, and U.S. agency 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 26, 2010.

**Table of Contents**

The following table sets forth financial instruments carried at fair value within the U.S. GAAP hierarchy and using the lowest level of input (in thousands):

	Financial Instruments Carried at Fair Value as of December 26, 2010			Total
	Quoted Prices in Active Markets for Identical Items (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
<b>Assets:</b>				
Cash equivalents				
Money market funds	\$ 23,974	\$	\$	\$ 23,974
Municipal bonds		15,601		15,601
U.S. agency securities		11,898		11,898
Total cash equivalents	23,974	27,499		51,473
<b>Short-term investments</b>				
Municipal bonds		455,191		455,191
Corporate bonds		114,019		114,019
Municipal variable rate demand notes		2,850		2,850
U.S. agency securities		61,069		61,069
U.S. government securities	2,015			2,015
Non-U.S. government securities		10,127		10,127
Total short-term investments	2,015	643,256		645,271
Total assets	\$ 25,989	\$ 670,755	\$	\$ 696,744

The Company utilizes specific identification in computing realized gains and losses on the sale of investments. Realized gains and losses from the sale of investments are included in Gain on sale of investments, 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 fair value has been below 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 recovery in market value.

**Note 6. Intangible Assets***Intangible Assets, net*

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

	December 26, 2010	June 27, 2010
Customer relationships	\$ 52,620	\$ 52,620
Developed technology	51,860	51,860
Patent and license rights	76,789	71,762
	\$ 181,269	\$ 176,242

## Edgar Filing: CREE INC - Form 10-Q

Accumulated amortization	(77,648)	(70,133)
Intangible assets, net	\$ 103,621	\$ 106,109

Total amortization expense, including the amortization of acquisition related intangibles, patents and license rights, recognized during the three and six months ended December 26, 2010 was \$3.8 and \$7.6 million, respectively. For the three and six months ended December 27, 2009, total amortization expense, including amortization of acquisition related intangibles, patents and license rights was \$4.1 and \$8.1 million, respectively.

**Table of Contents****Goodwill**

Goodwill increased during the six months ended December 26, 2010 due to the accrual of the final \$13.2 million earn-out payment related to the LLF acquisition that was considered additional purchase price and recorded as an increase to goodwill.

**Note 7. Shareholders' Equity**

In September 2009, the Company issued and sold 12.65 million shares of its common stock, with net proceeds of approximately \$434.0 million.

As of December 26, 2010, there remained approximately 4.5 million shares of the Company's common stock approved for repurchase under a repurchase program authorized by the Board of Directors that extends through June 2011. During the six months ended December 26, 2010, the Company did not repurchase any shares under the repurchase program.

The following presents a summary of activity in comprehensive income, net (in thousands):

	Three Months Ended		Six Months Ended	
	December 26, 2010	December 27, 2009	December 26, 2010	December 27, 2009
<b>Net income</b>	\$ 49,775	\$ 33,786	\$ 107,811	\$ 54,812
<b>Other comprehensive income:</b>				
Net unrealized (loss) gain on available-for-sale securities, net of tax (expense) benefit of \$1,177, \$(202), \$611, and \$(459), respectively	(1,945)	333	(1,010)	717
Total other comprehensive income	(1,945)	333	(1,010)	717
<b>Comprehensive income</b>	\$ 47,830	\$ 34,119	\$ 106,801	\$ 55,529

**Note 8. Earnings Per Share**

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

	Three Months Ended		Six Months Ended	
	December 26, 2010	December 27, 2009	December 26, 2010	December 27, 2009
<b>Basic:</b>				
Net income	\$ 49,775	\$ 33,786	\$ 107,811	\$ 54,812
Weighted average common shares	108,364	104,591	108,032	97,876
Basic earnings per share	\$ 0.46	\$ 0.32	\$ 1.00	\$ 0.56

**Table of Contents**

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

	Three Months Ended		Six Months Ended	
	December 26, 2010	December 27, 2009	December 26, 2010	December 27, 2009
<b>Diluted:</b>				
Net income	\$ 49,775	\$ 33,786	\$ 107,811	\$ 54,812
Weighted average common shares - basic	108,364	104,591	108,032	97,876
Dilutive effect of stock options, unvested shares and ESPP purchase rights	1,612	2,016	1,785	1,960
Weighted average common shares - diluted	109,976	106,607	109,817	99,836
Diluted earnings per share	\$ 0.45	\$ 0.32	\$ 0.98	\$ 0.55

Potential common shares that would have the effect of increasing diluted earnings per share are considered to be antidilutive. In accordance with U.S. GAAP, these shares were not included in calculating diluted earnings per share. For the three and six months ended December 26, 2010 there were 2.3 and 1.6 million shares, respectively, not included in calculating diluted earnings per share because their effect was antidilutive. For the three and six months ended December 27, 2009 there were 2.4 and 2.2 million shares, respectively, not included in calculating diluted earnings per share because their effect was antidilutive.

**Note 9. Stock-Based Compensation**

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

**Stock Option Awards**

The following table summarizes outstanding option awards as of December 26, 2010, and changes during the six months then ended (in thousands, except per share data):

	Number of Shares	Weighted- Average Exercise Price
Outstanding at June 27, 2010	5,638	\$ 31.23
Granted	2,193	55.74
Exercised	(1,089)	27.87
Forfeited or expired	(159)	66.29
Outstanding at December 26, 2010	6,583	\$ 39.10

**Table of Contents****Restricted Stock and Stock Unit Awards**

A summary of nonvested shares of restricted stock and stock unit awards outstanding under the Company's 2004 Long-Term Incentive Compensation Plan as of December 26, 2010, and changes during the six months then ended, follows (in thousands, except per share data):

	Number of Shares/Units	Weighted- Average Grant- Date Fair Value
Nonvested at June 27, 2010	418	\$ 28.68
Granted	211	55.32
Vested	(149)	28.38
Forfeited		
Nonvested at December 26, 2010	480	\$ 40.49

**Stock-Based Compensation Valuation and Expense**

The Company accounts for its employee stock-based compensation plan 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.

To estimate the fair value of the Company's stock option awards the Company currently uses the Black-Scholes option-pricing model. 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 exercise behaviors, risk-free interest rate and expected dividends. Due to the inherent limitations of option-valuation models available today, including 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 restricted stock and stock unit awards, 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 recorded net of estimated forfeitures such that expense is recorded 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):

Income Statement Classification	Three Months Ended		Six Months Ended	
	December 26, 2010	December 27, 2009	December 26, 2010	December 27, 2009
Cost of goods sold	\$ 1,351	\$ 729	\$ 2,483	\$ 1,554
Research and development	2,183	1,388	3,998	2,652
Sales, general and administrative	6,443	3,952	11,500	7,475
Total operating expenses	8,626	5,340	15,498	10,127
Total	\$ 9,977	\$ 6,069	\$ 17,981	\$ 11,681

**Note 10. Income Taxes**

The variation between the Company's effective income tax rate and the U.S. statutory rate of 35 percent is primarily due to the consolidation of our foreign operations, which are subject to income taxes at lower statutory rates. A change in the mix of pretax income from these various tax jurisdictions can have a significant impact on the Company's periodic effective tax rate.

---

## **Table of Contents**

Under U.S. GAAP, a two-step approach is followed to recognize and measure 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.

At June 27, 2010, the Company had recorded \$7.6 million of unrecognized tax benefits. During the six months ended December 26, 2010, there were no changes to that amount of recognized tax benefits. As a result, the total amount of unrecognized tax benefits as of December 26, 2010 is \$7.6 million. If any portion of this \$7.6 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.

The Company's policy is to include interest and penalties related to unrecognized tax benefits within the income tax expense line item in the consolidated statements of income. As of December 26, 2010, the Company had accrued \$80 thousand of interest and penalties.

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 29, 2008 and prior. The Company was notified during the quarter that the IRS will begin an examination of the Company's corporate tax return for the fiscal year ended June 28, 2009. For foreign purposes, the Company is generally no longer subject to examination for tax periods 1999 and prior. During the quarter, the Hong Kong tax authorities commenced an examination for fiscal years 2008 and 2009. For U.S. state tax returns the Company is generally no longer subject to tax examinations for fiscal years prior to 2007. Certain federal and state carryforward tax attributes generated in prior years remain subject to examination and adjustment.

### **Note 11. Commitments and Contingencies**

Please refer to the section entitled "Litigation" under Note 13 "Commitments and Contingencies" of the Notes to the Consolidated Financial Statements in Item 8 of the Company's Annual Report on Form 10-K for the fiscal year ended June 27, 2010 and Note 11 "Commitments and Contingencies" and Note 12 "Subsequent Events" of the Notes to Consolidated Financial Statements in Part I, Item 1 of the Company's Quarterly Report on Form 10-Q for the quarter ended September 26, 2010 for a description of material legal proceedings including the proceedings discussed below. The following is an update to the Company's legal proceedings.

#### ***The Fox Group, Inc. v. Cree, Inc. and Dow Corning Corporation***

The Company reported in its most recent Annual Report on Form 10-K that a patent infringement action is pending against it in the U.S. District Court for the Eastern District of Virginia. The complaint, which was filed on June 29, 2010, alleges that the Company is infringing two U.S. patents by making, using, selling, and/or offering for sale silicon carbide substrates and products that use silicon carbide that practice the inventions claimed in the patents, and it requests a judgment against the Company for damages in an unspecified amount, an injunction against infringements, attorneys' fees and costs. On August 30, 2010, the Company filed an answer and counterclaims in which it denies any infringement and asserts, among other defenses, that the patents are invalid and are unenforceable. The counterclaims seek a declaratory judgment that the Company has not infringed the patents and that the patents are invalid and unenforceable. The court has scheduled the trial for July 2011 and discovery has commenced.

#### ***Cree, Inc. v. SemiLEDs Corporation and Helios Crew Corp.***

The Company is the plaintiff in an action against defendants SemiLEDs Corporation and its subsidiary, Helios Crew Corp., pending in the U.S. District Court for the District of Delaware. The action was commenced by the filing of a complaint on October 8, 2010. The complaint alleges the defendants are infringing three U.S. patents owned by the Company. The three patents are No. 7,737,459 entitled "High Output Group III Nitride Light Emitting Diodes," No. 7,211,833 entitled "Light Emitting Diodes Including Barrier Layers/Sublayers" and No. 7,611,915, entitled "Methods for Manufacturing Light Emitting Diodes Including Barrier Layers/Sublayers." The suit seeks monetary damages and an injunction against future infringements. On November 3, 2010 the defendants filed an answer and counterclaims in which they deny any infringement and assert, among other defenses, that the patents are invalid. The counterclaims seek a declaratory judgment that the defendants have not infringed the patents and that the patents are invalid.

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

*Information set forth in this Quarterly Report on Form 10-Q contains various forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (Securities Act), and Section 21E of the Securities Exchange Act of 1934, as amended (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 and intend and other similar expressions constitute forward-looking statements. These forward-looking statements are subject to business, economic and other risks and uncertainties, both known and unknown, and actual results may differ materially from those contained in the forward-looking statements. Any forward-looking statements we make are as of the date made and we 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 27, 2010. 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 diodes (LEDs), LED lighting and semiconductor solutions for wireless and power applications. Our solutions are driving improvements in applications such as general illumination, video displays, automotive, electronic signs and signals, variable-speed motors and wireless systems.

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

We derive the largest portion of our revenue from the sales of our LED products. These products consist of LED components, LED chips, LED lighting products and SiC wafers. As we develop and improve our LED technology and the market focuses on energy efficiency, we believe the potential market for LED lighting applications will continue to expand. Our success in selling LED products depends upon our ability to drive adoption and offer innovative products and solutions that enable our customers to succeed in the market. By driving adoption we believe we can influence the direction of the market and open more opportunities for LEDs. Innovation is critical to maintain and grow our competitive position, especially as we face competition from various companies such as Nichia Corporation, OSRAM Semiconductor GmbH and Philips Lumileds Lighting Company, LLC, or other companies that may be targeting the LED lighting marketplace. Also included in LED product revenues are revenues derived from government agencies to support the development of LED lighting.

In addition, we generate revenue from sales of power and RF products. Also included are revenues derived from government agencies to support the development of SiC- and GaN-based power and RF technology.

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

We currently operate our business as one reportable segment.

## **Table of Contents**

### **Industry Dynamics and Trends**

There are a number of other 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 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. These uncertainties related to adoption make demand difficult to forecast for us and our distributors.

*Intense and Constantly Evolving Competitive Environment.* Competition in the industry is intense and new companies are entering the LED market. Product pricing pressures exist as market participants often undertake pricing strategies to gain or protect market share. To remain competitive, market participants must continuously increase product performance and reduce costs to offset lower average sales prices.

*Technological Innovation and Advancement.* Innovations and advancements in LED technology continue to expand the potential commercial application of LEDs particularly in the general illumination market. However, new technologies or standards could emerge, or improvements could be made in existing technologies, that reduce or limit the demand for LEDs 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.

*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.

### **Highlights of the Second Quarter Fiscal 2011**

The following is a summary of our financial results for the three months ended December 26, 2010:

Our year over year revenues increased 29% to \$257.0 million;

We achieved operating income of \$55.4 million in the second quarter of fiscal 2011 compared to \$46.0 million in the second quarter of fiscal 2010. Net income per diluted share was \$0.45 compared to \$0.32 for the second quarter of fiscal 2010;

We spent \$64.7 million on capital expenditures in the second quarter of fiscal 2011 compared to \$41.4 million in the second quarter of fiscal 2010 as we continue to expand our manufacturing capacity; and

Combined cash, cash equivalents and marketable investments increased to \$1,110.8 million at December 26, 2010 compared to \$1,066.4 million at June 27, 2010.

### **Business Outlook**

## Edgar Filing: CREE INC - Form 10-Q

We project that the markets for our products will remain highly competitive during the remainder of fiscal 2011. We anticipate focusing on the following key areas, among others, in response to this competitive environment:

*Build on our leadership in LED lighting.* We plan to continue to be a catalyst for LED lighting adoption by developing innovative products that lead the market and enable new applications for LED lighting, such as the recent demonstration of the brightest, most-efficient LED-based A-lamp to date that meets ENERGY STAR® performance requirements for a 60-watt standard LED replacement bulb. We see such new product launches and demonstrations as an important part of our effort to fundamentally change perceptions about LED lighting.

*Better enable our customers to develop high quality LED based lighting products.* We want to facilitate our customers' ability to create and successfully release high quality LED based lighting products. To accomplish this objective, we plan to continue to develop higher performing LED components that increase the value proposition for LED lighting and reduce their initial cost. We also plan to offer more highly integrated products, like the XLamp® CXA20 LED array, which is the first lighting-class array that can enable a 60-watt A-lamp equivalent. Additionally, we plan to expand our sales, applications and customer support capabilities.

*Expand and enhance our production capacity.* We plan to invest in the capacity to drive scale and support our transition to 150mm wafer production. In fiscal 2011, we are targeting to expand our production capacity at multiple points along the LED manufacturing process. In addition, we plan to increase research and development spending to support our efforts around our 150mm wafer capabilities and the development of new products.

**Table of Contents**

*Continue to invest in and grow our SiC power product line.* We have experienced growing sales of our SiC power products in recent quarters. We have also seen rising demand for energy efficient power switching technology and believe this product line is well positioned to grow over the next several years. We recently released our first SiC switch product, a 1200v SiC MOSFET, which we believe will expand the market opportunity for our products.

**Results of Operations**

The following table sets forth certain consolidated statement of income data for the periods indicated:

(Dollars in Thousands, Except Per Share Data)	Three Months Ended December 26, 2010		Three Months Ended December 27, 2009	
	Dollars	% of Revenue	Dollars	% of Revenue
<b>Revenue, net</b>	<b>\$ 256,983</b>	<b>100%</b>	<b>\$ 199,475</b>	<b>100%</b>
Cost of revenue, net	135,837	53%	105,405	53%
<b>Gross profit</b>	<b>121,146</b>	<b>47%</b>	<b>94,070</b>	<b>47%</b>
Research and development	29,233	11%	19,325	10%
Sales, general and administrative	33,366	13%	25,560	13%
Amortization of acquisition related intangibles	2,706	1%	3,045	2%
Loss on disposal or impairment of long-lived assets	429	0%	110	0%
<b>Operating income</b>	<b>55,412</b>	<b>22%</b>	<b>46,030</b>	<b>23%</b>
Gain on sale of investments, net		0%	1	0%
Other non-operating income	63	0%	(41)	0%
Interest income, net	2,170	1%	2,001	1%
<b>Income before income taxes</b>	<b>57,645</b>	<b>22%</b>	<b>47,991</b>	<b>24%</b>
Income tax expense	7,870	3%	14,205	7%
<b>Net income</b>	<b>49,775</b>	<b>19%</b>	<b>33,786</b>	<b>17%</b>
<b>Diluted earnings per share</b>	<b>\$ 0.45</b>		<b>\$ 0.32</b>	

(Dollars in Thousands, Except Per Share Data)	Six Months Ended December 26, 2010		Six Months Ended December 27, 2009	
	Dollars	% of Revenue	Dollars	% of Revenue
<b>Revenue, net</b>	<b>\$ 525,420</b>	<b>100%</b>	<b>\$ 368,605</b>	<b>100%</b>
Cost of revenue, net	273,745	52%	200,757	54%
<b>Gross profit</b>	<b>251,675</b>	<b>48%</b>	<b>167,848</b>	<b>46%</b>
Research and development	53,965	10%	39,499	11%
Sales, general and administrative	62,568	12%	49,173	13%
Amortization of acquisition related intangibles	5,412	1%	6,090	2%
Loss on disposal or impairment of long-lived assets	901	0%	403	0%
<b>Operating income</b>	<b>128,829</b>	<b>25%</b>	<b>72,683</b>	<b>20%</b>
Gain on sale of investments, net	1	0%	1	0%
Other non-operating income		0%	90	0%
Interest income, net	4,186	1%	3,631	1%

Edgar Filing: CREE INC - Form 10-Q

<b>Income before income taxes</b>	<b>133,016</b>	<b>25%</b>	<b>76,405</b>	<b>21%</b>
Income tax expense	25,205	5%	21,593	6%
<b>Net income</b>	<b>107,811</b>	<b>21%</b>	<b>54,812</b>	<b>15%</b>
<b>Diluted earnings per share</b>	<b>\$ 0.98</b>		<b>\$ 0.55</b>	

**Table of Contents****Revenues**

Revenues for the three and six months ended December 26, 2010 and December 27, 2009 were comprised of the following (in thousands, except percentages):

	Three Months Ended			Six Months Ended			Change	
	December 26, 2010	December 27, 2009	Change	December 26, 2010	December 27, 2009	Change		
LED products	\$ 229,699	\$ 181,986	\$ 47,713	26%	\$ 474,065	\$ 338,013	\$ 136,052	40%
<i>Percent of total revenues</i>	89%	91%			90%	92%		
Power and RF products	27,284	17,489	9,795	56%	51,355	30,592	20,763	68%
<i>Percent of total revenues</i>	11%	9%			10%	8%		
<b>Total revenues</b>	<b>\$ 256,983</b>	<b>\$ 199,475</b>	<b>\$ 57,508</b>	<b>29%</b>	<b>\$ 525,420</b>	<b>\$ 368,605</b>	<b>\$ 156,815</b>	<b>43%</b>

**LED Products**

We derive the largest portion of our revenue from the sale of our LED products which comprised approximately 89% and 91% of our total revenues for the second quarter of fiscal 2011 and fiscal 2010, respectively. For the six months ended December 26, 2010 and December 27, 2009, revenue from the sale of our LED products comprised approximately 90% and 92% of our total revenues, respectively.

Revenue from LED products increased approximately 26% to \$229.7 million in the second quarter of fiscal 2011 from \$182.0 million in the second quarter of fiscal 2010. For the six months ended December 26, 2010, revenue from our LED products increased approximately 40% to \$474.1 million from \$338.0 million for the six months ended December 27, 2009. Our year over year sales growth was primarily driven by increased sales of LED components. The blended average selling price (ASP) for our LED products increased by 50% in the second quarter of fiscal 2011 compared to the second quarter of fiscal 2010. This increase was due to a shift in product mix to a higher proportion of revenues generated from sales of our LED components and LED lighting products versus our LED chips.

**Power and RF Products**

Revenues from our power and RF products comprised approximately 11% and 9% of our total revenues for the second quarter of fiscal 2011 and fiscal 2010, respectively. For the six months ended December 26, 2010 and December 27, 2009, revenue from the sale of our power and RF products comprised approximately 10% and 8% of our total revenues, respectively.

Revenue from power and RF increased approximately 56% to \$27.3 million in the second quarter of fiscal 2011 from \$17.5 million in the second fiscal quarter of 2010. For the six months ended December 26, 2010, revenue from our power and RF products increased approximately 68% to \$51.4 million from \$30.6 million for the six months ended December 27, 2009. The increase in our power and RF products revenue was primarily due to increased orders for SiC Schottky diodes and GaN monolithic microwave integrated circuits, or (MMICs).

**Gross Profit**

Cost of revenue includes materials, labor and overhead costs incurred internally or paid to contract manufacturers to produce our products. Gross profit in dollars and gross margin were as follows (in thousands, except percentages):

	Three Months Ended			Six Months Ended			Change	
	December 26, 2010	December 27, 2009	Change	December 26, 2010	December 27, 2009	Change		
Total gross profit	\$ 121,146	\$ 94,070	\$ 27,076	29%	\$ 251,675	\$ 167,848	\$ 83,827	50%
<i>Total gross margin</i>	47%	47%			48%	46%		

Gross profit in the second quarter of fiscal 2011 increased approximately 29% to \$121.1 million from \$94.1 million in the second quarter of fiscal 2010. For the six months ended December 26, 2010 gross profit increased approximately 50% to \$251.7 million from \$167.8 million for the six months ended December 27, 2009. For the second quarter of fiscal 2011 our gross margin remained flat relative to the second quarter of

## Edgar Filing: CREE INC - Form 10-Q

fiscal 2010. For the six months ended December 26, 2010 our gross margin increased to 48% from 46% for the six months ended December 27, 2009. Factors contributing to the increase in gross margin were changes in product mix to higher margin products and lower production costs across our product lines due to higher production yields.

**Table of Contents****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 compensation and benefits, 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			Change	Six Months Ended			Change
	December 26, 2010	December 27, 2009			December 26, 2010	December 27, 2009		
Research and development	\$ 29,233	\$ 19,325	\$ 9,908	51%	\$ 53,965	\$ 39,499	\$ 14,466	37%
<i>Percent of total revenues</i>	11%	10%			10%	11%		

Research and development expenses in the second quarter of fiscal 2011 increased 51% to \$29.2 million from \$19.3 million in the second quarter of fiscal 2010. For the six months ended December 26, 2010 research and development expenses increased 37% to \$54.0 million from \$39.5 million for the six months ended December 27, 2009. The increase was primarily due to increased spending to support the development of 150mm wafer capabilities as well as continued research and development activities focusing on brighter LED chips, LED components, LED lighting products, and power 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, timing of expenditures and the number and nature of our ongoing research and development activities. However, we anticipate that in general our research and development expenses will continue to increase over time to support future growth.

**Sales, General and Administrative**

Sales, general and administrative expenses are composed primarily of costs associated with our sales and marketing personnel and our executive and administrative personnel (for example, legal, finance, information technology and human resources personnel) 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) facilities and insurance costs, and 4) 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			Change	Six Months Ended			Change
	December 26, 2010	December 27, 2009			December 26, 2010	December 27, 2009		
Sales, general and administrative	\$ 33,366	\$ 25,560	\$ 7,806	31%	\$ 62,568	\$ 49,173	\$ 13,395	27%
<i>Percent of total revenues</i>	13%	13%			12%	13%		

Sales, general and administrative expenses in the second quarter of fiscal 2011 increased 31% to \$33.4 million from \$25.6 million in the second quarter of fiscal 2010. For the six months ended December 26, 2010 sales, general and administrative expenses increased 27% to \$62.6 million from \$49.2 million for the six months ended December 27, 2009. The increase in second quarter of fiscal 2011 is primarily due to an increase in spending on sales and marketing as we expand our direct sales resources and channels and invest in building the Cree brand. Additionally, costs increased due to higher patent litigation costs.

**Amortization of Acquisition Related Intangibles**

As a result of our acquisitions, we have recorded various intangible assets that require amortization, including customer relationships and developed technologies. During fiscal 2007, we acquired INTRINSIC Semiconductor Corporation and COTCO, resulting in \$63.7 million of amortizable intangible assets principally composed of customer relationships and developed technology. In fiscal 2008, we acquired LLF, resulting in an additional \$41.2 million of amortizable intangible assets. These intangible assets are principally composed of developed technology that specifically relates to technologies underlying the development of LED lighting products for the general illumination market. Amortization of intangible assets related to our acquisitions is as follows (in thousands):

Edgar Filing: CREE INC - Form 10-Q

	Three Months Ended			Six Months Ended				
	December 26, December 27,		Change	December 26, December 27,		Change		
	2010	2009		2010	2009			
INTRINSIC	\$ 186	\$ 186	\$	0%	\$ 372	\$ 372	\$	0%
COTCO	1,734	2,073	(339)	-16%	3,468	4,146	(678)	-16%
LLF	786	786		0%	1,572	1,572		0%
Total	\$ 2,706	\$ 3,045	\$ (339)	-11%	\$ 5,412	\$ 6,090	\$ (678)	-11%

**Table of Contents****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 processes change 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 for possible impairments in value. The following table sets forth our loss on disposal or impairment of long-lived assets (in thousands):

	Three Months Ended			Change	Six Months Ended			Change
	December 26, 2010	December 27, 2009			December 26, 2010	December 27, 2009		
Loss on disposal or impairment of long-lived assets, net	\$ 429	\$ 110	\$ 319	290%	\$ 901	\$ 403	\$ 498	124%

We recorded a net loss of \$0.4 million on the disposal of long-lived assets in the second quarter of fiscal 2011 compared to a net loss of \$0.1 million in the second quarter of fiscal 2010. For the six months ended December 26, 2010 we recorded a loss of \$0.9 million compared to \$0.4 million for the six months ended December 27, 2009. The fiscal 2011 losses are due to the disposal of certain equipment due to manufacturing process changes and due to the impairment of certain capitalized patent costs.

**Non-Operating Income**

The following table sets forth our non-operating income (in thousands):

	Three Months Ended			Change	Six Months Ended			Change
	December 26, 2010	December 27, 2009			December 26, 2010	December 27, 2009		
Gain on sale of investments, net	\$	\$ 1	\$ (1)	-100%	\$ 1	\$ 1	\$	0%
Other non-operating income (expense)	\$ 63	\$ (41)	\$ 104	-254%	\$	\$ 90	\$ (90)	-100%
Interest income, net	\$ 2,170	\$ 2,001	\$ 169	8%	\$ 4,186	\$ 3,631	\$ 555	15%

We have no debt or lines of credit and we are in a net interest income position. We have historically invested portions of our available cash in fixed interest rate securities such as high-grade corporate debt, commercial paper, government securities, municipal bonds, and other fixed interest rate investments. The primary objective of our investments is to preserve principal while maximizing our yields.

Net interest income was \$2.2 million compared to \$2.0 million for the second quarter of fiscal 2011 and fiscal 2010, respectively. For the six months ended December 26, 2010 net interest income was \$4.2 million compared to \$3.6 million for the six months ended December 27, 2009. Year over year changes in interest income are due to a combination of fluctuations in interest rates on our cash and investments and differences between the periods in our average cash and investment balances.

Other non-operating income is comprised primarily of foreign exchange gains and losses.

**Income Tax Expense**

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

	Three Months Ended			Change	Six Months Ended			Change
	December 26, 2010	December 27, 2009			December 26, 2010	December 27, 2009		
Income tax expense	\$ 7,870	\$ 14,205	\$ (6,335)	-45%	\$ 25,205	\$ 21,593	\$ 3,612	17%
Effective tax rate	13.7%	29.6%			18.9%	28.3%		

The variation between the Company's effective tax rate and the U.S. statutory rate of 35 percent is primarily due to the consolidation of our foreign operations, which are subject to income taxes at lower statutory rates. A change in the mix of pretax income from these various tax jurisdictions can have a material impact on our periodic effective tax rate.



---

## **Table of Contents**

We recorded income tax expense of \$7.9 million for an effective tax rate of 13.7% in the second quarter of fiscal 2011 as compared to income tax expense of \$14.2 million for an effective tax rate of 29.6% in the second quarter of fiscal 2010. For the six months ended December 26, 2010 we recorded income tax expense of \$25.2 million for an effective tax rate of 18.9% compared to income tax expense of \$21.6 million for an effective tax rate of 28.3% for the six months ended December 27, 2009. The decrease in our effective tax rate is primarily due to the following:

An overall higher percentage of income in lower tax jurisdictions outside the United States.

On December 17, 2010, the U.S. government passed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (H.R. 4853) which included a retroactive extension of the Research and Development tax credit. As a result of the changes in the applicable tax laws resulting from the act, we estimated a benefit of approximately \$4.0 million. A portion of this, \$2.1 million, was treated as a discrete event and recorded as a reduction to our income tax expense for the three months ended December 26, 2010.

During the first quarter of fiscal 2011, we were awarded a tax holiday on our operations in Malaysia. In certain conditions this arrangement allows us a tax holiday for ten years starting in fiscal 2011.

During fiscal 2010, we were notified by the Internal Revenue Service that we had been allocated \$39 million of federal tax credits as part of the American Recovery and Reinvestment Act of 2009 (Internal Revenue Code Section 48C). This \$39 million allocation was based upon our projecting that we would put into service approximately \$130 million of qualified equipment into our United States manufacturing locations over the following three years. We generated \$10.8 million of 48C credits in fiscal 2010. We anticipate generating the remainder of the awarded 48C credits (approximately \$28.2 million) during fiscal 2011. The tax benefit (net of related basis adjustments) will be amortized into income over the useful life (5 years) of the underlying equipment that was placed in service to generate these credits. In fiscal 2011, we anticipate we will recognize approximately a \$5.1 million income tax benefit related to these credits, of this amount, \$2.6 million has been recorded in the first six months of fiscal 2011.

## **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 on hand, 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 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 new debt or additional shares of common stock in connection with the acquisition of complementary businesses or other significant assets or for other strategic opportunities.

### ***Financial Condition***

Our liquidity and capital resources depend on our cash flows from operations and our working capital. Our working capital increased to \$1.3 billion as of December 26, 2010 from \$1.2 billion at June 27, 2010, primarily due to positive cash flows from operations. The following table presents the components of our cash conversion cycle for our second fiscal quarter of 2011 and fourth fiscal quarter of 2010:

## Edgar Filing: CREE INC - Form 10-Q

	December 26, 2010	June 27, 2010	Change	
Days of sales outstanding <sup>(a)</sup>	47	40	7	18%
Days of supply in inventory <sup>(b)</sup>	96	76	20	26%
Days in accounts payable <sup>(c)</sup>	(53)	(43)	(10)	23%
Cash conversion cycle	90	73	17	23%

- (a) Days of sales outstanding (DSO) calculates the average collection period of our accounts receivable. DSO is based on the ending net trade receivables and the most recent quarterly revenue for each period. DSO is calculated by dividing accounts receivable, net of allowance for doubtful accounts and revenue reserves, by average net revenue for the current quarter (90 days).

**Table of Contents**

- (b) Days of supply in inventory (DSI) measures the average number of days from procurement to sale of our product. DSI is based on net ending inventory and most recent quarterly cost of sales for each period. DSI is calculated by dividing net ending inventory by average cost of goods sold for the current quarter (90 days).
- (c) Days in accounts payable (DPO) calculates the average number of days our payables remain outstanding before payment. DPO is based on ending accounts payable and most recent quarterly cost of sales for each period. DPO is calculated by dividing accounts payable by average cost of goods sold for the current quarter (90 days).

Overall our cash conversion cycle, or days to cash, increased primarily due to an increase in inventory on hand. The increase in inventory is primarily related to our building product in response to a higher demand forecast than our actual results.

As of December 26, 2010, all of our investments had investment grade ratings, and any such investments that were in an unrealized loss position at December 26, 2010 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. When evaluating our investments for possible impairment, we review factors such as the length of time and extent to which fair value has been below our cost basis, the financial condition of the entity in which the investment is made, and our ability and intent to hold the investment for a period of time that may be sufficient for anticipated recovery in market value. 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 26, 2010.

We believe our current working capital and anticipated cash flows from operations will be adequate to meet our cash needs for our daily operations and capital expenditures for the remainder of fiscal 2011. We have and may continue to use a portion of our available cash and cash equivalents, or funds underlying our marketable securities, to repurchase shares of our common stock. 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.

**Cash Flows**

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

	Six Months Ended		Change	
	December 26, 2010	December 27, 2009		
Cash provided by operating activities	\$ 145,756	\$ 82,699	\$ 63,057	76%
Cash used in investing activities	(117,122)	(439,225)	322,103	-73%
Cash provided by financing activities	39,254	548,739	(509,485)	-93%
Effects of foreign exchange changes	238	190	48	25%
<b>Net increase in cash and cash equivalents</b>	<b>\$ 68,126</b>	<b>\$ 192,403</b>	<b>\$ (124,277)</b>	<b>-65%</b>

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 \$145.8 million in the first six months of fiscal 2011 compared to \$82.7 million for the first six months of fiscal 2010. This increase was primarily driven by a year over year rise in our net income, offset in part by higher levels of inventory and receivables.

**Cash Flows from Investing Activities**

Our investing activities primarily relate to transactions within our investments, strategic acquisitions, purchase of property, plant and equipment and purchase of patent and license rights. Net cash used in investing activities was \$117.1 million for the first six months of fiscal 2011 compared to \$439.2 million for the first six months of fiscal 2010. This year over year decrease was primarily the result of an overall net decrease in investment activity. This decrease was partially offset by an increase in our current year capital expenditures for property, plant and equipment to expand our global production capacity.



---

## **Table of Contents**

We will continue to closely monitor our capital expenditures, while making strategic investments to develop our existing products, pursue strategic initiatives where appropriate and invest in our manufacturing and information technology infrastructure to meet the needs of our business. We target committing capital of approximately \$250 to \$260 million in fiscal 2011 for capital expenditures.

### *Cash Flows from Financing Activities*

Net cash provided by financing activities was \$39.3 million for the first six months of fiscal 2011 compared to \$548.7 million for the first six months of fiscal 2010. This year over year decrease was primarily related to our sale of 12.65 million shares of our common stock in a follow-on public offering during fiscal 2010, with net proceeds of approximately \$434.0 million.

### **Off-Balance Sheet Arrangements**

We do not use off-balance sheet arrangements with unconsolidated entities or related parties, nor do we use 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 26, 2010, 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 leases primarily for certain of our facilities in the normal course of business. These arrangements are often referred to as a form of off-balance-sheet financing. Please refer to Part II, Item 7 of our Annual Report on Form 10-K for the fiscal year ended June 27, 2010, in the section entitled "Contractual Obligations" for the future minimum lease payments due under our operating leases as of June 27, 2010.

### **Critical Accounting Policies and Estimates**

For information about our other 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 27, 2010.

### **Recent Accounting Pronouncements**

See Note 1, "Basis of Presentation and Changes in Significant Accounting Policies," to our unaudited financial statements in Part I, Item 1 of this Quarterly Report for a description of recent accounting pronouncements, including the expected dates of adoption and estimated 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 Item 7A of our Annual Report on Form 10-K for the fiscal year ended June 27, 2010.

### **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 the 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 are recorded, processed, summarized and reported within the time periods required by the United States Securities and Exchange Commission'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 2011 that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.



---

**Table of Contents**

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

The information required by this item is set forth under Note 11 of Notes to Consolidated Financial Statements included 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 27, 2010. If any of the risks described below actually occurs, our business, financial condition or results of operations could be materially and adversely affected.

***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 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, 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;

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, we purchased a 565,000-square-foot facility in Huizhou, Guangdong Province, China to support LED chip and LED component production and we recently announced our intention to expand LED wafer production at our facility in North Carolina. However, 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 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 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.

## Edgar Filing: CREE INC - Form 10-Q

In connection with our efforts to cost-effectively manage our growth, we have increasingly relied on subcontractors 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.

---

**Table of Contents**

***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 or sell LED chips and LED components as well as those that sell LED lighting products. Competitors continue to offer new LED products with aggressive pricing and improved performance. Competitive pricing pressures may accelerate the rate of decline of our average sales prices.

With the growth potential for LEDs, we may face increased competition in the future. For example, Samsung has entered the LED market and Taiwan Semiconductor Manufacturing Company has announced its intention to enter the LED market as well. Additionally, new technologies could emerge or improvements could be made in existing technologies that may also reduce the demand for LEDs in certain markets.

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. Additionally, we anticipate that increased competition will result in pressure to lower the selling prices of our products. Therefore, our ability to continually produce more efficient, higher brightness LEDs that meet the evolving needs of our customers at lower costs will be critical to our success. Competitors may also try to align with some of our strategic customers. This could mean lower prices for our products, reduced demand for our products and a corresponding reduction in our ability to recover development, engineering and manufacturing costs. Any of these developments could have an adverse effect on our business, results of operations or financial condition.

***We depend on a limited number of customers 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. For example, in fiscal 2010, two distribution customers, Arrow Electronics, Inc. and World Peace Industrial Co. Ltd., individually accounted for more than 10% of our net revenue, for a combined total of 30% of our total net revenue. Sales to these and most of our other large customers are made on a purchase order basis, which does not generally require any long-term customer commitments. Therefore, these customers may alter their past 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. If our customers alter their past (or expected) purchasing behavior, or if we encounter any problems collecting amounts due from them, our financial condition and results of operations could be negatively impacted.

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

We have expanded into business channels that are different from those that we have historically operated in as we grow our business and sell LED lighting products and more LED components versus LED chips. If we are unable to effectively penetrate these channels or develop channels to ensure our products are reaching the appropriate customer base, our financial results may be adversely impacted. In addition, if we successfully penetrate or develop 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.

A substantial portion of our products are sold through 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 impacted. We typically recognize revenue on product sold to distributors when the item is shipped and title passes to the distributor (sell-in method). Distributors must balance the need to have enough products in stock in order to meet their customers' needs against the risk of potential inventory obsolescence. The risks of inventory obsolescence are especially true with technological products. In addition, 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 revise our estimates and our operating results could be impacted.

***Our LED revenues are highly dependent on our customers' ability to produce, market and sell more integrated products using our LED products.***

Because our customers generally integrate our LED products into the products that they produce, market and sell, our LED revenues depend on getting our LED products designed into a larger number of our customers' products and in turn,

---

## **Table of Contents**

our customers' ability to produce, market and sell their LED 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, there can be no assurance that our customers will be successful in marketing and selling these products in the marketplace.

We also have current and prospective customers that create white LED components using our blue LEDs, in combination with phosphors. Sales of blue LED chips are highly dependent upon our customers' ability to procure efficient phosphors, develop high quality and highly efficient white LED components and gain access to the necessary intellectual property rights. Even if our customers are able to develop competitive white LED components using our blue LED chips, there can be no assurance that our customers will be successful in the marketplace.

***The adoption of or changes in government policies, standards or regulations relating to the efficiency, performance or other aspects of LED lighting or changes in government policies, standards or regulations that discourage the use of certain traditional lighting technologies, could impact the demand for our LED products.***

The adoption of or changes in government policies, standards or regulations relating to the efficiency, performance or other aspects of LED lighting may impact the demand for our LED products. For example, the Chinese government recently delayed purchases of LED street and tunnel lighting while developing new standards for the required performance for such lighting products in China. The process resulted in reduced short-term demand for those lighting applications.

Demand for our LED products may also be impacted by changes in government policies, standards or regulations that discourage the use of certain traditional lighting technologies. For example, the Energy Independence and Security Act of 2007 in the United States imposes constraints on the sale of incandescent lights beginning in 2012. These constraints may be eliminated or delayed by legislative action, which could have a negative impact on demand for our products.

***Our results of operations, financial condition and business could be harmed if we were 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. For example, we purchased a 565,000-square-foot facility in Huizhou, Guangdong Province, China to support LED chip and LED component production and we recently announced our intention to expand LED wafer production at our facility in North Carolina. 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 expansion costs), if demand does not increase at the rate forecasted, we may not be able to manage manufacturing expenses or overhead costs at the same rate as demand, which could also result in lower margins and adversely impact our business and results of operations. Therefore, if product demand decreases or we fail to forecast demand accurately, we may be required to record impairments on our long-lived assets, including facilities and equipment as well as intangible assets, and we could be required to record excess capacity charges, all of which would have a negative impact on our results of operations. Also, excess inventory may result in us recording inventory write-off charges.

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.

***As a result of our continued expansion into new markets existing customers may reduce orders.***

Through acquisitions and organic growth, we continue to expand into new markets. In these new markets, some of our current customers may now perceive us as a competitor. In response, our customers may reduce their orders for our products. This reduction in orders could occur faster than our sales growth in these new markets, which could adversely affect our business, results of operations or financial condition.

***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 and lower cost solutions for existing and new markets and for customers to accept those solutions. We must introduce new products in a timely and cost-effective manner, and we must secure production orders for those products from our customers. The development of new products is a highly complex process, and we historically have experienced delays in completing the development and introduction of new products. 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 and introduction of these 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;

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 expand sales and influence key customers to adopt our products;

our ability to develop repeatable processes to manufacture new products in sufficient quantities, with the desired specifications and at competitive costs for commercial sales;

our ability to effectively transfer products and technology developed in one country to our manufacturing facilities in other countries;

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

acceptance of our customers' products by the market.

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

***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. For example, in March 2007 we acquired COTCO and in February 2008 we acquired LLF. If we choose to enter into such transactions, we face certain risks, such as, failure of an acquired business to meet our performance expectations, diversion of management attention, retention of existing customers of our current and acquired businesses, 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.

## **Table of Contents**

*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, 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;

production yield loss, inventory shrinkage or human errors;

defects in production processes (including system assembly) either within our facilities or at our subcontractors; and

any transitions or changes in our production process, planned or unplanned.

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

In addition, our ability to convert volume manufacturing to larger diameter substrates can be an important factor in allowing for 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 significantly affect our margins 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.

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;

a rise in warranty expense and costs associated with customer support;

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.

We also may be the target of product liability lawsuits, and could suffer losses from a significant product liability judgment against us if the use of our products at issue is determined to have caused injury. A significant product recall or product liability case could also result in adverse publicity, damage to our reputation, and a loss of customer confidence in our products.

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

We are often involved in patent infringement litigation as described in Note 13, Commitments and Contingencies, to our consolidated financial statements included in Item 8 of our Annual Report on Form 10-K for the fiscal year ended

## **Table of Contents**

June 27, 2010. 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.

***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 take steps to seek to obtain a license or to avoid the infringement. However, we cannot predict 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 foreign patent authorities.

## Edgar Filing: CREE INC - Form 10-Q

However, our existing patents are subject to expiration 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.

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

## **Table of Contents**

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.

***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, or their customers, may continue to experience difficulty obtaining the 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.

***Our operations in foreign countries, including China and other Asian 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 subcontract 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 foreign 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.

## Edgar Filing: CREE INC - Form 10-Q

In some instances, we have been provided and may continue to receive competing 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 China, as the Chinese national and local governments seek to encourage the development of the technology industry in China. 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.

---

**Table of Contents**

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

We expect that revenue from international sales will continue to represent the majority of our total revenue. In fiscal 2010, approximately 81% of our revenue was derived from sales to non-U.S. customers, with approximately 40% of revenue from sales to customers in China (including Hong Kong). As such, a significant slowdown in these foreign economies 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 our export privileges could be 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 not entered into any foreign currency derivative financial instruments; however, we may choose to do so in the future in an effort to manage or hedge our foreign exchange rate risk.

***We rely on a number of key sole source and limited source suppliers, and are subject to high price volatility on certain commodity inputs.***

We depend on a number of sole source and limited source suppliers for certain raw materials, including rare earth elements, 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. 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, such as passive electrical components used in LED lighting applications, 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 that have impacted our cost of sales.

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 the general 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, our key suppliers were unable to support our demand for any reason, or we were unable to identify and qualify alternative suppliers, our manufacturing operations could be interrupted or hampered significantly.

**Table of Contents**

We rely on arrangements with independent shipping companies, such as Federal Express and United Parcel Service, 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.

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

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

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

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

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

adjustments to estimated taxes upon finalization of various tax returns;

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 (APIC) 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.

## Edgar Filing: CREE INC - Form 10-Q

For example, proposals have been made by various U.S. governmental bodies to change the U.S. tax laws that include, among other things, limiting U.S. tax deductions for expenses related to un-repatriated foreign-source income and modifying the U.S. foreign tax credit rules. Although the scope of the proposed changes is unclear, it is possible that these or other changes in U.S. tax laws could increase our U.S. income tax liability and adversely affect our profitability. At this time, we cannot determine the timing that the proposed changes, if enacted, would become effective.

Any significant increase in our future effective tax rates could adversely 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 and accruals 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 adversely affected.

---

**Table of Contents**

***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 (including Hong Kong). 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 attract 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, which include non-qualified stock options and restricted stock. If the value of such stock 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.

***We may be subject to intellectual property theft or misuse, which could harm our business and results of operations.***

We may face attempts by others to gain unauthorized access through the Internet to our information technology systems. These attempts might be the result of industrial or other espionage, or actions by hackers seeking to harm us. We actively seek to prevent, detect and investigate any security incidents, but in some cases we might be unaware of an incident or 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, product development, and marketing could be reduced. Our business could be subject to significant disruption, and we could suffer monetary or other losses.

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

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

***Our 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.

## Edgar Filing: CREE INC - Form 10-Q

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.

---

**Table of Contents**

***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, especially in the case of our single site for SiC wafer and LED fabrication. A catastrophic event that results in the destruction or disruption to our supply chain or any of our critical business or information technology systems could severely affect our ability to conduct normal business operations and, as a result, our operating results could be adversely affected.

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

The methods, estimates and judgments that we use in applying our accounting policies have a significant impact on our results of operations (see Critical Accounting Policies and Estimates in our Management's Discussion and Analysis of Financial Condition and Results of Operations included in Item 7 of our Annual Report on Form 10-K for the fiscal year ended June 27, 2010). 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.

Likewise, our results of operations may be impacted due to changes in the accounting rules to be applied, such as the increased use of fair value measurement rules and the potential requirement that U.S. registrants prepare financial statements in accordance with International Financial Reporting Standards.

***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 \$12.57 in fiscal 2009 to a high of \$83.38 in fiscal 2010. 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 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.

***We may be required to record a significant charge to earnings if our goodwill or amortizable intangible assets become impaired.***

We are required under generally accepted accounting principles to review our amortizable intangible assets and investments in equity interests for impairment when events or changes in circumstances indicate the carrying value may not be recoverable. Goodwill is required to be tested for impairment at least annually. Factors that may be considered a change in circumstances indicating that the carrying value of our amortizable intangible assets or goodwill may not be recoverable include a decline in stock price and market capitalization and slower growth rates in our industry. We may be required to record a significant charge to earnings in our consolidated financial statements during the period in which any impairment of our amortizable intangible assets or goodwill is determined to exist. This could adversely impact our results of operations.

***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 investments is to preserve principal and we only acquire investments rated AAA. However, our investments are generally not FDIC insured and may lose value and/or become illiquid regardless of their rating.

**Table of Contents**

**Item 2. Unregistered Sale of Equity Securities and Use of Proceeds**  
Not applicable.

**Item 3. Defaults Upon Senior Securities**  
Not applicable.

**Item 4. (Removed and Reserved)**

**Item 5. Other Information**  
Not applicable.

**Item 6. Exhibits**  
The following exhibits are being filed herewith and are numbered in accordance with Item 601 of Regulation S-K:

<b>Exhibit No.</b>	<b>Description</b>
3.1	Bylaws, as amended (incorporated herein by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K, dated October 25, 2010, as filed with the Securities and Exchange Commission on October 29, 2010)
10.1	Form of Cree, Inc. Indemnification Agreement for Directors and Officers (incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K, dated October 25, 2010, as filed with the Securities and Exchange Commission on October 29, 2010)
10.2	2004 Long-Term Incentive Compensation Plan, as amended (incorporated herein by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K, dated October 25, 2010, as filed with the Securities and Exchange Commission on October 29, 2010)
10.3	Amendment One to Non-Employee Director Stock Compensation and Deferral Program
10.4	Form of Master Stock Option Award Agreement for Grants of Nonqualified Stock Options
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 26, 2010 formatted in XBRL (eXtensible Business Reporting Language) and furnished electronically herewith: (i) Consolidated Balance Sheets; (ii) Consolidated Statements of Income; (iii) Consolidated Statements of Cash Flows; and (iv) Notes to Consolidated Financial Statements*

## Edgar Filing: CREE INC - Form 10-Q

\* Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files in Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

**Table of Contents**

**SIGNATURE**

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

January 19, 2011

CREE, INC

/s/ John T. Kurtzweil  
John T. Kurtzweil  
Executive Vice President, Chief Financial Officer and Treasurer  
(Authorized Officer and Principal Financial and Chief Accounting  
Officer)

36

**Table of Contents**

**EXHIBIT INDEX**

<b>Exhibit No.</b>	<b>Description</b>
3.1	Bylaws, as amended (incorporated herein by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K, dated October 25, 2010, as filed with the Securities and Exchange Commission on October 29, 2010)
10.1	Form of Cree, Inc. Indemnification Agreement for Directors and Officers (incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K, dated October 25, 2010, as filed with the Securities and Exchange Commission on October 29, 2010)
10.2	2004 Long-Term Incentive Compensation Plan, as amended (incorporated herein by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K, dated October 25, 2010, as filed with the Securities and Exchange Commission on October 29, 2010)
10.3	Amendment One to Non-Employee Director Stock Compensation and Deferral Program
10.4	Form of Master Stock Option Award Agreement for Grants of Nonqualified Stock Options
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 26, 2010 formatted in XBRL (eXtensible Business Reporting Language) and furnished electronically herewith: (i) Consolidated Balance Sheets; (ii) Consolidated Statements of Income; (iii) Consolidated Statements of Cash Flows; and (iv) Notes to Consolidated Financial Statements*

\* Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files in Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.