

STEC, INC.
Form 10-Q
August 03, 2011
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2011

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 000-31623

STEC, INC.

(Exact name of Registrant as specified in its charter)

Edgar Filing: STEC, INC. - Form 10-Q

CALIFORNIA
(State or other jurisdiction of
incorporation or organization)

33-0399154
(I.R.S. Employer
Identification No.)

3001 Daimler Street

Santa Ana, CA
(Address of principal executive offices)

92705-5812
(Zip Code)

(949) 476-1180

(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 definitions of "accelerated filer," "large 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 \$0.001, as of July 22, 2011 was 51,609,603.

Table of Contents

STEC, INC.

**INDEX TO FORM 10-Q FOR THE
QUARTERLY PERIOD ENDED JUNE 30, 2011**

PART I. FINANCIAL INFORMATION

| | | |
|---------|---|----|
| ITEM 1. | <u>FINANCIAL STATEMENTS</u> | 1 |
| | <u>UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS AS OF JUNE 30, 2011 AND DECEMBER 31, 2010</u> | 1 |
| | <u>UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2011 AND JUNE 30, 2010</u> | 2 |
| | <u>UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE SIX MONTHS ENDED JUNE 30, 2011 AND JUNE 30, 2010</u> | 3 |
| | <u>NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS</u> | 4 |
| ITEM 2. | <u>MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS</u> | 13 |
| ITEM 3. | <u>QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK</u> | 25 |
| ITEM 4. | <u>CONTROLS AND PROCEDURES</u> | 25 |

PART II. OTHER INFORMATION

| | | |
|----------|--|----|
| ITEM 1. | <u>LEGAL PROCEEDINGS</u> | 26 |
| ITEM 1A. | <u>RISK FACTORS</u> | 26 |
| ITEM 2. | <u>UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS</u> | 39 |
| ITEM 3. | <u>DEFAULTS UPON SENIOR SECURITIES</u> | 39 |
| ITEM 4. | <u>(REMOVED AND RESERVED)</u> | 39 |
| ITEM 5. | <u>OTHER INFORMATION</u> | 39 |
| ITEM 6. | <u>EXHIBITS</u> | 40 |
| | <u>SIGNATURES</u> | 41 |

Except as otherwise noted in this report, STEC, the Company, we, us and our collectively refer to STEC, Inc. and its subsidiaries.

Table of Contents**PART I FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****STEC, INC.****UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS**

(in thousands, except per share amounts)

| | June 30, 2011 | December 31, 2010 |
|---|-------------------|----------------------|
| ASSETS: | | |
| Current Assets: | | |
| Cash and cash equivalents | \$ 213,292 | \$ 170,457 |
| Accounts receivable, net of allowances of \$4,117 at June 30, 2011 and \$3,853 at December 31, 2010 | 45,583 | 47,831 |
| Inventory | 80,177 | 88,968 |
| Other current assets | 3,401 | 4,606 |
| Total current assets | 342,453 | 311,862 |
| Leasehold interest in land | 2,573 | 2,596 |
| Property, plant and equipment, net | 35,066 | 35,037 |
| Goodwill | 1,682 | 1,682 |
| Other long-term assets | 5,029 | 5,173 |
| Deferred income taxes | 14,961 | 9,304 |
| Total assets | \$ 401,764 | \$ 365,654 |
| LIABILITIES AND SHAREHOLDERS' EQUITY: | | |
| Current Liabilities: | | |
| Accounts payable | \$ 26,380 | \$ 25,762 |
| Accrued and other liabilities | 13,946 | 13,470 |
| Total current liabilities | 40,326 | 39,232 |
| Long-term income taxes payable | 5,651 | 4,248 |
| Commitments and contingencies (Note 9) | | |
| Shareholders' Equity: | | |
| Preferred stock, \$0.001 par value, 20,000 shares authorized, no shares issued and outstanding | | |
| Common stock, \$0.001 par value, 100,000 shares authorized, 51,595 shares issued and outstanding as of June 30, 2011 and 51,046 shares issued and outstanding as of December 31, 2010 | 52 | 51 |
| Additional paid-in capital | 178,897 | 169,127 |
| Retained earnings | 176,838 | 152,996 |
| Total shareholders' equity | 355,787 | 322,174 |
| Total liabilities and shareholders' equity | \$ 401,764 | \$ 365,654 |

See accompanying notes to unaudited condensed consolidated financial statements.

Table of Contents**STEC, INC.****UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(in thousands, except per share amounts)**

| | For the Three Months Ended June 30, | | For the Six Months Ended June 30, | |
|--|--|-----------|--------------------------------------|------------|
| | 2011 | 2010 | 2011 | 2010 |
| Net revenues | \$ 82,451 | \$ 61,348 | \$ 177,395 | \$ 100,157 |
| Cost of revenues | 45,604 | 35,226 | 100,275 | 60,849 |
| Gross profit | 36,847 | 26,122 | 77,120 | 39,308 |
| Sales and marketing | 6,053 | 4,807 | 11,719 | 8,603 |
| General and administrative | 7,905 | 7,099 | 15,314 | 14,038 |
| Research and development | 12,987 | 10,366 | 24,987 | 20,020 |
| Special charges (Note 7) | | 18 | | (48) |
| Total operating expenses | 26,945 | 22,290 | 52,020 | 42,613 |
| Operating income (loss) | 9,902 | 3,832 | 25,100 | (3,305) |
| Other income | 90 | 523 | 43 | 389 |
| Income (loss) from continuing operations before income taxes | 9,992 | 4,355 | 25,143 | (2,916) |
| (Provision) benefit for income taxes | (298) | (1,418) | (1,301) | 500 |
| Income (loss) from continuing operations | 9,694 | 2,937 | 23,842 | (2,416) |
| Discontinued operations (Note 8): | | | | |
| Loss from operations of Consumer Division | | (258) | | (258) |
| Benefit for income taxes | | 108 | | 108 |
| Loss from discontinued operations | | (150) | | (150) |
| Net income (loss) | \$ 9,694 | \$ 2,787 | \$ 23,842 | \$ (2,566) |
| Net income (loss) per share: | | | | |
| Basic: | | | | |
| Continuing operations | \$ 0.19 | \$ 0.06 | \$ 0.46 | \$ (0.05) |
| Discontinued operations | | | | |
| Total | \$ 0.19 | \$ 0.06 | \$ 0.46 | \$ (0.05) |
| Diluted: | | | | |
| Continuing operations | \$ 0.18 | \$ 0.06 | \$ 0.45 | \$ (0.05) |
| Discontinued operations | | | | |
| Total | \$ 0.18 | \$ 0.06 | \$ 0.45 | \$ (0.05) |
| Shares used in per share computation: | | | | |
| Basic | 51,495 | 50,673 | 51,361 | 50,495 |

Edgar Filing: STEC, INC. - Form 10-Q

| | | | | |
|---------|--------|--------|--------|--------|
| Diluted | 52,652 | 51,463 | 52,672 | 50,495 |
|---------|--------|--------|--------|--------|

See accompanying notes to unaudited condensed consolidated financial statements.

Table of Contents**STEC, INC.****UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(in thousands)**

| | For the Six Months Ended June 30, | |
|--|--|-------------------|
| | 2011 | 2010 |
| Cash flows from operating activities: | | |
| Net income (loss) | \$ 23,842 | \$ (2,566) |
| Loss from discontinued operations | | 150 |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | |
| Depreciation and amortization | 6,207 | 6,231 |
| Loss on sale of property, plant and equipment | 22 | 22 |
| Non-cash special charges | | (104) |
| Accounts receivable provision (benefit) | 293 | (535) |
| Deferred income taxes | (4,362) | (5,881) |
| Stock-based compensation expense | 6,010 | 4,032 |
| Excess tax benefits from share-based payment arrangements | (1,734) | (1,516) |
| Change in operating assets and liabilities: | | |
| Accounts receivable | 1,955 | 38,242 |
| Inventory | 8,791 | (24,105) |
| Leasehold interest in land | 23 | 22 |
| Other assets | 975 | (1,154) |
| Accounts payable | (1,040) | (9,640) |
| Income taxes | 5,360 | 2,710 |
| Accrued and other liabilities | (2,378) | (4,663) |
| Cash flows used in discontinued operations | | (27) |
| Net cash provided by operating activities | 43,964 | 1,218 |
| Cash flows from investing activities: | | |
| Purchases of short-term investments | | (4,998) |
| Sales of short-term investments | | 9,998 |
| Purchases of property, plant and equipment | (5,425) | (2,974) |
| Other | (249) | 219 |
| Net cash (used in) provided by investing activities | (5,674) | 2,245 |
| Cash flows from financing activities: | | |
| Proceeds from exercise of stock options | 2,834 | 2,265 |
| Excess tax benefits from share-based payment arrangements | 1,734 | 1,516 |
| Taxes paid related to net-share settlement of equity awards | (23) | |
| Net cash provided by financing activities | 4,545 | 3,781 |
| Net increase in cash and cash equivalents | 42,835 | 7,244 |
| Cash and cash equivalents at beginning of period | 170,457 | 135,658 |
| Cash and cash equivalents at end of period | \$ 213,292 | \$ 142,902 |
| Supplemental schedule of noncash investing activities: | | |
| Additions to property, plant and equipment acquired under accounts payable | \$ 1,579 | \$ 554 |

Edgar Filing: STEC, INC. - Form 10-Q

See accompanying notes to unaudited condensed consolidated financial statements.

Table of Contents**STEC, INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****Note 1 Basis of Presentation**

The accompanying interim unaudited condensed consolidated financial statements of STEC, Inc., a California corporation, and its subsidiaries (the Company), have been prepared in accordance with generally accepted accounting principles in the United States of America (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. The unaudited condensed consolidated financial statements include the accounts of the Company and each of its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. In the opinion of management, all adjustments (consisting of normal and recurring adjustments and the special charges discussed in Note 7) considered necessary for a fair statement of the consolidated financial position of the Company as of June 30, 2011, the consolidated results of operations for each of the three and six months ended June 30, 2011 and 2010, and the consolidated results of cash flows for each of the six months ended June 30, 2011 and 2010 have been included. These interim unaudited condensed consolidated financial statements do not include all of the information and footnotes required by GAAP for complete financial statements and, therefore, should be read in conjunction with the consolidated financial statements and related notes contained in the Company's most recent Annual Report on Form 10-K filed with the Securities and Exchange Commission (SEC). The December 31, 2010 balances reported herein are derived from the audited consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2010. The results for the interim periods are not necessarily indicative of results to be expected for the full year. Certain amounts previously reported have been reclassified to conform to the 2011 presentation.

The preparation of financial statements in conformity with GAAP requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities (e.g., sales returns, bad debts, inventory reserves, asset impairments), disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. The Company's reported revenues are net of reserves for price protection, sales returns and sales and marketing incentives. Actual results could differ significantly from those estimates.

Note 2 Sales Concentration

As shown in the table below, customer concentrations of revenues of greater than 10% were as follows:

| | For the Three Months Ended June 30, | | For the Six Months Ended June 30, | |
|-------------------|-------------------------------------|------|-----------------------------------|------|
| | 2011 | 2010 | 2011 | 2010 |
| Customer A | 30% | 38% | 28% | 23% |
| Customer B | 22% | * | 25% | * |
| Customer C | 16% | 13% | 18% | 14% |
| Customer D | * | 18% | * | 25% |

* Less than 10%

Sales, which are derived from billings to customers, by geographic region are presented as a percentage of total revenues as follows:

| | For the Three Months Ended June 30, | | For the Six Months Ended June 30, | |
|-----------------------|-------------------------------------|------|-----------------------------------|------|
| | 2011 | 2010 | 2011 | 2010 |
| United States | 28% | 44% | 31% | 38% |
| Singapore | 39% | 16% | 43% | 19% |
| Czech Republic | 20% | 11% | 15% | * |
| Malaysia | * | 16% | * | 21% |
| Other | 13% | 13% | 11% | 22% |
| Total | 100% | 100% | 100% | 100% |

Edgar Filing: STEC, INC. - Form 10-Q

* Less than 10%

No other single foreign country accounted for more than 10% of revenues during the three and six months ended June 30, 2011 and 2010.

Table of Contents**STEC, INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Note 3 Financial Instruments**

Financial instruments consist principally of cash equivalents, accounts receivable and accounts payable. Carrying amounts of the Company's financial instruments approximate fair value due to their short maturities. Generally, the Company considers all highly liquid investments that are readily convertible into cash and have an original maturity of three months or less at the time of purchase to be cash equivalents.

As of June 30, 2011 and December 31, 2010, cash equivalents consisted of money market funds. The Company determined the fair value of its cash equivalents based on Level 1 inputs, which consist of quoted prices in active markets for identical assets.

Cash and cash equivalents consisted of the following (in thousands):

| | June 30, 2011 | December 31, 2010 |
|---------------------------------|---------------|-------------------|
| Cash and cash equivalents: | | |
| Cash | \$ 132,794 | \$ 90,021 |
| Money market funds | 80,498 | 80,436 |
| Total cash and cash equivalents | \$ 213,292 | \$ 170,457 |

Note 4 Income Taxes

The Company recorded a provision for income taxes of \$1.3 million and a benefit for income taxes of \$500,000 for the six months ended June 30, 2011 and June 30, 2010, respectively. The Company's effective tax rates were 5.2% and 17.1% for the six months ended June 30, 2011 and June 30, 2010, respectively. The difference between the Company's effective tax rate and the 35% federal statutory rate for the six months ended June 30, 2011 resulted primarily from foreign earnings taxed at rates lower than the federal statutory rate. The difference between the Company's effective tax rate and the 35% federal statutory rate for the six months ended June 30, 2010 resulted primarily from foreign earnings taxed at rates lower than the federal statutory rate, partially offset by permanent differences between GAAP pre-tax income and taxable income. The decrease in the effective tax rate for the six months ended June 30, 2011 from the same period in 2010 is due primarily to a change in the revenue composition, which resulted in increased international sales and earnings in jurisdictions outside of the U.S. that were taxed at rates lower than U.S. federal statutory rate. The decrease was also due to federal research and development tax credits of \$385,000 from which the Company received benefits in the first six months of 2011 but did not receive benefits in the first six months of 2010 because the federal government had not extended the tax credits to be effective for 2010 as of June 30, 2010. In December 2010, the federal government retroactively applied the research and development tax credits for the full year 2010 and extended them through December 31, 2011.

Income from continuing operations before income taxes by foreign country in jurisdictions where the Company is assessed income tax consisted of the following (in thousands):

| | For the Three Months | | For the Six Months Ended | |
|----------------|----------------------|---------------|--------------------------|---------------|
| | June 30, 2011 | June 30, 2010 | June 30, 2011 | June 30, 2010 |
| Japan | \$ 272 | \$ 90 | \$ 672 | \$ 135 |
| United Kingdom | 160 | 109 | 231 | 93 |
| Taiwan | 145 | 101 | 325 | 247 |
| China | 39 | 45 | 73 | 71 |
| Italy | 37 | 43 | 77 | 68 |
| India | 37 | | 37 | |

Edgar Filing: STEC, INC. - Form 10-Q

| | | | | |
|---------|--------|--------|----------|--------|
| Germany | 18 | 46 | 40 | 50 |
| Austria | 17 | 31 | 36 | 44 |
| | \$ 725 | \$ 465 | \$ 1,491 | \$ 708 |

The Company also had income (loss) from continuing operations in Malaysia and the Cayman Islands that was not subject to income tax as the Company has an income tax holiday in Malaysia effective through September 30, 2027 and there are no income taxes assessed on corporate income in the Cayman Islands.

As an incentive to establish operations in Malaysia, the Company was provided a fifteen-year income tax holiday and certain grants by the Malaysian government subject to meeting certain conditions. This income tax holiday in Malaysia was effective through September 30, 2022. In May 2011, the Company accepted an additional incentive package from the Malaysian government as part of its plan to establish a research and development center in Malaysia. This incentive package includes a

Table of Contents**STEC, INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

five-year extension through September 30, 2027 of the existing income tax holiday term and certain research and development grants. The impact of the Malaysia income tax holiday decreased our provision for income taxes by \$1.9 million and \$980,000 in the three months ended June 30, 2011 and June 30, 2010, respectively. The impact of the Malaysia income tax holiday decreased our provision for income taxes by \$4.2 million in the six months ended June 30, 2011 and increased our benefit for income taxes by \$1.5 million in the six months ended June 30, 2010. The benefit of the income tax holiday on earnings per share was \$0.04 and \$0.02 for the three months ended June 30, 2011 and June 30, 2010, respectively, and \$0.08 and \$0.03 for the six months ended June 30, 2011 and June 30, 2010, respectively.

Note 5 Net Income (Loss) Per Share

The following table sets forth the computation of basic and diluted net income (loss) per share for the three and six months ended June 30, 2011 (in thousands, except per share amounts).

| | For the Three Months Ended June 30, | | For the Six Months Ended June 30, | |
|--|--|----------|--------------------------------------|------------|
| | 2011 | 2010 | 2011 | 2010 |
| Numerator: Income (loss) from continuing operations | \$ 9,694 | \$ 2,937 | \$ 23,842 | \$ (2,416) |
| Numerator: Loss from discontinued operations | | (150) | | (150) |
| Numerator: Net income (loss) | \$ 9,694 | \$ 2,787 | \$ 23,842 | \$ (2,566) |
| Denominator for net income per share (basic) | 51,495 | 50,673 | 51,361 | 50,495 |
| Effect of dilutive securities: | | | | |
| Stock awards | 1,157 | 790 | 1,311 | |
| Denominator for net income per share (diluted) | 52,652 | 51,463 | 52,672 | 50,495 |
| Net income (loss) per share (basic): | | | | |
| Continuing operations | \$ 0.19 | \$ 0.06 | \$ 0.46 | \$ (0.05) |
| Discontinued operations | | | | |
| Total | \$ 0.19 | \$ 0.06 | \$ 0.46 | \$ (0.05) |
| Net income (loss) per share (diluted): | | | | |
| Continuing operations | \$ 0.18 | \$ 0.06 | \$ 0.45 | \$ (0.05) |
| Discontinued operations | | | | |
| Total | \$ 0.18 | \$ 0.06 | \$ 0.45 | \$ (0.05) |
| Anti-dilutive shares excluded from net income (loss) per share calculation | 2,336 | 2,573 | 1,859 | 1,286 |

Table of Contents**STEC, INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Note 6 Supplemental Balance Sheet Information**

Inventory consisted of the following (in thousands):

| | June 30, 2011 | December 31, 2010 |
|------------------|----------------------|--------------------------|
| Raw materials | \$ 60,508 | \$ 62,026 |
| Work-in-progress | 2,051 | 507 |
| Finished goods | 17,618 | 26,435 |
| Total | \$ 80,177 | \$ 88,968 |

Other long-term assets consisted of the following (in thousands):

| | As of June 30, 2011 | | | As of December 31, 2010 | | |
|---------------------------------------|----------------------------|-------------------------------------|-----------------|--------------------------------|-------------------------------------|-----------------|
| | Gross | Accumulated Amortization | Net | Gross | Accumulated Amortization | Net |
| Developed technology (five years) | \$ 1,345 | \$ 1,039 | \$ 306 | \$ 1,070 | \$ 958 | \$ 112 |
| Customer relationships (five years) | 792 | 792 | | 792 | 792 | |
| Acquisition-related intangible assets | 2,137 | 1,831 | 306 | 1,862 | 1,750 | 112 |
| Technology licenses | 6,909 | 2,186 | 4,723 | 6,771 | 1,710 | 5,061 |
| Total | \$ 9,046 | \$ 4,017 | \$ 5,029 | \$ 8,633 | \$ 3,460 | \$ 5,173 |

The Company recorded amortization expense of \$304,000 and \$295,000 for the three months ended June 30, 2011 and 2010, respectively, and \$557,000 and \$604,000 for the six months ended June 30, 2011 and 2010, respectively. Other long-term assets are amortized on a straight-line basis over a period of three to five years. Estimated other long-term asset amortization expense for the remainder of the years ending December 31, 2011, 2012, 2013, and 2014 is \$527,000, \$1.5 million, \$1.6 million, \$1.2 million, \$214,000 and \$14,000, respectively. Amortization is estimated to be completed as of the end of 2016.

Accrued and other liabilities consisted of the following (in thousands):

| | June 30, 2011 | December 31, 2010 |
|---------------|----------------------|--------------------------|
| Payroll costs | \$ 9,207 | \$ 10,028 |
| Marketing | 527 | 568 |
| Other | 4,212 | 2,874 |
| Total | \$ 13,946 | \$ 13,470 |

Note 7 Special Charges

Special charges consisted of the following (in thousands):

Edgar Filing: STEC, INC. - Form 10-Q

| | For the Three Months Ended June 30, 2010 | For the Six Months Ended June 30, 2010 |
|---|---|---|
| Employee severance and termination benefits | \$ 30 | \$ 69 |
| Gain on assets held for sale | (12) | (117) |
| Total special charges | \$ 18 | \$ (48) |

During the first quarter of 2009, the Company commenced the first phase of a reduction in its workforce primarily at its Santa Ana, California headquarters as part of the transition of certain of its operations to its facility in Penang, Malaysia. During the second quarter of 2010, the Company commenced the second phase of a reduction in its workforce, which also primarily impacted its Santa Ana, California headquarters. The first and second phases of the reduction in its workforce were completed as of March 31, 2010 and December 31, 2010, respectively. In connection with the second phase of a reduction in its workforce the Company recorded charges for employee severance and termination benefits of approximately \$30,000 during the three months ended June 30, 2010. In connection with both the first and second phases of the reduction in its workforce the Company recorded charges for employee severance and termination benefits of approximately \$69,000 during the six months ended June 30, 2010, all of which was paid by December 31, 2010. The Company recorded gains on the sale of impaired assets of approximately \$12,000 and \$117,000 during the three and six months ended June 30, 2010, respectively.

Table of Contents**STEC, INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The Company recognizes a liability for restructuring costs at fair value only when the liability is incurred. The two main components of the Company's restructuring plan have been related to workforce reductions and asset impairments. Workforce-related charges are accrued when it is determined that a liability has been incurred, which is deemed to be after individuals have been notified of their termination dates and expected severance benefits.

Note 8 Discontinued Operations

On February 9, 2007, the Company entered into an Asset Purchase Agreement (Purchase Agreement) with Fabrik, Inc. (Fabrik) and Fabrik Acquisition Corp. (together with Fabrik, the Purchasers) for the sale of assets relating to a portion of the Company's business which was engaged in the design, final assembling, sale, marketing and distribution of consumer-oriented products based on Flash memory, DRAM technologies and external storage solutions known as the Consumer Division of the Company. The consideration paid to the Company pursuant to the Purchase Agreement consisted of cash in the amount of approximately \$43.0 million. The purchase price was subject to a post-closing adjustment for accrued expenses, reserves on inventory, reserves on accounts receivable and overhead capitalization of the Consumer Division (Purchase Price Adjustment). Subsequent to the closing of the sale, the Purchasers disputed certain amounts calculated by the Company in regards to the Purchase Price Adjustment. The original claim amount was approximately \$6.7 million. In accordance with the Purchase Agreement, both parties agreed to resolve their Purchase Price Adjustment disputes through a third-party arbitrator. During the arbitration proceeding, the Purchasers conceded approximately \$4.0 million of their original disputed amounts. In January 2008, the arbitrator rejected substantially all of the Purchasers' claims. In March 2010, Fabrik filed a petition to confirm the January 2008 arbitration ruling, claiming it was owed an additional \$486,784 plus accrued interest from the Company. In April 2010, the Company filed a response to the petition defending its position that Fabrik was seeking additional amounts outside of the arbitration ruling and was time barred from its attempt to modify or correct the arbitration award. In May 2010, Fabrik withdrew its petition and the parties satisfactorily resolved their dispute in July 2010.

Operating results of the Consumer Division, which are accounted for as discontinued operations, for the three and six months ended June 30, 2010, are summarized as follows (in thousands):

| | For the Three Months Ended June 30, 2010 | For the Six Months Ended June 30, 2010 |
|-----------------------------------|---|---|
| Net revenues | \$ | \$ |
| Loss from discontinued operations | (258) | (258) |
| Benefit for income taxes | 108 | 108 |
| Loss from discontinued operations | \$ (150) | \$ (150) |

Note 9 Commitments and Contingencies***Class Action Litigation***

From November 6, 2009 through March 2, 2010, seven purported class action complaints were filed against the Company and several of its senior officers and directors in the United States District Court for the Central District of California. The Court consolidated the complaints and appointed Lead Plaintiffs. The Court did not consider the sufficiency of Lead Plaintiff's initial consolidated complaint and instead replaced the former Lead Plaintiffs with a new Lead Plaintiff. The new Lead Plaintiff filed a consolidated amended complaint that the Court dismissed without prejudice. Thereafter, the new Lead Plaintiff filed a second amended complaint, purportedly on behalf of all persons and entities who acquired the Company's common stock between June 16, 2009 and February 23, 2010. The second amended complaint alleges claims against the Company and several of its senior officers and directors for violations of Section 10(b) of the Securities and Exchange Act of 1934 (the

Exchange Act) and Rule 10b-5 thereunder, and claims against several of its senior officers and directors for violations of Section 20A and Section 20(a) of the Exchange Act. In addition, the second amended complaint alleges claims against the Company, several of its senior officers and directors, and four of its underwriters for violations of Section 11 and Section 12(a)(2) of the Securities Act of 1933 (the Securities Act), and claims against several of the Company's senior officers and directors for violations of Section 15 of the Securities Act. The second amended

Edgar Filing: STEC, INC. - Form 10-Q

complaint seeks compensatory damages for all damages sustained as a result of the defendants' alleged actions and further seeks reasonable costs and expenses, rescission, counsel fees, and other relief the Court deems just and proper. The defendants filed a motion to dismiss and on June 17, 2011, the court entered an order granting the underwriters' motion to dismiss the Securities Act claims without prejudice and denying the Company's motion to dismiss the Exchange Act claims. The Company believes the lawsuit is without merit and intends to vigorously defend itself. No amounts have been recorded in the consolidated financial statements for this matter as the Company believes it is too early in the proceedings to determine an outcome.

Table of Contents**STEC, INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

On July 1, 2011, a purported class action complaint was filed against the Company and several of its senior officers and directors in the Superior Court of Orange County, California. The complaint alleges claims against the Company, several of its senior officers and directors, and four of its underwriters for violations of Section 11 and Section 12(a)(2) of the Securities Act, and further alleges claims against several of the Company's senior officers and directors for violations of Section 15 of the Securities Act. The complaint, which arises out of the same underlying factual allegations as the federal court class action discussed above, seeks compensatory damages and rescission or a rescissory measure of damages where applicable, reasonable costs and expenses, including counsel fees and expert fees, and other relief the Court may deem just and proper. The Company has not yet filed its response to the new state court class action complaint. The Company believes the lawsuit is without merit and intends to vigorously defend itself. No amounts have been recorded in the consolidated financial statements for this matter as the Company believes it is too early in the proceedings to determine an outcome.

Shareholder Derivative Litigation

From November 12, 2009 through December 3, 2009, four shareholder derivative actions were filed purportedly on the Company's behalf against several of its senior officers and directors in the Superior Court of Orange County, California. These cases were consolidated and have been stayed until further order by the Court. Despite the stay, the Company and the individual defendants each filed demurrers to the consolidated complaint on July 28, 2010, pursuant to court order. At a status conference on June 13, 2011, the Superior Court left the stay in place. Additionally, two shareholder derivative actions were filed purportedly on the Company's behalf against several of its senior officers and directors in the United States District Court for the Central District of California. These two federal lawsuits were consolidated on April 13, 2010, and stayed by order of the Court until a ruling was made on the defendants' motions to dismiss the second amended complaint in the federal securities class action lawsuit. The consolidated complaints in both the state and federal actions allege claims for breach of fiduciary duties for insider selling and misappropriation of information, abuse of control, gross mismanagement, waste of corporate assets, unjust enrichment and violations of the California Corporations Code (with respect to the state court action only) related to allegedly false and misleading statements regarding the Company's business and alleged illegal stock sales. The shareholder derivative actions generally seek compensatory damages for all alleged losses sustained as a result of the defendants' alleged actions, including interest, reasonable costs and expenses, corporate governance reforms, disgorgement of profits, treble damages (with respect to the state court action only), equitable relief (with respect to the federal court action only), and other relief as the Court may deem just and proper. No amounts have been recorded in the consolidated financial statements for these matters as the Company believes it is too early in the proceedings to determine an outcome.

Shareholder Demand

From January 5, 2010 through August 2, 2010, the Company received letters from counsel for four purported shareholders demanding that the Company take action to remedy breaches of fiduciary duties by several of its senior officers and directors. The allegations in these letters are similar to those found in the shareholder derivative complaints filed in state and federal court, and demand that the Company take action to recover damages from its senior officers and directors and to correct alleged deficiencies in its internal controls. The demand letters state that if, within a reasonable time, the Company's board of directors has not commenced the requested action, or if the board of directors refuses to commence the requested action, the named shareholders will commence derivative actions. In evaluating the demand letters, the independent members of the Company's board of directors conducted a review of the issues and allegations raised by the purported shareholders. After considering a number of factors, including the legal and factual merits of the claims made in the demand letters, the independent members of the Company's board of directors unanimously determined that it would not be in the Company's best interests to pursue the claims alleged in the demand letters against any of the individuals mentioned therein. This determination was formally communicated to counsel for the four purported shareholders on December 17, 2010. Counsel for two of the purported shareholders responded by letter dated July 13, 2011, further demanding that the Company take action to remedy alleged breaches of fiduciary duties by several of its senior officers and directors. The independent members of the Company's board of directors are evaluating this July 13, 2011 letter.

Other Legal Proceedings

As first disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2009, the United States Securities and Exchange Commission (SEC) is conducting a formal investigation involving trading in the Company's securities. The Company and certain of the Company's officers and employees, including its CEO and President, have received subpoenas in connection with the SEC's investigation. The Company is fully cooperating with the SEC in regards to this matter. On July 19, 2011, the Company received a Wells Notice from the SEC, stating that the Staff of the SEC (the Staff) is considering recommending that the SEC initiate a civil injunctive action against the

Edgar Filing: STEC, INC. - Form 10-Q

Company, its CEO and President, charging them with violations of the antifraud and reporting provisions of the federal securities laws. Under a

Table of Contents**STEC, INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

process established by the SEC, the Company, its CEO and President have the opportunity to submit to the Staff any reasons of law, policy or fact why they believe that the civil action should not be brought (a Wells Submission) before the Staff makes its formal recommendation to the SEC regarding what action, if any, should be brought. The Company, its CEO and President intend to continue to cooperate with the SEC to attempt to resolve the Staff's concerns, but there can be no assurance that the SEC will decide not to bring an action against them.

The Company is involved in other suits and claims in the ordinary course of business, and the Company may from time to time become a party to other legal proceedings arising in the ordinary course of business.

As is common in the industry, the Company currently has in effect a number of agreements in which it has agreed to defend, indemnify and hold harmless certain of its suppliers and customers from damages and costs which may arise from the infringement by the Company's products of third-party patents, trademarks or other proprietary rights. In addition, the Company has entered into indemnification agreements with its directors and certain of its officers that will require the Company, among other things, to indemnify them against certain liabilities that may arise by reason of their status or service as directors or officers. The Company maintains director and officer insurance, which may cover certain liabilities arising from its obligation to indemnify its directors and officers in certain circumstances. It is not possible to determine the maximum potential amount under these indemnification agreements due to the limited history of prior indemnification claims and the unique facts and circumstances involved in each particular agreement. Further, such indemnification agreements may not be subject to maximum loss clauses. The scope of such indemnity varies, but may, in some instances, include indemnification for damages and expenses, including attorneys' fees. The term of these indemnification agreements is generally perpetual any time after execution of the agreement. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited. The Company has never incurred significant costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, and after consideration of the Company's current director and officer insurance coverage, the Company believes the estimated fair value of these agreements is minimal. Accordingly, the Company has no liabilities recorded for these agreements as of June 30, 2011.

Note 10 Credit Facility

On November 23, 2009, the Company's subsidiary, STEC Malaysia, entered into an agreement for a short-term credit facility (the Short-term Facility) with Deutsche Bank (Malaysia) Berhad. The agreement allows STEC Malaysia to borrow an aggregate principal amount of \$10 million in the form of letters of credit, trust receipts, bills acceptances/financing, banker's acceptances, and banker's and shipping guarantees which are commonly used to conduct business in Asia. Credit under the Short-term Facility will be available until notice of termination by either party. Borrowings under the Short-term Facility will bear interest at various rates with repayments due between 30 days and 14 months, depending on the form of borrowing. The Short-term Facility is guaranteed by STEC, Inc. and contains customary affirmative and negative covenants. As of June 30, 2011, there was approximately \$200,000 of banker's guarantees outstanding under the Short-term facility and STEC Malaysia was in compliance with all required covenants. The purpose of the Short-term Facility is to facilitate general business transactions and fund working capital requirements for STEC Malaysia, on an as-needed basis.

Note 11 Shareholders Equity

The 2000 Stock Incentive Plan (the 2000 Plan) was adopted by the Company's board of directors and approved by its shareholders in June 2000. On April 17, 2006, the 2000 Plan was amended and restated by the board of directors and approved by the Company's shareholders on May 25, 2006. The 2000 Plan provided for the direct issuance or sale of shares and the grant of options to purchase shares of the Company's common stock to officers and other employees, non-employee board members and consultants. Under the 2000 Plan, eligible participants were granted options to purchase shares of common stock at an exercise price not less than 100% of the fair market value of those shares on the grant date. In addition, the 2000 Plan as amended and restated, allowed for the issuance of restricted stock units to officers and other employees, non-employee board members and consultants. The 2000 Plan expired pursuant to its terms on February 28, 2010, and no further shares may be issued under the 2000 Plan.

The 2010 Incentive Award Plan (the 2010 Plan) was adopted by the Company's board of directors on March 26, 2010, and was approved by its shareholders on May 27, 2010. The 2010 Plan provides for the direct issuance or sale of shares and the grant of options to purchase shares of the Company's common stock to officers and other employees, non-employee board members and consultants. On May 19, 2011, the Company's shareholders approved an amendment to the 2010 Plan to increase the number of shares reserved for issuance thereunder by 2,000,000 shares to

Edgar Filing: STEC, INC. - Form 10-Q

6,600,000 shares. The other terms and conditions of the 2010 Plan were not changed. Under the 2010 Plan, eligible individuals may be granted options to purchase shares of common stock at an exercise price not less than 100% of the fair market value of those shares on the grant date. Other types of equity awards that may be granted under the 2010 Plan include performance awards, dividend equivalents,

Table of Contents**STEC, INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

deferred stock units, stock payments, restricted stock, restricted stock units, stock appreciation rights and other incentive awards. The Company's board of directors, its compensation committee, or its equity awards committee determines the eligibility and vesting schedules for awards granted under the 2010 Plan. Options expire within a period of not more than ten years from the date of grant. Restricted stock units are share awards that entitle the holder to receive shares of the Company's common stock upon vesting.

As of June 30, 2011, the 2010 Plan provided for the issuance of up to 3,469,788 shares of common stock.

During the six months ended June 30, 2011, options for the purchase of 579,400 shares at a weighted-average option price of \$16.36 per share, with annual vesting of 25%, were awarded pursuant to the 2010 Plan. The contractual lives of 2011 awards are consistent with those of prior years. The per share fair values of the options granted in the six months ended June 30, 2011 were estimated with the following weighted average assumptions:

| | |
|-------------------------|-------|
| Expected term (years) | 5.8 |
| Risk-free interest rate | 2.2% |
| Volatility | 67.0% |
| Dividend rate | 0.0% |

The weighted average per share grant date fair value of options granted in the first six months of 2011 was \$9.94.

During the six months ended June 30, 2011, the Company issued 180,813 restricted stock units with a grant fair value per share determined by the closing price of the common stock on the issuance date. Each unit represents the right to receive one share of the Company's common stock as each restricted stock unit vests. The weighted average per share grant date fair value of restricted stock units granted in the first six months of 2011 was \$17.45.

Restricted stock units that vested during the three and six months ended June 30, 2011 had a fair value of \$2.8 million as of the vesting date. Of the 172,174 restricted stock units that vested during the six months ended June 30, 2011, 124,838 were net-share settled such that the Company withheld shares with value equivalent to the employees' minimum statutory obligation for the applicable income and other employment taxes. The number and value of the shares withheld were 48,384 shares and \$807,000, respectively, during the three and six months ended June 30, 2011. The value of the total shares was based on the value of the restricted stock units on their vesting date as determined by the Company's closing stock price. Total payments for the employees' tax obligations to the tax authorities were \$23,000 and are reflected as a financing activity within the Consolidated Statements of Cash Flows. These net-share settlements had the effect of share repurchases by the Company as they reduced and retired the number of shares that would have otherwise been issued as a result of the vesting and did not represent an expense to the Company.

Options to purchase 4,722,000 and 4,515,000 shares of common stock were outstanding as of June 30, 2011 and 2010, respectively. In addition, 1,053,000 and 646,000 restricted stock units payable in shares of common stock were outstanding as of June 30, 2011 and 2010, respectively.

As of June 30, 2011, total unrecognized compensation expense related to unvested option-based compensation arrangements already granted under the 2000 Plan and the 2010 Plan was approximately \$22.8 million, which the Company expects to recognize over a weighted-average period of 2.7 years.

As of June 30, 2011, total unrecognized compensation expense related to unvested restricted stock units already granted under the 2000 Plan and the 2010 Plan was approximately \$14.3 million, which the Company expects to recognize over a weighted average period of 3.2 years.

Table of Contents**STEC, INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following table sets forth the total stock-based compensation expense resulting from stock options and restricted stock units included in the Company's unaudited condensed consolidated statements of operations (in thousands):

| | For the Three Months Ended | | For the Six Months | |
|---|----------------------------|-----------------|--------------------|-----------------|
| | June 30, | | Ended | |
| | 2011 | 2010 | 2011 | 2010 |
| Cost of revenues | \$ 138 | \$ 101 | \$ 237 | \$ 192 |
| Sales and marketing | 543 | 396 | 1,012 | 769 |
| General and administrative | 1,212 | 764 | 2,211 | 1,455 |
| Research and development | 1,346 | 918 | 2,550 | 1,616 |
| Total stock-based compensation expense | \$ 3,239 | \$ 2,179 | \$ 6,010 | \$ 4,032 |

During the six months ended June 30, 2011, the Company received \$2.8 million in cash proceeds for the exercise of 424,107 options and \$1.7 million for excess tax benefits from share-based payment arrangements.

From time to time, the Company's board of directors has authorized various programs to repurchase shares of its common stock depending on market conditions and other factors. In November 2009, the board of directors authorized a share repurchase program effective November 10, 2009, enabling the Company to repurchase up to \$75 million of its common stock over an 18-month period that expired on May 9, 2011. The Company did not make any share repurchases under this plan during 2011.

Note 12 New Accounting Pronouncements

The Company has implemented all new accounting pronouncements that are in effect and that may impact its consolidated financial statements and does not believe that there are any other new accounting pronouncements that have been issued that might have a material impact on its consolidated financial statements.

Table of Contents**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS*****Cautionary Statement***

Certain statements in this Quarterly Report on Form 10-Q are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 21E of the Securities Exchange Act of 1934, as amended, and Section 27A of the Securities Act of 1933, as amended. These forward-looking statements often can be, but are not always, identified by the use of words such as anticipate, assume, believe, could, estimate, expect, goal, intend, may, might, plan, potential, predict, project, should, and similar expressions, or the like, and other expressions. They include, but are not limited to: statements regarding our revenue growth initiatives; growing acceptance, adoption and qualification of solid-state drives (SSDs) within the enterprise-storage and enterprise-server markets; the evolving storage industry; changes in the average selling prices of our products; the loss of, or reduction in sales to, any of our key customers; our ability to deliver new and enhanced products on a timely basis; statements concerning customer adoption and utilization of our technologies and solutions; the capabilities and performance of our products; the adoption of our products into new applications; our sales, operating results and anticipated cash flows; our ability to forecast customer demand; the availability of certain components in our products that we obtain from a limited number of suppliers; competition from other companies in our industry; changes in political and economic conditions and local regulations, particularly outside of the United States; our ability to protect our intellectual property rights; and fluctuations in foreign currency exchange rates.

We base these forward-looking statements on our current expectations and projections about future events, our assumptions regarding these events and our knowledge of facts at the time the statements are made. These forward-looking statements are subject to various risks and uncertainties, including those described in this Quarterly Report on Form 10-Q under the heading Risk Factors and in other filings we make from time to time with the U.S. Securities and Exchange Commission (SEC). Some of these risks and uncertainties may be outside our control and our actual results could differ materially from our projected results. Please see our most recent Annual Report on Form 10-K and the information contained in our subsequent SEC filings for a further discussion of these and other risks and uncertainties applicable to our business. We are not able to predict all of the factors that may affect future results. Forward-looking statements speak only as of the date of this Quarterly Report on Form 10-Q. Except as required by applicable laws or regulations, we do not undertake any obligation to update or revise any forward-looking statement, whether as a result of new information, future events or otherwise.

The following discussion should be read in conjunction with our unaudited condensed consolidated financial statements and notes thereto included elsewhere in this Quarterly Report on Form 10-Q.

Overview

STEC, Inc. (collectively with our subsidiaries, is referred to in this Report as STEC , we , our and us) is a leading global provider of SSDs that are designed specifically for enterprise systems and applications that require high input and output (IO) capabilities with low latencies for fast access to critical user data.

We design and develop our SSD controllers, enhance them with proprietary firmware and combine them with multi-sourced NAND Flash media to form high-performance SSDs, which provide a level of IO performance not currently possible with traditional hard disk drives (HDDs). We sell our SSDs to leading global enterprise hardware original equipment manufacturers (OEMs), which integrate them into products used in a variety of industries including cloud computing, financial services, virtualization, Web 2.0, government, transportation, defense, e-commerce, and healthcare. We also manufacture small form factor Flash-based SSDs, cards and modules, as well as custom high density dynamic random access memory (DRAM) modules for networking, communications and industrial applications. We are headquartered in Santa Ana, California and have operations in Penang, Malaysia. We also have sales and engineering offices located in Europe and Asia.

We market our products primarily to OEMs and OEM distributors, leveraging our custom design capabilities to offer memory solutions to address their specific needs.

We are focusing on certain revenue growth initiatives, including:

Continuing to develop and qualify customized SSDs, including our ZeusIOPS® and MACH-class of products;

Expanding our product portfolio to include software offerings;

Edgar Filing: STEC, INC. - Form 10-Q

Adding new PCIe-based solid-state accelerator products; and

Exploring new market opportunities that leverage our core SSD expertise.

Table of Contents

Over the past several years, we have expanded our custom design capabilities of Flash-based products for OEM applications. We have invested significantly in the design and development of customized Flash controllers, firmware and hardware. Prior strategic acquisitions also have enabled us to improve our Flash controller design capabilities, expand our product offerings, add intellectual property to our technology portfolio and enhance our capabilities to use third-party controllers.

Operating Results Volatility

In prior periods, we have experienced volatility in our quarterly operating results and we expect this trend to continue for several reasons. First, the majority of our sales are currently being generated from one product line (ZeusIOPS®) and a significant amount of our revenues are concentrated within a small number of customers. A loss or reduction of sales to any one of our major customers or a decrease in demand for our ZeusIOPS® products, may negatively impact our revenues on a quarterly basis. Moreover, substantially all of our sales are transacted through individual customer purchase orders as opposed to long-term contractual commitments. Each customer purchase order is unique and stands on its own and there is no assurance that we will be able to obtain additional purchase orders under the same terms and dollar commitment levels with these customers in future quarters. As a result, it is difficult to forecast our customers' demand as purchases in one period may not be indicative of purchases in future periods. In addition, the enterprise SSD market is relatively new and rapidly evolving with new competitors entering our markets. Many of these competitors are large, conglomerate businesses with considerable resources. Currently, we are facing competition from SSD suppliers with lower-cost, lower performance SATA-based drives with a connectivity bridge to a SAS or FC interface. These lower cost alternatives have been gaining traction, which has resulted in a decrease of our market share at certain customers despite the performance and latency advantages of our ZeusIOPS® drives. Furthermore, we believe that competitive SAS-based SSDs are in the process of being qualified or in some cases have already been qualified at certain of our customers, which may lead to a reduction in orders of our ZeusIOPS® SAS-based SSDs. Until we can further diversify our customer base and product offerings, we believe that these factors and quarterly operating results volatility will continue to impact our business for the foreseeable future.

Flash-based Products

Flash-based product revenue was \$79.2 million and \$48.6 million in the second quarter of 2011 and 2010, respectively. The quarterly increase in Flash-based product revenues was due primarily to a \$28.3 million increase in Flash-based product sales to five customers. Sales of Flash-based products represented 96% and 79% of our total revenues in the second quarter of 2011 and 2010, respectively.

A significant development in enterprise SSDs is the use of Multi-Level Cell (MLC) Flash, which is more cost-effective than Single Level Cell (SLC) Flash. Incorporating MLC Flash into SSDs is an increasingly important factor driving adoption of SSDs within the enterprise-storage market given the growing need for cost-effective, high-performance enterprise-storage solutions. Our MLC-based SSDs are enhanced by our proprietary technologies, including our CellCare technology, which increases endurance of MLC Flash to meet enterprise life requirement levels and our Secure Array of Flash Elements™ (S.A.F.E.) technology, which provides added data reliability. Our MLC-based SSDs also use our proprietary controller technology to achieve fast write speeds and improved performance.

A major area of our overall research and development investment has been applied to developing and advancing our SSD technologies. We believe the advantages of SSDs are currently being defined in several distinct markets including: a) enterprise-storage applications, b) enterprise-server applications, and c) government, defense and industrial applications. We see opportunities to leverage our SSD expertise across each of these markets where we believe our technology can outperform existing HDD solutions.

In April 2011, we acquired certain assets of Knowledge Quest Infotech Private Limited (KQI), a software development company based in Pune, India. The portfolio of acquired assets includes KQI's intellectual property rights. In addition, we hired approximately 30 key employees of KQI to augment our existing software development team. The acquisition of certain assets of KQI was not material to our historical consolidated financial position, results of operations or cash flows. We believe that this acquisition will provide us with additional system design, storage software and virtualization expertise to leverage our existing development of SSD solutions. We expect to continue to make strategic investments to advance our product portfolio.

Although the enterprise Flash-based SSD market is relatively new, evolving and difficult to predict, we are encouraged by the variety of applications that our SSDs are able to support. As more of our customers and end-users experience the benefits of SSD technology, we believe that adoption will continue to expand. The increased use of data-tiering software by storage OEMs is also helping to increase SSD adoption as the combination of data-tiering software and SSDs enhance the overall performance level of enterprise-storage systems. In addition, we previously employed certain marketing programs and sales initiatives on a selective basis with our customers in an effort to help accelerate the adoption of our SSD products.

Table of Contents

DRAM Products

We also offer both monolithic DRAM modules and DRAM modules based on our proprietary stacking technology. We derived \$3.0 million and \$12.7 million in revenues from the sale of DRAM products during the second quarter of 2011 and 2010, respectively. Sales of DRAM products represented 4% and 21% of our total revenues in the second quarter of 2011 and 2010, respectively. The quarterly decrease in sales of DRAM products in absolute dollars was due primarily to a decrease in product sales to a single customer. Since our revenue growth initiatives are focused on sales of our SSDs and sales of our DRAM products are made to a limited number of customers, we expect this variability will continue in the future.

Malaysia Income Tax Holiday

As an incentive to establish operations in Malaysia, we were provided a fifteen-year income tax holiday and certain grants by the Malaysian government subject to meeting certain conditions. This income tax holiday in Malaysia was effective through September 30, 2022. In May 2011, the Company accepted an additional incentive package from the Malaysian government as part of its plan to establish a research and development center in Malaysia. This incentive package includes a five-year extension through September 30, 2027 of the existing income tax holiday term and certain research and development grants. The impact of the Malaysia income tax holiday decreased the provision for income taxes by \$1.9 million or \$0.04 per share during the second quarter of 2011, and decreased the provision for income taxes by \$980,000 or \$0.02 per share in the second quarter of 2010.

Customers

Historically, a limited number of customers have accounted for a significant percentage of our revenues. Our ten largest customers accounted for an aggregate of 90.6% of our revenues during the first six months of 2011, compared to 83.0% of our revenues during the first six months of 2010, and 89.3% of our revenues during the second quarter of 2011, compared to 87.7% of our revenues during the second quarter of 2010. See Note 2, Sales Concentration, to our unaudited consolidated financial statements for a breakdown of customers accounting for more than 10% of our total revenues during the first six months of 2011 and 2010, respectively, and during the second quarter of 2011 and 2010, respectively. With certain exceptions, sales of our products are generally made through individual purchase orders and, in certain cases, are made under master agreements governing the terms and conditions of the customer relationships.

We expect that sales of our products to a limited number of customers will continue to account for a majority of our revenues in the foreseeable future and believe that our financial results will depend in significant part upon the success of our customers. The composition of our major customer base changes from quarter to quarter as the market demand for our products changes, and we expect this variability will continue in the future. The loss of, or a significant reduction in purchases by, any of our major customers would harm our business, financial condition and results of operations. See Item 1A, Risk Factors Historically, sales to a limited number of customers, particularly EMC Corporation, have comprised a significant portion of our revenues and the loss of, or significant reduction in purchases by, any key customer could materially impact our financial results.

During March 2011, an earthquake and tsunami in northeastern Japan caused considerable damage to the country's infrastructure. While we have not sustained significant disruptions in our ability to procure components for our products due to these events in Japan, some of our customers experienced direct or indirect disruptions in their supply chains which affected their ability to manufacture and sell their products to their end-user customers. As a result, some customers were unable to obtain a sufficient supply of components required for their end products and canceled orders for our products, which negatively impacted our second quarter results. See Item 1A, Risk Factors Business interruptions could substantially harm our business.

Table of Contents**Revenues by Geographic Region**

Sales, which are derived from billings to customers, by geographic region are presented as a percentage of total revenues as follows:

| | For the Three Months Ended June 30, | | For the Six Months Ended June 30, | |
|----------------|-------------------------------------|-------------|-----------------------------------|-------------|
| | 2011 | 2010 | 2011 | 2010 |
| United States | 28% | 44% | 31% | 38% |
| Singapore | 39% | 16% | 43% | 19% |
| Czech Republic | 20% | 11% | 15% | * |
| Malaysia | * | 16% | * | 21% |
| Other | 13% | 13% | 11% | 22% |
| Total | 100% | 100% | 100% | 100% |

* Less than 10%

No other single foreign country accounted for more than 10% of revenues during the three and six months ended June 30, 2011 and 2010.

Sales billed to customers in Singapore increased due primarily to an increase in product sales to two customers, sales billed to customers in the Czech Republic increased due primarily to an increase in product sales to a single customer and sales billed to customers in Malaysia decreased due primarily to a decrease in product sales to a single customer.

Substantially all of our foreign sales are shipped internationally through our facility in Malaysia. For additional information regarding our international sales, see Item 1A, Risk Factors We face risks associated with doing business in foreign countries, including foreign currency fluctuations and trade barriers, that could lead to a decrease in demand for our products or an increase in the cost of the components used in our products.

Seasonality

In the past, we have had and expect to continue to experience some seasonality in our business resulting in higher sales generally in the fourth quarter of each year due to corporate customers seeking to spend their full capital budgets before the end of each year. Due to the volatility of our business, concentration of our customers and limited adoption of SSDs in our markets, seasonality may not always apply.

Results of Operations

The following table sets forth, for the periods indicated, certain consolidated statement of operations data reflected as a percentage of revenues.

| | Three Months Ended June 30, | | Three Months | Six Months Ended June 30, | |
|----------------------------|-----------------------------|--------|----------------------|---------------------------|--------|
| | 2011 | 2010 | Ended March 31, 2011 | 2011 | 2010 |
| Net revenues | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |
| Cost of revenues | 55.3 | 57.4 | 57.6 | 56.5 | 60.8 |
| Gross profit | 44.7 | 42.6 | 42.4 | 43.5 | 39.2 |
| Operating expenses: | | | | | |
| Sales and marketing | 7.3 | 7.9 | 6.0 | 6.6 | 8.6 |
| General and administrative | 9.6 | 11.6 | 7.8 | 8.6 | 14.0 |
| Research and development | 15.8 | 16.9 | 12.6 | 14.1 | 20.0 |
| Special charges | 0.0 | 0.0 | 0.0 | 0.0 | (0.1) |

Edgar Filing: STEC, INC. - Form 10-Q

| | | | | | |
|--------------------------|------|------|------|------|-------|
| Total operating expenses | 32.7 | 36.4 | 26.4 | 29.3 | 42.5 |
| Operating income (loss) | 12.0 | 6.2 | 16.0 | 14.2 | (3.3) |
| Other income | 0.1 | 0.9 | 0.0 | 0.0 | 0.4 |

| | | | | | |
|--|-------|------|-------|-------|--------|
| Income (loss) from continuing operations before income taxes | 12.1% | 7.1% | 16.0% | 14.2% | (2.9)% |
|--|-------|------|-------|-------|--------|

Comparison of Three Months Ended June 30, 2011 to Three Months Ended June 30, 2010

Net Revenues. Our revenues increased 35% from \$61.3 million in the second quarter of 2010 to \$82.5 million in the second quarter of 2011 due primarily to a 63% increase in Flash-based product sales from \$48.6 million in the second quarter of 2010 to \$79.2 million in the second quarter of 2011, partially offset by a 76% decrease in sales of DRAM products from \$12.7 million in the second quarter of 2010 to \$3.0 million in the second quarter of 2011. Within Flash-based product sales, shipments of our ZeusIOPS® SSDs into the enterprise-storage market increased 79% from \$34.7 million in the second quarter of 2010 to \$62.1 million in the second quarter of 2011. The quarterly increase in Flash-based product revenues was due primarily to a \$28.3 million increase in Flash-based product sales to five customers. The quarterly decrease in sales of DRAM products was due primarily to a decrease in product sales to a single customer.

Table of Contents

Our reported revenues are net of reserves for price protection, sales returns and sales and marketing incentives. With certain exceptions, sales of our products are generally made through individual purchase orders and, in certain cases, are made under master agreements governing the terms and conditions of the customer relationships. Some customers may have the ability to change, cancel or delay orders with limited or no penalties. In the absence of a non-cancellable customer supply agreement, our ability to predict future sales is limited because a majority of our quarterly product revenues come from orders that are received just prior to or within the same quarter. In addition, our SSDs are currently offered as options in our customers' systems. Therefore, the demand for these SSDs is unpredictable and fully dependent on end-user requirements. Unless and until our SSDs are offered as a standard feature in our customers' systems, our demand visibility will continue to be limited.

Gross Profit. Our gross profit was \$36.8 million in the second quarter of 2011, compared to \$26.1 million in the same period in 2010. Gross profit as a percentage of revenues was 44.7% in the second quarter of 2011, compared to 42.6% in the second quarter of 2010. The increase in gross profit in absolute dollars and as a percentage of revenue was due primarily to a 63% increase in sales of higher margin Flash-based products and a \$620,000 decrease in write-downs of our inventory related to obsolescence, excess quantities and declines in market value below our costs.

Sales and Marketing. Sales and marketing expenses are primarily comprised of payroll and payroll-related expenses for our domestic and international sales and marketing employees and expenses for trade shows. Sales and marketing expenses increased 27% from \$4.8 million in the second quarter of 2010 to \$6.1 million in the second quarter of 2011. Sales and marketing expenses as a percentage of revenue decreased from 7.9% in the second quarter of 2010 to 7.3% in the second quarter of 2011. The increase in sales and marketing expenses in absolute dollars was due primarily to a \$670,000 increase in commissions as the result of higher revenues for the second quarter of 2011 and a \$420,000 increase in payroll and payroll-related costs due to an increase in employee headcount and higher stock-based compensation. The decrease in sales and marketing expenses as a percentage of revenues was due primarily to the fixed nature of certain sales costs such as payroll and payroll-related expenses, excluding sales commissions, and the increase in revenues in the second quarter of 2011 compared to the second quarter of 2010.

General and Administrative. General and administrative expenses are comprised primarily of personnel costs for our executive and administrative employees, professional fees and facilities overhead. General and administrative expenses increased from \$7.1 million in the second quarter of 2010 to \$7.9 million in the second quarter of 2011. General and administrative expenses as a percentage of revenues decreased from 11.6% in the second quarter of 2010 to 9.6% in the second quarter of 2011. The increase in general and administrative expenses in absolute dollars was due primarily to a \$930,000 increase in payroll and payroll-related costs due to an increase in employee headcount and stock-based compensation. The decrease in general and administrative expenses as a percentage of revenues was due primarily to the fixed nature of certain general and administrative costs such as payroll and payroll-related expenses and the increase in revenues in the second quarter of 2011 compared to the second quarter of 2010.

Research and Development. Research and development expenses are comprised primarily of personnel costs for our engineering staff, product design consulting fees and material costs related to new product designs. Research and development expenses increased 25% from \$10.4 million in the second quarter of 2010 to \$13.0 million in the second quarter of 2011. Research and development expenses as a percentage of revenues decreased from 16.9% in the second quarter of 2010 to 15.8% in the second quarter of 2011. The increase in research and development expenses in absolute dollars was due primarily to an increase in payroll and payroll-related costs from an increase in research and development employee headcount from 251 as of June 30, 2010 to 339 as of June 30, 2011, as the result of our expanding global research and development efforts. The decrease in research and development expenses as a percentage of revenues was due primarily to the fixed nature of certain research and development costs such as payroll and payroll-related expenses and the increase in revenues in the second quarter of 2011 compared to the second quarter of 2010.

Special Charges. Special charges consisted of approximately \$30,000 in employee severance and termination benefits and approximately \$12,000 related to a gain on the sale of previously impaired assets in the second quarter of 2010. There were no special charges in the second quarter of 2011.

During the first quarter of 2009, we commenced the first phase of a reduction of our workforce primarily at our Santa Ana, California headquarters as part of the transition of certain of our operations to our facility in Penang, Malaysia. During the second quarter of 2010, we commenced the second phase of a reduction in our workforce, which also primarily impacted our Santa Ana, California headquarters. The first and second phases of the reduction in our workforce were completed as of March 31, 2010 and December 31, 2010, respectively.

Other Income. Other income was \$90,000 in the second quarter of 2011 and was comprised of interest earned on our cash and cash equivalents and gains from foreign currency transactions. Other income was \$523,000 in the second quarter of 2010 and was comprised of government grant income received from the Malaysian government authority for qualified research and development expenses, interest earned on our cash, cash equivalents, and short-term investments, partially offset by losses on foreign currency transactions.

Table of Contents

Provision (Benefit) for Income Taxes. We recorded a provision for income taxes of \$298,000 and \$1.4 million in the second quarter of 2011 and 2010, respectively. Our effective tax rate decreased from 32.6% in the second quarter of 2010 to 3.0% in the second quarter of 2011 due primarily to a change in the revenue composition, which resulted in increased international sales and earnings in jurisdictions outside of the U.S. that were taxed at rates lower than U.S. federal statutory rates. The decrease was also due to federal research and development tax credits of \$195,000 from which we received benefits in the second quarter of 2011 but did not receive benefits in the second quarter of 2010 because the federal government had not yet extended the tax credits to be effective for 2010 as of June 30, 2010. In December 2010, the federal government retroactively applied the research and development tax credits for the full year 2010 and extended them through December 31, 2011. We operate under an income tax holiday in Malaysia, which is effective through September 30, 2027 subject to meeting certain conditions. The impact of the Malaysia income tax holiday decreased our provision for income taxes by \$1.9 million and \$980,000 in the second quarter of 2011 and 2010, respectively. The benefit of the income tax holiday on earnings per share was \$0.04 and \$0.02 for the second quarter of 2011 and 2010, respectively.

Income from Continuing Operations. Income from continuing operations was \$9.7 million and \$2.9 million in the second quarter of 2011 and 2010, respectively. The quarterly increase in income from continuing operations was due primarily to a \$10.7 million increase in gross profit and a \$1.1 million decrease in the provision for income taxes, partially offset by a \$4.7 million increase in operating expenses.

Loss from Discontinued Operations. As the result of the sale of the assets of our Consumer Division on February 9, 2007, the Consumer Division is reflected as discontinued operations. Loss from discontinued operations was \$150,000 in the second quarter of 2010 due to a legal settlement related to the resolution of disputes with the acquiring company of our Consumer Division over the final purchase price and was \$0 in the second quarter of 2011.

Comparison of Six Months Ended June 30, 2011 to Six Months Ended June 30, 2010

Net Revenues. Our revenues increased 77% from \$100.2 million in the first six months of 2010 to \$177.4 million in the first six months of 2011 due primarily to a 133% increase in Flash-based product sales from \$72.4 million in the first six months of 2010 to \$169.0 million in the first six months of 2011, partially offset by a 74% decrease in sales of DRAM products from \$27.6 million in the first six months of 2010 to \$7.2 million in the first six months of 2011. Within Flash-based product sales, shipments of our ZeusIOPS® SSDs into the enterprise-storage market increased 192% from \$45.0 million in the first six months of 2010 to \$131.5 million in the first six months of 2011. The increase in Flash-based product revenues was due primarily to a \$90.4 million increase in Flash-based product sales to four customers, including our largest customer. With respect to our largest customer, an inventory carryover in early 2010 related to sales made during the second half of 2009 negatively impacted our Flash-based product revenues in the first six months of 2010. Sales to this customer increased by \$26.8 million in the first six months of 2011 compared to the first six months of 2010. The decrease in sales of DRAM products was due primarily to a decrease in product sales to a single customer.

Our reported revenues are net of reserves for price protection, sales returns and sales and marketing incentives. With certain exceptions, sales of our products are generally made through individual purchase orders and, in certain cases, are made under master agreements governing the terms and conditions of the customer relationships. Some customers may have the ability to change, cancel or delay orders with limited or no penalties. In the absence of a non-cancellable customer supply agreement, our ability to predict future sales is limited because a majority of our quarterly product revenues come from orders that are received just prior to or within the same quarter. In addition, our SSDs are currently offered as options in our customers' systems. Therefore, the demand for these SSDs is unpredictable and fully dependent on end-user requirements. Unless and until our SSDs are offered as a standard feature in our customers' systems, our demand visibility will continue to be limited.

Gross Profit. Our gross profit was \$77.1 million in the first six months of 2011, compared to \$39.3 million in the same period in 2010. Gross profit as a percentage of revenues was 43.5% in the first six months of 2011, compared to 39.2% in the first six months of 2010. The increase in gross profit in absolute dollars and as a percentage of revenue was due primarily to a 133% increase in sales of higher margin Flash-based products and a \$1.4 million decrease in write-downs of our inventory related to obsolescence, excess quantities and declines in market value below our costs.

Sales and Marketing. Sales and marketing expenses are primarily comprised of payroll and payroll-related expenses for our domestic and international sales and marketing employees and expenses for trade shows. Sales and marketing expenses increased 36% from \$8.6 million in the first six months of 2010 to \$11.7 million in the first six months of 2011. Sales and marketing expenses as a percentage of revenue decreased from 8.6% in the first six months of 2010 to 6.6% in the first six months of 2011. The increase in sales and marketing expenses in absolute dollars was due primarily to a \$2.2 million increase in commissions as the result of higher revenues for the first six months of 2011 and a \$610,000 increase in payroll and payroll-

Table of Contents

related costs due to an increase in employee headcount and higher stock-based compensation. The decrease in sales and marketing expenses as a percentage of revenues was due primarily to the fixed nature of certain sales costs such as payroll and payroll-related expenses, excluding sales commissions, and the increase in revenues in the first six months of 2011 compared to the first six months of 2010.

General and Administrative. General and administrative expenses are comprised primarily of personnel costs for our executive and administrative employees, professional fees and facilities overhead. General and administrative expenses increased 9% from \$14.0 million in the first six months of 2010 to \$15.3 million in the first six months of 2011. General and administrative expenses as a percentage of revenues decreased from 14.0% in the first six months of 2010 to 8.6% in the first six months of 2011. The increase in general and administrative expenses in absolute dollars was due primarily to a \$1.7 million increase in payroll and payroll-related costs due to an increase in employee headcount and stock-based compensation, partially offset by a \$600,000 decrease in legal fees. The decrease in general and administrative expenses as a percentage of revenues was due primarily to the fixed nature of certain general and administrative costs such as payroll and payroll-related expenses and the increase in revenues in the first six months of 2011 compared to the first six months of 2010.

Research and Development. Research and development expenses are comprised primarily of personnel costs for our engineering staff, product design consulting fees and material costs related to new product designs. Research and development expenses increased 25% from \$20.0 million in the first six months of 2010 to \$25.0 million in the first six months of 2011. Research and development expenses as a percentage of revenues decreased from 20.0% in the first six months of 2010 to 14.1% in the first six months of 2011. The increase in research and development expenses in absolute dollars was due primarily to a \$3.3 million increase in payroll and payroll-related costs from an increase in research and development employee headcount from 251 as of June 30, 2010 to 339 as of June 30, 2011, as the result of our expanding global research and development efforts and higher stock-based compensation of \$930,000. The decrease in research and development expenses as a percentage of revenues was due primarily to the fixed nature of certain research and development costs such as payroll and payroll-related expenses and the increase in revenues in the first six months of 2011 compared to the first six months of 2010.

Special Charges. Special charges consisted of approximately \$69,000 in employee severance and termination benefits and approximately \$117,000 related to a gain on the sale of previously impaired assets in the first six months of 2010. There were no special charges in the first six months of 2011.

Other Income. Other income was \$43,000 in the first six months of 2011 and was comprised of interest earned on our cash and cash equivalents, partially offset by losses on foreign currency transactions. Other income was \$389,000 in the first six months of 2010 and was comprised of government grant income received from the Malaysian government authority for qualified research and development expenses, interest earned on our cash and cash equivalents, and short-term investments, partially offset by losses on foreign currency transactions.

Provision (Benefit) for Income Taxes. We recorded a provision for income taxes of \$1.3 million and a benefit for income taxes of \$500,000 in the first six months of 2011 and 2010, respectively. Our effective tax rate decreased from 17.1% in the first six months of 2010 to 5.2% in the first six months of 2011 due primarily to a change in the revenue composition, which resulted in increased international sales and earnings in jurisdictions outside of the U.S. that were taxed at rates lower than U.S. federal statutory rates. The decrease was also due to federal research and development tax credits of \$385,000 from which we received benefits in the first six months of 2011 but did not receive benefits in the first six months of 2010 because the federal government had not yet extended the tax credits to be effective for 2010 as of June 30, 2010. In December 2010, the federal government retroactively applied the research and development tax credits for the full year 2010 and extended them through December 31, 2011. We operate under an income tax holiday in Malaysia, which is effective through September 30, 2027 subject to meeting certain conditions. The impact of the Malaysia income tax holiday decreased our provision for income taxes by \$4.2 million and \$1.5 million in the first six months of 2011 and 2010, respectively. The benefit of the income tax holiday on earnings per share was \$0.08 and \$0.03 for the first six months of 2011 and 2010, respectively.

Income (Loss) from Continuing Operations. Income from continuing operations was \$23.8 million and loss from continuing operations was \$2.4 million in the first six months of 2011 and 2010, respectively. The increase in income from continuing operations was due primarily to a \$37.8 million increase in gross profit, partially offset by a \$9.4 million increase in operating expenses and a \$1.8 million increase in the provision for income taxes.

Loss from Discontinued Operations. As the result of the sale of the assets of our Consumer Division on February 9, 2007, the Consumer Division is reflected as discontinued operations. Loss from discontinued operations was \$150,000 in the first six months of 2010 and was due to a legal settlement related to the resolution of disputes with the acquiring company of our Consumer Division over the final purchase price and was \$0 for the first six months of 2011.

Table of Contents
Comparison of Three Months Ended June 30, 2011 to Three Months Ended March 31, 2011

Net Revenues. Our revenues decreased 13% from \$94.9 million in the first quarter of 2011 to \$82.5 million in the second quarter of 2011 due primarily to a 12% decrease in Flash-based product sales from \$89.8 million in the first quarter of 2011 to \$79.2 million in the second quarter of 2011 and a 29% decrease in sales of DRAM products from \$4.2 million in the first quarter of 2011 to \$3.0 million in the second quarter of 2011. Within Flash-based product sales, shipments of our ZeusIOPS[®] SSDs into the enterprise-storage market decreased 11% from \$69.4 million in the first quarter of 2011 to \$62.1 million in the second quarter of 2011. The quarterly decrease in Flash-based product revenues was due primarily to a \$13.0 million decrease in Flash-based product sales to two customers. The quarterly decrease in sales of DRAM products was due primarily to a decrease in product sales to a single customer.

Our reported revenues are net of reserves for price protection, sales returns and sales and marketing incentives. With certain exceptions, sales of our products are generally made through individual purchase orders and, in certain cases, are made under master agreements governing the terms and conditions of the customer relationships. Some customers may have the ability to change, cancel or delay orders with limited or no penalties. In the absence of a non-cancellable customer supply agreement, our ability to predict future sales is limited because a majority of our quarterly product revenues come from orders that are received just prior to or within the same quarter. In addition, our SSDs are currently offered as options in our customers' systems. Therefore, the demand for these SSDs is unpredictable and fully dependent on end-user requirements. Unless and until our SSDs are offered as a standard feature in our customers' systems, our demand visibility will continue to be limited.

Gross Profit. Our gross profit was \$36.8 million in the second quarter of 2011, compared to \$40.3 million in the first quarter of 2011. Gross profit as a percentage of revenues was 44.7% in the second quarter of 2011, compared to 42.4% in the first quarter of 2011. The decrease in gross profit in absolute dollars was due primarily to decreased revenues for Flash-based products. The increase in gross profit as a percentage of revenue was due primarily to a 17% decrease in material costs of Flash-based products.

Sales and Marketing. Sales and marketing expenses are primarily comprised of payroll and payroll-related expenses for our domestic and international sales and marketing employees and expenses for trade shows. Sales and marketing expenses increased 7% from \$5.7 million in the first quarter of 2011 to \$6.1 million in the second quarter of 2011. Sales and marketing expenses as a percentage of revenue increased from 6.0% in the first quarter of 2011 to 7.3% in the second quarter of 2011. The increase in sales and marketing expenses in absolute dollars and as a percentage of sales was due primarily to a \$270,000 increase in payroll and payroll-related costs due to an increase in employee headcount and higher stock-based compensation. The increase in sales and marketing expenses as a percentage of revenues was due primarily to the fixed nature of certain sales costs such as payroll and payroll-related expenses, excluding sales commissions, and the decrease in revenues in the second quarter of 2011 compared to the first quarter of 2011.

General and Administrative. General and administrative expenses are comprised primarily of personnel costs for our executive and administrative employees, professional fees and facilities overhead. General and administrative expenses increased from \$7.4 million in the first quarter of 2011 to \$7.9 million in the second quarter of 2011. General and administrative expenses as a percentage of revenues increased from 7.8% in the first quarter of 2011 to 9.6% in the second quarter of 2011. The increase in general and administrative expenses in absolute dollars and as a percentage of revenues was due primarily to a \$410,000 increase in payroll and payroll-related costs due to an increase in employee headcount and stock-based compensation.

Research and Development. Research and development expenses are comprised primarily of personnel costs for our engineering staff, product design consulting fees and material costs related to new product designs. Research and development expenses increased 8% from \$12.0 million in the first quarter of 2011 to \$13.0 million in the second quarter of 2011. Research and development expenses as a percentage of revenues increased from 12.6% in the first quarter of 2011 to 15.8% in the second quarter of 2011. The increase in research and development expenses in absolute dollars and as a percentage of revenues was due primarily to an increase in payroll and payroll-related costs from an increase in research and development employee headcount from 285 as of March 31, 2011 to 339 as of June 30, 2011, as the result of our expanding global research and development efforts.

Other Income (Expense). Other income was \$90,000 in the second quarter of 2011 and was comprised of interest earned on our cash and cash equivalents and gains from foreign currency transactions. Other expense was \$47,000 in the first quarter of 2011 and was comprised of losses on foreign currency transactions, partially offset by interest earned on our cash and cash equivalents.

Provision (Benefit) for Income Taxes. We recorded a provision for income taxes of \$298,000 and \$1.0 million in the second quarter of 2011 and the first quarter of 2011, respectively. Our effective tax rate decreased from 6.6% in the first quarter of

Table of Contents

2011 to 3.0% in the second quarter of 2011 due primarily to an increase in the income tax benefit from research and development tax credits relative to income from continuing operations before income taxes. We operate under an income tax holiday in Malaysia, which is effective through September 30, 2027 subject to meeting certain conditions. The impact of the Malaysia income tax holiday decreased our provision for income taxes by \$1.9 million and \$2.3 million in the second quarter of 2011 and first quarter of 2011, respectively. The benefit of the income tax holiday on earnings per share was \$0.04 for each of the first two quarters of 2011.

Net Income. Net income was \$9.7 million and \$14.1 million in the second quarter of 2011 and first quarter of 2011, respectively. The quarterly decrease in net income was due primarily to a \$3.4 million decrease in gross profit and a \$1.9 million increase in operating expenses, partially offset by a \$705,000 decrease in the provision for income taxes.

Liquidity and Capital Resources***Working Capital, Cash and Cash Equivalents***

As of June 30, 2011, we had working capital of \$302.1 million, including \$213.3 million of cash and cash equivalents compared to working capital of \$272.6 million, including \$170.5 million of cash and cash equivalents as of December 31, 2010 and working capital of \$228.7 million, including \$147.9 million of cash, cash equivalents and short-term investments as of June 30, 2010. Current assets were 8.5 times current liabilities as of June 30, 2011, compared to 7.9 times current liabilities as of December 31, 2010, and 8.2 times current liabilities as of June 30, 2010.

As of June 30, 2011, of the \$213.3 million of aggregate cash and cash equivalents held by us, the amount of cash and cash equivalents held by our foreign subsidiaries was \$51.2 million. If these funds are needed for our operations in the U.S., we would be required to accrue and pay U.S. taxes to repatriate these funds. However, our intent is to reinvest indefinitely these funds outside the U.S. and our current plans do not demonstrate a need to repatriate them to fund our U.S. operations.

Operating Activities

Net cash provided by operating activities was \$44.0 million in the first six months of 2011 and resulted primarily from net income of \$23.8 million, an \$8.8 million decrease in inventory, a \$2.2 million decrease in accounts receivable, net of reserves, a \$5.4 million increase in income taxes payable, non-cash depreciation and amortization of \$6.2 million, and \$6.0 million of stock-based compensation expense, partially offset by a \$4.4 million benefit from non-cash deferred income taxes and a \$2.4 million decrease in accrued and other liabilities. Inventory decreased due primarily to lower inventory purchases in the second quarter of 2011, compared to the fourth quarter of 2010. In 2010, we had increased purchases of raw materials under non-cancelable inventory purchase commitments in preparation for anticipated sales demand in 2011. Accounts receivable, net of reserves, decreased due primarily to a decrease in revenues in the second quarter of 2011, compared to the fourth quarter of 2010. Accrued and other liabilities decreased due primarily to the payment of annual bonuses during the first six months of 2011. During the first six months of 2011, we recorded approximately \$1.4 million of legal fees in excess of our insurance deductible under our director and officer insurance coverage, and our insurance carriers paid \$1.5 million of claims for legal fees incurred by us. We have recognized a liability, with a corresponding receivable that offsets legal expense, until the remainder of our claims are paid by our insurance carrier.

Investing Activities

Net cash used in investing activities was \$5.7 million in the first six months of 2011 resulting primarily from \$5.4 million in purchases of property, plant and equipment related to production and engineering equipment at our Malaysia and U.S. facilities and tenant improvements made to our facility in the U.S.

As of June 30, 2011, we have made capital expenditures of approximately \$43 million for our Malaysia facility primarily related to building construction costs, acquisition of land and purchases of production equipment. We estimate that total investments in property, plant, and equipment will be approximately \$42 million over the next five years ending June 30, 2016. We expect that the substantial majority of these estimated investments will relate to our Malaysia operations.

Financing Activities

Net cash provided by financing activities was \$4.5 million in the first six months of 2011 and resulted primarily from \$2.8 million of proceeds realized from the exercise of stock options and \$1.7 million of excess tax benefits from share-based payment arrangements.

Edgar Filing: STEC, INC. - Form 10-Q

From time to time, the Company's board of directors has authorized various programs to repurchase shares of its common stock depending on market conditions and other factors. In November 2009, the board of directors authorized a share repurchase program effective November 10, 2009, enabling the Company to repurchase up to \$75 million of its common stock over an 18-month period that expired on May 9, 2011. The Company did not make any share repurchases under this plan during 2011.

Table of Contents

On November 23, 2009, our subsidiary, STEC Technology Sdn. Bhd. (STEC Malaysia) entered into a short-term credit facility (the Short-term Facility) with Deutsche Bank (Malaysia) Berhad. The agreement allows STEC Malaysia to borrow an aggregate principal amount of \$10 million in the form of letters of credit, trust receipts, bills acceptances/financing, banker s acceptances, and banker s and shipping guarantees which are commonly used to conduct business in Asia. Credit under the Short-term Facility will be available until notice of termination by either party. Borrowings under the Short-term Facility will bear interest at various rates with repayments due between 30 days and 14 months, depending on the form of borrowing. The Short-term Facility is guaranteed by STEC, Inc. and contains customary affirmative and negative covenants. As of June 30, 2011, there was approximately \$200,000 of banker s guarantees outstanding under the Short-term Facility and STEC Malaysia was in compliance with all required covenants. The Short-term Facility will be used to facilitate general business transactions and fund working capital requirements for STEC Malaysia on an as-needed basis.

We believe that our existing assets, cash and cash equivalents on hand, together with the \$10 million Short-term Facility, and cash that we expect to generate from our operations, will be sufficient to meet our capital needs for at least the next twelve months. However, it is possible that we may need or elect to raise additional cash to fund our activities beyond the next year to provide additional working capital if our revenues increase substantially, to expand our international operations or to consummate acquisitions of other businesses, products or technologies. We could raise such funds by accessing the capital or credit markets to issue equity or debt securities, or by borrowing money. In addition, even though we may not need additional funds, we may still elect to sell additional equity securities or obtain additional credit facilities for other reasons. There can be no assurance that we will be able to obtain additional funds on commercially favorable terms, or at all. If we raise additional funds by issuing more equity or new convertible debt securities, the ownership percentages of existing shareholders would be reduced. In addition, the equity or debt securities that we issue may have rights, preferences or privileges senior to those of the holders of our common stock.

We determine our future capital and operating requirements and liquidity based, in large part, upon our projected financial performance, and we regularly review and update these projections due to changes in general economic conditions, our current and projected operating and financial results, the competitive landscape and other factors. Although we believe we have sufficient capital to fund our activities for at least the next twelve months, our future capital requirements may vary materially from those now planned. The amount of capital that we will need in the future will depend on many factors, including:

General economic and political conditions and specific conditions in the markets we address, including the continuing volatility in the technology sector and semiconductor industry, and fluctuation in the global economy;

The inability of certain of our customers who depend on credit to have access to their traditional sources of credit to finance the purchase of products from us, which may lead them to reduce their level of purchases or to seek credit or other accommodations from us;

Whether our revenues increase substantially;

Our relationships with suppliers and customers;

The market acceptance of our products;

Expansion of our international business, including the opening of offices and facilities in foreign countries;

Price discounts on our products to our customers;

Our pursuit of strategic transactions, including acquisitions, joint ventures and capital investments;

Edgar Filing: STEC, INC. - Form 10-Q

Our business, product, capital expenditure and research and development plans and product and technology roadmaps;

The levels of inventory and accounts receivable that we maintain;

Our entrance into new markets;

Capital improvements to new and existing facilities;

Technological advances; and

Our responses to competitive products.

Table of Contents

Contractual Obligations and Off-Balance Sheet Arrangements

Other than lease commitments incurred in the normal course of business (see Contractual Obligation table below), we do not have any material off-balance sheet financing arrangements or liabilities, guarantee contracts, retained or contingent interest in transferred assets, or any obligations arising out of a material variable interest in an unconsolidated entity. We do not have any majority-owned subsidiaries that are not included in the consolidated financial statements. Additionally, we do not have any interest in, or relationship with, any special purpose entities.

In the ordinary course of business, we may provide indemnifications of varying scope and terms to customers, vendors, lessors, business partners and other parties with respect to certain matters, including, but not limited to, losses arising out of our breach of such agreements, services to be provided by us, or from intellectual property infringement claims made by third parties. In addition, we have entered into indemnification agreements with our directors and certain of our officers that will require us, among other things, to indemnify them against certain liabilities that may arise by reason of their status or service as directors or officers. We maintain director and officer insurance, which may cover certain liabilities arising from our obligation to indemnify our directors and officers in certain circumstances. It is not possible to determine the maximum potential amount under these indemnification agreements due to the limited history of prior indemnification claims and the unique facts and circumstances involved in each particular agreement. Such indemnification agreements may not be subject to maximum loss clauses. Historically, we have not incurred material costs as a result of obligations under these agreements.

Table of Contents

Set forth in the table below is our estimate of our significant contractual obligations as of June 30, 2011 (in thousands).

| Contractual Obligation | Total | Payment due by period | | | More than 5 years |
|---|------------------|-----------------------|-----------------|-----------------|----------------------|
| | | Less than 1 year | 1-3 years | 3-5 years | |
| Non-cancelable inventory purchase commitments | \$ 46,476 | \$ 46,476 | \$ | \$ | \$ |
| Operating lease obligations | 4,978 | 1,019 | 1,666 | 1,575 | 718 |
| Other non-cancelable purchase commitments | 2,351 | 2,351 | | | |
| Non-cancelable capital equipment purchase commitments | 1,510 | 1,510 | | | |
| Total | \$ 55,315 | \$ 51,356 | \$ 1,666 | \$ 1,575 | \$ 718 |

Inflation

Inflation was not a material factor in either revenue or operating expenses in the first six months of 2011 and 2010.

New Accounting Pronouncements

We have implemented all new accounting pronouncements that are in effect and that may impact our consolidated financial statements and we do not believe that there are any other new accounting pronouncements that have been issued that might have a material impact on our consolidated financial statements.

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations are based upon our unaudited condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America and include the accounts of STEC, Inc. and each of its subsidiaries. All accounts and transactions among STEC and its subsidiaries have been eliminated in consolidation. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses for each period. Information with respect to our critical accounting policies which we believe could have the most significant effect on our reported results and require subjective or complex judgments is contained in the notes to the consolidated financial statements in the Annual Report on Form 10-K for the fiscal year ended December 31, 2010. There have been no significant changes in our critical accounting policies and estimates during the six months ended June 30, 2011 as compared to what was previously disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2010.

Table of Contents

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest Rate Risk

As of June 30, 2011, our cash and cash equivalents were \$213.3 million invested primarily in bank deposit accounts and money market funds. Our cash and cash equivalents are not subject to significant interest rate risk. As of June 30, 2011, the carrying value of our cash and cash equivalents approximated fair value. Our main investment objectives are the preservation of investment capital and the maximization of after-tax returns on our investment portfolio. Consequently, we invest in securities that meet high credit quality standards and we limit the amount of our credit exposure to any one issuer. We do not use derivative instruments for speculative or investment purposes.

At any time, fluctuations in interest rates could affect interest earnings on our cash and cash equivalents. We believe that the effect, if any, of reasonably possible near-term changes in interest rates on our financial position, results of operations and cash flows would not be material. Currently, we do not hedge these interest rate exposures.

In a declining interest rate environment, as short-term investments mature, reinvestment occurs at less favorable market rates. Given the short-term nature of certain investments, the current interest rate environment may negatively impact our investment income.

Global economic conditions have had widespread negative effects on the financial markets. Due to credit concerns and lack of liquidity in the short-term funding markets, we have shifted a larger percentage of our portfolio to high credit quality money market funds, which may negatively impact our investment income, particularly in the form of declining yields.

We are also exposed to interest rate risks due to the possibility of changing interest rates under the Short-term Facility described in Liquidity and Capital Resources. Loan draws under the Short-term Facility will bear interest at various rates depending on the type of borrowing. As of June 30, 2011, there was approximately \$200,000 of banker's guarantees drawn against the Short-term Facility.

Foreign Currency Exchange Rate Risk

More than 95% of our international sales are denominated in U.S. dollars. Consequently, if the value of the U.S. dollar increases relative to a particular foreign currency, our products could become relatively more expensive. In addition, we purchase substantially all of our integrated circuit (IC) components from local distributors of Japanese, Korean and Taiwanese suppliers. More than 95% of our purchases from international vendors are denominated in U.S. dollars. To date, we have not entered any derivative instruments to manage risks related to interest rate or foreign currency exchange rates.

ITEM 4. CONTROLS AND PROCEDURES

We maintain disclosure controls and procedures, as such term is defined under Rule 13a-15(e) of the Exchange Act, that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosures. In designing and evaluating the disclosure controls and procedures, our management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives and, in reaching a reasonable level of assurance, our management necessarily was required to apply its judgment in evaluating and implementing possible controls and procedures.

Evaluation of Disclosure Controls and Procedures

We carried out an evaluation as of June 30, 2011, under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, of the effectiveness of our disclosure controls and procedures. Based upon their evaluation and subject to the foregoing, our principal executive officer and principal financial officer concluded that, as of June 30, 2011, our disclosure controls and procedures were effective at the reasonable assurance level.

Changes in Internal Control Over Financial Reporting

Our management determined that as of June 30, 2011, there were no changes in our internal control over financial reporting (as defined in Rule 13a-15(f) of the Exchange Act) that occurred during the fiscal quarter then ended that have 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 set forth under Note 9 Commitments and Contingencies to the Unaudited Condensed Consolidated Financial Statements of this Quarterly Report on Form 10-Q is incorporated herein by reference.

ITEM 1A. RISK FACTORS

Investing in our common stock involves a high degree of risk. Before deciding to purchase, hold, or sell our common stock, you should carefully consider the risks described below in addition to the cautionary statements and risks described elsewhere and the other information contained in this Report and in our other filings with the SEC, including subsequent reports on Forms 10-Q and 8-K. The risks and uncertainties described below are not the only ones we face. 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 December 31, 2010.

Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also impair our business operations. If any of these known or unknown risks or uncertainties actually occurs with material adverse effects on STEC, our business, financial condition, results of operations and/or liquidity could be seriously harmed, which could cause our actual results to vary materially from recent results or from our anticipated future results. In addition, the trading price of our common stock could decline due to any of these known or unknown risks or uncertainties, and you could lose all or part of your investment.

Historically, sales to a limited number of customers, particularly EMC Corporation, have comprised a significant portion of our revenues and the loss of, or significant reduction in purchases by, any key customer could materially impact our financial results.

Historically, sales to a relatively limited number of customers have accounted for a significant percentage of our revenues. In the second quarter of 2011 and 2010, sales to our ten largest customers accounted for an aggregate of 89.3% and 87.7%, respectively, of our total revenues. In 2010, our largest customer was EMC Corporation (EMC), which accounted for 37.8% of our total revenues.

The major industries in which we participate are dominated by a limited number of OEM companies; therefore, the rate of SSD adoption will be driven by a limited number of potential customers. In addition, the industries in which many of our customers compete have experienced, and may continue to experience, consolidation which may result in increased customer concentration and/or the loss of customers. The composition of our major customer base changes from quarter to quarter as the market demand for our customers' products changes, and we expect this variability to continue in the future. Our customers' demand for our products can vary considerably from quarter to quarter, and it is difficult to forecast our customers' demand beyond the immediate future, as purchases in one period may not be indicative of purchases in future periods. We expect that sales of our products to a limited number of customers will continue to comprise a substantial portion of our revenues for the foreseeable future. The loss of, or a significant reduction in purchases by, any of our major customers could materially harm our business, financial condition and results of operations. For example, the results of our operations during the first half of 2010 were negatively impacted due to an inventory carryover by EMC. If we are unable to secure significant purchase orders from EMC or our other large customers in the future, our financial results may be negatively impacted.

The market for enterprise Flash-based SSD products is relatively new and rapidly evolving, which makes it difficult to forecast end-user adoption rates and customer demand, for our products.

The enterprise Flash-based SSD market is relatively new and rapidly evolving. As a result, we may encounter risks and uncertainties related to our business and future prospects. It is difficult to predict, with any precision, end-user adoption rates, customer demand for our products or the future growth rate and size of this market. Our ability to predict future sales is further limited because our SSDs are currently offered as options in our customers' systems. Unless and until our SSDs are offered as a standard feature in our customers' systems, this product runs the risk of serving a niche market and may never reach mass adoption, and our demand visibility may continue to be limited.

Table of Contents

We may not be able to maintain or improve our competitive position because of the intense competition in the memory and storage industry.

We conduct business in an industry characterized by intense competition. We primarily compete with Hitachi GST, Intel, Micron, Samsung, SanDisk, Seagate, SMART Modular, Toshiba, and Western Digital in connection with the sale of our products. Our competitors include many large U.S. and international companies that have substantially greater financial, technical, marketing, distribution and other resources, broader product lines, lower cost structures, greater brand recognition and longer-standing relationships with customers and suppliers. As a result, our competitors may be in a better position than us to influence or respond to new or emerging technologies or standards and changes in customer requirements. Our competitors may also be able to devote greater resources to the development, promotion and sale of products, and may be able to deliver competitive products at a lower price.

Some of our competitors earn a significant portion of their revenue from business units outside the storage industry. Because they do not depend solely on sales of storage products to achieve profitability, they may sell storage devices at lower prices and operate their storage business unit at a loss over an extended period of time while choosing to offset these losses with profits from other business units. In addition, some of our customers have integrated and may continue to integrate lower cost, lower performance SATA drives with a SAS or Fibre Channel connectivity bridge instead of our native SAS and Fibre Channel ZeusIOPS® products, thereby offering a lower cost alternative to our products and negatively affecting the sales of our products to those customers. Our operating results may be adversely affected if we cannot successfully compete with the pricing by these companies.

Some of our significant suppliers, including Samsung and Toshiba, are also our competitors, and have the ability to manufacture competitive products at lower costs as a result of their higher levels of integration. In addition, these suppliers may reduce the supply of memory chips available to the industry or us. We also face competition from current and prospective customers that evaluate our capabilities against the merits of manufacturing products internally. Competition may arise from new and emerging companies or from the development of cooperative relationships among our current and potential competitors or third parties to develop products that address the needs of our customers. We expect our competitors will continue to improve the performance of their current products, reduce their prices and introduce new products that may offer greater performance, or otherwise render our technology or products obsolete or uncompetitive, any of which could cause a decline in our operating results or loss of market acceptance of our products.

We have been named as a party to purported class action lawsuits and purported shareholder derivative actions, and we may be named in additional litigation, all of which could require significant management time and attention and result in significant legal expenses. An unfavorable outcome in one or more of these lawsuits could have a material adverse effect on our business, financial condition, results of operations and cash flows.

As described in detail in Note 9 – Commitments and Contingencies to the Unaudited Condensed Consolidated Financial Statements of this Quarterly Report on Form 10-Q, a purported class action is pending in the U.S. District Court for the Central District of California, alleging, among other things, that our company and certain of our officers and directors violated the federal securities laws by issuing materially false and misleading statements. A similar purported class action is pending in Orange County Superior Court against our company, certain of our officers and directors, and four of our underwriters, based on allegations substantially similar to the purported federal class action. In addition, purported shareholder derivative actions are pending in Orange County Superior Court and U.S. District Court for the Central District of California against certain of our officers and directors based on allegations substantially similar to those set forth in the purported class action. Regardless of the merits, the expense of defending such litigation may have a substantial impact if our insurance carriers fail to cover the cost of the litigation, and the time required to defend the actions could divert management's attention from the day-to-day operations of our business, which could adversely affect our business, results of operations and cash flows. An unfavorable outcome in such litigation could have a material adverse effect on our business, financial condition, results of operations and cash flows.

The U.S. Securities and Exchange Commission formal investigation could require significant management time and attention and result in significant legal expenses. An unfavorable outcome could have a material adverse effect on our business, financial condition, results of operations and cash flows.

As first disclosed in our Annual Report on Form 10-K for the year ended December 31, 2009, the United States Securities and Exchange Commission (SEC) is conducting a formal investigation involving trading in our securities. We are fully cooperating with the SEC in regards to this investigation. On July 19, 2011, the Company received a Wells Notice from the SEC stating that the Staff of the SEC (the Staff) is considering recommending that the Commission institute a civil injunctive action against our company, CEO and President for violations of the antifraud and reporting provisions of the federal securities laws. Under a process established by the SEC, we, in addition to our CEO and President, have the

Table of Contents

opportunity to submit to the Staff any reasons of law, policy or fact why we and the two company officers believe that the civil action should not be brought (a Wells Submission) before the Staff makes its formal recommendation to the SEC regarding what action, if any, should be brought. We, including our CEO and President, continue to cooperate with the SEC to attempt to resolve the Staff's concerns, but there can be no assurance that the SEC will decide not to bring an action against us or that the investigation will be concluded favorably. Regardless of the merits, the expense of defending such claims may have a substantial impact if our insurance carriers fail to cover the cost of the defense, and the time required to defend the actions could divert management's attention from the day-to-day operations of our business, which could adversely affect our business, results of operations and cash flows. An unfavorable outcome of this investigation could have a material adverse effect on our business, financial condition, results of operations and cash flows.

Business interruptions could substantially harm our business.

Substantially all of our manufacturing operations are located in Penang, Malaysia. In addition, a substantial amount of our supply chain is dependent on international suppliers and a significant amount of our products are shipped to international customers. Further, we undertake various research and development, sales and marketing activities through regional offices in a number of foreign countries. These international operations are subject to many inherent risks, including but not limited to, human error, government intervention, political instability, acts of terrorism, power failures, health pandemics and natural disasters, including earthquakes, tsunamis, fires or floods. Our U.S. operations are also subject to many of these inherent risks. For example, our headquarters and various U.S.-based research and development activities are located in Southern California, an area with above average seismic activity due to the proximity of major earthquake fault lines. In addition, our Santa Ana, California headquarters and our facility in Penang, Malaysia are located within close proximity to airports and flight paths.

Any of these risks, could negatively impact our operations which could harm our business. In particular, a disruption to our facility in Penang, Malaysia could substantially limit our manufacturing capabilities. In addition, the March 2011 earthquake and tsunami in Japan has disrupted the global supply chain for components manufactured in Japan that are incorporated in our products and in the end user's products of certain of our customers. Due to these cross dependencies, supply chain disruptions stemming from these natural disasters in Japan adversely affected the demand for our products. The impact of these types of business disruptions may result in our customers being unable to obtain a sufficient supply of components required for their end products, causing them to postpone or cancel orders for our products which could materially harm our business, financial condition and results of operations.

The introduction and acceptance of new and enhanced versions of our products may cause fluctuations in our operating results.

The introduction of new and enhanced versions of our products may shorten the life cycle of our existing products, or replace sales of some of our current products, thereby offsetting the benefit of even a successful product introduction, and may cause customers to defer purchasing our existing products in anticipation of the new and enhanced versions. Conversely, customers may accelerate purchases of existing products and defer purchases of new life cycle products due to the cost and lead times involved in the qualification of new products. Any of these instances may cause volatility in our operating results and fluctuations in our inventory levels. The complexity and difficulties in managing product transitions at the end-of-life stage of a product can also create excess inventory associated with the outgoing product that can also lead to product obsolescence and increased expenses. Any or all of the above problems could materially harm our business and operating results.

Our dependence on a small number of component suppliers, including integrated circuit device suppliers, and our inability to obtain a sufficient supply of these components on a timely basis could harm our ability to fulfill orders.

Typically integrated circuit (IC) devices represent more than 80% of the component costs of our products. We are dependent on a small number of suppliers that supply key components and important component-related information used in the development and manufacture of our products. Since we have no long-term supply contracts, there is no assurance that our suppliers will agree to supply the quantities of components we may need to meet our production requirements or the component information required to optimize these components in our finished products. In the first six months of 2011, Samsung, Toshiba and Hynix supplied substantially all of the IC devices used in our Flash-based products while Samsung supplied substantially all of the DRAM IC devices used in our DRAM products.

Our customers typically qualify the specific controller and Flash and DRAM ICs that are components in our products as part of the product qualification process. If any of our suppliers experience quality control problems, our products that utilize that supplier's ICs may be disqualified by one or more of our customers. A supplier disqualification would disrupt our supply of ICs, reduce the number of suppliers available to us and adversely affect our ability to fulfill our customers' product orders. In some instances, we may be required to qualify a new supplier's ICs, which could negatively impact our revenues during the new qualification process. There can be no assurance that we would be able to find and successfully qualify new suppliers in a timely manner or obtain ICs from new suppliers on commercially reasonable terms, which could damage our relationships with existing or potential customers and could materially harm our operating results.

Table of Contents

Moreover, from time to time, our suppliers experience shortages in IC devices and foundry services which have resulted in placing their customers, including us, on component allocation. This means that while we may have customer orders, we may not be able to obtain the materials that we need to fill those orders in a timely manner or at competitive prices. As a result, our reputation could be harmed, we may lose business from our customers, our revenues may decline, and we may lose market share to our competitors.

In addition to Flash and DRAM ICs, a number of other components that we use in our products are available from only a single or limited number of suppliers. In the development of our own application-specific ICs (ASICs), we also depend on certain foundry subcontractors to manufacture these ASICs as well as on certain third-party subcontractors to assemble, obtain packaging materials for, and test these ASICs. Our dependence on a small number of suppliers and the lack of any guaranteed sources of supply expose us to several risks, including:

The inability to obtain an adequate supply of components;

The inability to obtain component information that is used in the optimization of a supplier's components in our finished products;

Price increases, late deliveries and poor component quality;

An unwillingness of a supplier to supply such components to us;

A key supplier's or sub-supplier's inability to access credit necessary to operate its business;

Failure of a key supplier to remain in business or adjust to market conditions;

Consolidation among suppliers, resulting in some suppliers exiting the industry or discontinuing the manufacture of components; or

Failure of a supplier to meet our quality, yield or production requirements.

Since we have no long-term supply contracts with these third-party foundry subcontractors, there is no guarantee that they will devote sufficient resources to manufacture our components. If we are unable to increase the capacity of our current subcontractors or qualify and engage additional subcontractors, we may not be able to meet demand for our products, which could adversely affect our revenue and results of operations. In addition, we are not able to directly control component delivery schedules.

We may be less competitive if we fail to develop new and enhanced products and introduce them in a timely manner.

The enterprise-storage, enterprise-server, and government, defense and industrial applications markets are subject to rapid technological change, product obsolescence, frequent new product introductions and enhancements, changes in end-user requirements and evolving industry standards. Our ability to compete in these markets will depend in significant part upon our ability to successfully develop, introduce and sell new and enhanced products on a timely and cost-effective basis, and to respond to changing customer requirements.

Delays in the development and introduction of new products could provide a competitor a first-to-market opportunity and allow a competitor to achieve greater market share. Once a customer designs a competitor's product into its product offering, it becomes significantly more difficult for us to sell our products to that customer because changing suppliers involves significant cost, time, effort and risk for the customer. Our product development is inherently risky because it is difficult to foresee developments in technology, anticipate the adoption of new standards, coordinate our technical personnel, and identify and eliminate design flaws. Defects or errors found in our products after commencement of production could result in significant delays and damage our reputation and competitive position. New products, even if first introduced by us, may not gain market acceptance or result in future profitability. Lack of market acceptance for our new products will jeopardize our ability to recoup research and development expenditures, hurt our reputation and harm our business, financial condition and results of operations. In

Edgar Filing: STEC, INC. - Form 10-Q

addition, after we have developed a new product, our customers will usually test and evaluate our products for three or more months before qualifying it for production and an additional three or more months to begin volume production of the equipment that incorporates our products. Even if a customer selects our product to incorporate into its equipment, we have no assurance that the customer will ultimately bring its product to market or that such effort by our customer will be successful.

We may also seek to develop products with new standards for our industry; however, it will take time for these new standards and products to be adopted, for customers to accept and transition to these new products and for significant sales to be generated from them, if this happens at all. Moreover, broad acceptance of new standards or products by customers may

Table of Contents

reduce demand for our older products. If this decreased demand is not offset by increased demand for our new products, our results of operations could be harmed. There can be no assurances that any new products or standards we develop will be commercially successful.

If our products fail to meet our or our customers' specifications for quality and reliability, our results of operations may be adversely impacted and our competitive position may suffer.

Although we place great emphasis on product quality, we may from time to time experience problems with the performance of our products, which could result in one or more of the following:

Increased costs related to fulfillment of our warranty obligations;

The reduction, delay or cancellation of orders or the return of a significant amount of products;

Focused failure analysis causing distraction of the sales, operations and management teams; or

The loss of reputations in the market and customer goodwill.

These factors could cause our business, financial condition and results of operations to be materially and adversely affected.

Demand for storage capacity may not continue to grow at current industry estimates, which may lower the prices our customers are willing to pay for new products.

Our customers' demand for storage capacity may not continue to grow at current industry estimates as a result of developments in the regulation and enforcement of digital rights management, the emergence of processes such as cloud computing, data deduplication and storage virtualization, or otherwise. These factors could lead to our customers' storage capacity needs being satisfied at lower prices, thereby decreasing our revenue. As a result, even with increasing aggregate demand for storage capacity, our average selling prices could decline, which could adversely affect our operating results.

We may make acquisitions that are dilutive to existing shareholders, result in unanticipated accounting charges or otherwise adversely affect our results of operations.

We intend to grow our business through business combinations or other acquisitions of businesses, products or technologies that allow us to complement our existing product offerings, expand our market coverage, increase our engineering workforce or enhance our technological capabilities. If we make any future acquisitions, we could issue stock that would dilute our shareholders' percentage ownership, incur substantial debt, reduce our cash reserves or assume contingent liabilities. Furthermore, acquisitions may require material charges and could result in adverse tax consequences, substantial depreciation, deferred compensation charges, in-process research and development charges, the amortization of amounts related to deferred compensation and identifiable purchased intangible assets or impairment of goodwill, any of which could negatively impact our results of operations.

Our limited experience in acquiring other businesses, product lines and technologies may make it difficult for us to overcome problems encountered in connection with any acquisitions we may undertake.

We continually evaluate and explore strategic opportunities as they arise, including business combinations, strategic partnerships, capital investments and the purchase, licensing or sale of assets. Our experience in acquiring other businesses, product lines and technologies is limited. The attention of our management team may be diverted from our core business if we undertake any future acquisitions. Any potential future acquisition involves numerous risks, including, among others:

Problems or delays in successfully closing the acquisition;

Edgar Filing: STEC, INC. - Form 10-Q

Problems or delays assimilating and integrating the purchased operations, personnel, technologies, products and information systems;

Unanticipated costs and expenditures associated with the acquisition, including any need to infuse significant capital into the acquired operations;

Adverse effects on existing business relationships with suppliers, customers and strategic partners;

Risks associated with entering markets and foreign countries in which we have limited or no prior experience;

Contractual, intellectual property or employment issues;

Potential loss of key employees of purchased organizations; and

Potential litigation arising from the acquired company's operations before the acquisition.

Table of Contents

These risks could disrupt our ongoing business, distract our management and employees, harm our reputation and increase our expenses. Our inability to overcome problems encountered in connection with any acquisition could further divert the attention of management, utilize scarce corporate resources and otherwise harm our business. These challenges are magnified as the size of an acquisition increases, and we cannot assure you that we will realize the intended benefits of any acquisition.

We cannot assure that we will be able to consummate any pending or future acquisitions. We may not be able to find suitable acquisition opportunities and even if we do find suitable acquisition opportunities, we may not be able to consummate the acquisitions on commercially acceptable terms or realize the anticipated benefits of any acquisitions we do undertake.

We expect our quarterly operating results to fluctuate in future periods, causing our stock price to fluctuate or decline.

Our quarterly operating results have fluctuated in the past, and we believe they will continue to do so in the future. Some of these fluctuations may be more pronounced than they were in the past due to the uncertain current global economic environment. Fluctuations in our operating results may be due to a number of factors, including, but not limited to, those identified throughout this Risk Factors section and the following:

Impact of changing and recently volatile U.S. and global economic conditions;

Our suppliers' production levels for the components used in our products;

Our ability to procure required components;

Market acceptance of new and enhanced versions of our products;

Expansion of our international business, including the opening of offices and facilities in foreign countries;

The timing of the introduction of new products or components and enhancements to existing products or components by us, our competitors or our suppliers;

Fluctuations in the cost of components and changes in the average sales prices of our products;

Fluctuating market demand for our products;

Changes in our customer or product revenue mix;

The loss of one or more of our customers;

Our ability to successfully integrate any acquired businesses or assets;

Expenses associated with the start up of new operations or divisions;

Order cancellations, product returns, inventory buildups by customers and inventory write-downs;

Manufacturing inefficiencies associated with the start-up of new manufacturing operations, new products and volume production;

Expenses associated with strategic transactions, including acquisitions, joint ventures and capital investments;

Our ability to adequately support potential future rapid growth;

Our ability to absorb manufacturing overhead if revenues decline;

The effects of litigation; and

Increases in our sales and marketing and research and development expenses in connection with decisions to pursue new product initiatives.

Due to such factors, quarterly revenues and results of operations are difficult to forecast, and period-to-period comparisons of our operating results may not be predictive of future performance.

Ineffective management of inventory levels or product mix, order cancellations, product returns and inventory write-downs could adversely affect our results of operations.

With certain exceptions, sales of our products are generally made through individual purchase orders and, in certain cases, are made under master agreements governing the terms and conditions of the customer relationships. Some customers may have the ability to change, cancel or delay orders with limited or no penalties. It is difficult to accurately predict what or how many products our customers will need in the future. Anticipating demand is challenging because our customers face volatile pricing and unpredictable demand for their products and are increasingly focused on cash preservation and tighter inventory management. We have experienced cancellations of orders and changes in order levels from period-to-period, and we expect to continue to experience similar cancellations and changes in the future, which could result in fluctuations in our revenues.

Table of Contents

If we are unable to properly monitor, control and manage our inventory and maintain an appropriate level and mix of products to support our customers' needs, we may incur increased and unexpected costs associated with our inventory. If we manufacture products in anticipation of future demand that does not materialize, or if a customer cancels outstanding orders, we could experience an unanticipated increase in our inventory that we may be unable to sell in a timely manner, if at all. If demand does not meet our expectations, we could incur increased expenses associated with writing off excess or obsolete inventory.

We also maintain third-party inventory hubbing arrangements with certain of our customers. Pursuant to these arrangements, we deliver products to a customer or a designated third-party warehouse based upon the customer's projected needs but do not recognize product revenue unless and until the customer has removed our product from the warehouse to incorporate into its end products. If a customer does not take our products under a hubbing arrangement in accordance with the schedule it originally provided us, our predicted future revenue stream could vary substantially from our forecasts and our results of operations could be materially and adversely affected. Additionally, since we own inventory that is physically located in a third party's warehouse, our ability to effectively manage inventory levels may be impaired, causing our total inventory turns to decrease, which could increase expenses associated with excess and obsolete inventory and negatively impact our cash flow. In addition, while we may not be contractually obligated to accept returned products, we may determine that it is in our best interest to accept returns in order to maintain good relationships with our customers. Product returns would increase our inventory and reduce our revenues. Alternatively, we could end up with too little inventory and we may not be able to satisfy demand, which could have a material adverse effect on our customer relationships. Our risks related to inventory management are exacerbated by our strategy of closely matching inventory levels with product demand, leaving limited margin for error. We have had to in the past and may need to in the future write down inventory for reasons such as obsolescence, excess quantities and declines in market value below our costs. These inventory write-downs can have a material adverse effect on our financial condition and operating results.

Declines in our average sales prices may result in declines in our revenues and gross profit.

Our industry is competitive and historically has been characterized by declines in average sales prices. Our average sales prices may decline due to several factors, including competition, overcapacity in the worldwide supply of DRAM and Flash memory components as a result of worldwide economic conditions, increased manufacturing efficiencies, implementation of new manufacturing processes and expansion of manufacturing capacity by component suppliers. In the past, overcapacity has resulted in significant declines in component prices, which in turn has negatively impacted our average sales prices, revenues and gross profit. In addition, since a large percentage of our sales are to a small number of customers that are primarily distributors and large OEMs, these customers have exerted, and we expect they will continue to exert, pressure on us to make price concessions. If not offset by increases in volume of sales or the sales of newly-developed products with higher margins, decreases in average sales prices would likely have a material adverse effect on our business and operating results.

Our business could be adversely affected by the cyclical nature of the semiconductor industry.

The semiconductor industry, including the memory markets in which we compete, is highly cyclical and characterized by constant and rapid technological change, rapid product obsolescence and price erosion, evolving standards, and wide fluctuations in product supply and demand. The industry has experienced significant downturns often connected with, or in anticipation of, maturing product cycles of both semiconductor companies and their customers' products and declines in general economic conditions.

These downturns have been characterized by diminished product demand, production overcapacity, high inventory levels and accelerated erosion of average sales prices which have negatively impacted our average sales prices, revenues and earnings. Any future downturns could have a material adverse effect on our business and results of operations.

Further industry consolidation could provide competitive advantages to our competitors.

The storage industry has experienced consolidation over the past several years. Consolidation by our competitors may enhance their capacity, abilities and resources and lower their cost structure, causing us to be at a competitive disadvantage. Additionally, continued industry consolidation may lead to uncertainty in areas such as component availability, which could negatively impact our cost structure.

The manufacturing of our products is complex and subject to production output yield problems, which could decrease available supply and increase costs.

The manufacture of our Flash controllers, Flash-based products and stacked DRAM products is a complex process, and it is often difficult for companies such as ours to achieve, after completed assembly and testing, acceptable production output yields (i.e., the ratio of usable product output to expected output based on given component inputs). Reduced production

Table of Contents

yields could decrease available supply and increase costs. Flash controller production output yields depend on both our product design and the manufacturing process technology unique to our semiconductor foundry partners. Because low yields may result from either design defects or process difficulties, we may not identify yield problems until well into the production cycle, when an actual product defect exists and can be analyzed and tested. In addition, many of these yield problems are difficult to diagnose and time consuming or expensive to remedy.

The execution of our business strategy depends on our ability to retain key personnel, including our executive officers, and to attract qualified personnel.

Competition for employees in our industry is intense. We have had and may continue to have difficulty hiring the necessary engineering, sales and marketing and management personnel to support our business strategy. The successful implementation of our business model and business strategy depends on the continued contributions of our senior management and other key research and development, sales and marketing and operations personnel, including Manouch Moshayedi, our Chief Executive Officer and Chairman of the Board of Directors, Mark Moshayedi, our President, Chief Operating Officer, Chief Technical Officer, Secretary and a Director, and Raymond D. Cook, our Chief Financial Officer. The loss of any key employee, the failure of any key employee to perform in his or her current position, or the inability of our officers and key employees to expand, train and manage our employee base would have an adverse effect on the execution of our business strategy.

Our efforts to expand our business internationally may not be successful and may expose us to additional risks that may not exist in the United States.

We sell our products to customers in foreign countries and seek to increase our level of international business activity through the expansion of our operations into select markets, including Asia and Europe. Such strategy may include opening sales offices in foreign countries, the outsourcing of manufacturing operations, establishing joint ventures with foreign partners, and the establishment of additional manufacturing operations in foreign countries.

A failure to successfully and timely integrate these operations into our global infrastructure will have a negative impact on our overall operations, cause us to delay or forego some of the original perceived benefits of operating internationally, such as lower average production and engineering labor costs, better access to global markets, improved supply chain efficiency, reduced lead times, increased manufacturing efficiency through investments in new state-of-the-art equipment and a lower overall long-term effective tax rate.

Establishing and running operations in a foreign country or region presents numerous risks, including:

Difficulties and costs of staffing and managing operations in certain foreign countries;

Foreign laws and regulations, which may vary country by country, and may impact how we conduct our business;

Higher costs of doing business in certain foreign countries, including different employment laws;

Difficulty protecting our intellectual property rights from misappropriation or infringement;

Political or economic instability;

Changes in import/export duties;

Necessity of obtaining government approvals;

Trade restrictions;

Work stoppages or other changes in labor conditions;

Difficulties in collecting accounts receivables on a timely basis or at all;

Changes in local tax regulations;

Changes to or untimely lapses in government incentives;

Longer payment cycles and foreign currency fluctuations; and

Seasonal reductions in business activity in some parts of the world, such as Europe.

In addition, changes in policies and/or laws of the U.S. or foreign governments resulting in, among other things, higher taxation, currency conversion limitations, restrictions on fund transfers or the expropriation of private enterprises, could reduce the anticipated benefits of our international expansion. Moreover, as a result of our international operations, we are subject to tax in multiple jurisdictions. If any taxing authority (in the U.S. or otherwise) were to successfully challenge our interpretation of the applicable tax laws or our determination of the income and expenses attributable to operations in a

Table of Contents

specific jurisdiction, we could be required to pay additional taxes, interest and penalties. Furthermore, any actions by countries in which we conduct business to reverse policies that encourage foreign trade or investment could adversely affect our business. If we fail to realize the anticipated revenue growth of our future international operations, our business and operating results could suffer.

We expect that our strategy to expand our international operations will require the expenditure of significant resources and the efforts and attention of our management. Unlike some of our competitors, we have limited experience operating our business in foreign countries. Some of our competitors may have a substantial advantage over us in attracting customers in certain foreign countries due to earlier established operations in that country, greater knowledge with respect to cultural differences of customers residing in that country and greater brand recognition and longer-standing relationships with customers in that country. If our international expansion efforts in any foreign country are unsuccessful, we may decide to cease these foreign operations, which would likely harm our reputation and cause us to incur expenses and losses.

We face risks associated with doing business in foreign countries, including foreign currency fluctuations and trade barriers, that could lead to a decrease in demand for our products or an increase in the cost of the components used in our products.

The volatility of general economic conditions and fluctuations in currency exchange rates affect the prices of our products and the prices of the components used in our products. International sales, which are derived from billings to foreign customers, accounted for 69% and 62%, of our total revenues for the first six months of 2011 and 2010, respectively. In the first six months of 2011, 43% and 15% of our revenues were derived from billings to customers in Singapore and the Czech Republic, respectively. In the first six months of 2010, 21% and 19% of our revenues were derived from billings to customers in Malaysia and Singapore, respectively. In the first six months of 2011 and 2010, more than 95% of our international sales were denominated in U.S. dollars, and if the U.S. dollar experiences significant appreciation relative to the currency of a specific country, the prices of our products will rise in such country and our products may be less competitive. In addition, we cannot be sure that our international customers will continue to be willing to place orders denominated in U.S. dollars. If they do not, our revenues and results of operations will be subject to foreign exchange fluctuations, which could harm our business. We do not hedge against foreign currency exchange rate risks.

Furthermore, we purchase a majority of the Flash and DRAM components used in our products from foreign suppliers. Although our purchases of Flash and DRAM components are currently denominated in U.S. dollars, a devaluation of the U.S. dollar relative to the currency of a foreign supplier would likely result in an increase in our cost of Flash and DRAM components.

Our intellectual property may not be adequately protected, which could harm our competitive position.

Our intellectual property is critical to our success. As of June 30, 2011, we owned 32 patents and 50 additional patent applications were pending. Although we protect our intellectual property rights through patents, trademarks, copyrights and trade secret laws, confidentiality procedures and employee disclosure and invention assignment agreements it is possible that our efforts to protect our intellectual property rights may not:

Prevent the challenge, invalidation or circumvention of our existing patents;

Result in patents that lead to commercially viable products or provide competitive advantages for our products;

Prevent our competitors from independently developing similar products, duplicating our products or designing around the patents owned by us;

Prevent third-party patents from having an adverse effect on our ability to do business;

Provide adequate protection for our intellectual property rights;

Edgar Filing: STEC, INC. - Form 10-Q

Prevent disputes with third parties regarding ownership of our intellectual property rights;

Prevent disclosure of our trade secrets and know-how to third parties or into the public domain; and

Result in patents from any of our pending applications.

In addition, despite our efforts to protect our intellectual property rights and confidential information, third parties could copy or otherwise obtain and make unauthorized use of our technologies or independently develop similar technologies. Furthermore, if any of our patents are challenged and found to be invalid, our ability to exclude competitors from making, using or selling the same or similar products related to such patents would cease. From time to time, we receive letters from third parties suggesting that some or all of our products may be covered by third party patents. In each instance, our management determines whether the letters have sufficient justification and specificity to require a response. When they believe it is appropriate to do so, our management seeks the advice of counsel on these matters.

Table of Contents

We have, on at least one occasion, applied for and may in the future apply for patent protection in foreign countries. The laws of foreign countries, however, may not adequately protect our intellectual property rights. Many U.S. companies have encountered substantial infringement problems in foreign countries. Because we sell some of our products overseas, we have exposure to foreign intellectual property risks.

We are involved from time to time in claims and litigation over intellectual property rights, which may adversely affect our ability to manufacture and sell our products.

Our industry is characterized by vigorous protection and pursuit of intellectual property rights. It may be necessary, from time to time, to initiate litigation against third parties to preserve our intellectual property rights. Some of our suppliers and licensors have generally agreed to provide us with various levels of intellectual property indemnification for products and technology we purchase or license from them. A third party could claim that our products infringe or contribute to the infringement of a patent or other proprietary right. From time to time, we have received, and may continue to receive in the future, notices that claim we have infringed upon, misappropriated or misused other parties' proprietary rights. Any of the foregoing events or claims could result in litigation. Such litigation, whether as plaintiff or defendant, would likely result in significant expense to us and divert the efforts of our technical and management personnel, whether or not such litigation is ultimately determined in our favor. In the event of an adverse result in such litigation, we could be required to pay substantial damages, cease the manufacture, use and sale of certain products, expend significant resources to develop, license or acquire non-infringing technology, discontinue the use of certain processes or obtain licenses to use the infringed technology. In addition, our suppliers' and licensors' obligation to indemnify us for intellectual property infringement may be insufficient or inapplicable to any such litigation or other claims of intellectual property infringement.

Our failure to obtain a required license on commercially reasonable terms, or at all, could cause us to incur substantial costs and suspend manufacturing products using the infringed technology. If we obtain a license, we would likely be required to pay license fees or make royalty payments for sales under the license. Such payments would increase our costs of revenues and reduce our gross margins and gross profit. If we are unable to obtain a license from a third party for technology, we could incur substantial liabilities or be required to expend substantial resources redesigning our products to eliminate the infringement. There can be no assurance that we would be successful in redesigning our products or that we could obtain licenses on commercially reasonable terms, if at all. Product development or license negotiating would likely result in significant expense to us and divert the efforts of our technical and management personnel.

Our indemnification obligations for products that infringe the intellectual property rights of others could require us to pay substantial damages.

We currently have in effect a number of agreements in which we have agreed to defend, indemnify and hold harmless our customers and suppliers from damages and costs which may arise from the infringement by our products and services of third-party patents, trademarks or other proprietary rights. The scope of such indemnity varies, but may, in some instances, include indemnification for damages and expenses, including attorneys' fees. We may from time to time be engaged in litigation as a result of such indemnification obligations. Our insurance does not cover intellectual property infringement. The term of these indemnification agreements is generally perpetual any time after execution of the agreement. The maximum potential amount of future payments we could be required to make under these indemnification agreements is generally unlimited. We may periodically have to respond to claims and litigate these types of indemnification obligations. Any such indemnification claims could require us to pay substantial damages that may result in a material adverse effect on our business and results of operations.

Our indemnification obligations to our customers and suppliers for product defects could require us to pay substantial damages.

A number of our product sales and product purchase agreements provide that we will defend, indemnify and hold harmless our customers and suppliers from damages and costs which may arise from product warranty claims or claims for injury or damage resulting from defects in our products. We maintain insurance to protect against certain claims associated with the use of our products, but our insurance coverage may not be adequate to cover all or any part of the claims asserted against us. A successful claim brought against us that is in excess of, or excluded from, our insurance coverage could substantially harm our business, financial condition and results of operations.

Table of Contents

Global economic conditions and the global financial crisis may have an impact on our business and financial condition in ways that we currently cannot predict.

As a result of the prolonged downturn in global economic activity, spending on information technology has deteriorated significantly in the U.S. and many other countries may remain depressed for the foreseeable future. Uncertainty in the financial and credit markets have caused many of our customers to postpone or cancel purchases. These worldwide economic conditions make it extremely difficult for our customers, our vendors and us to accurately forecast and plan future business activities, and they could cause our customers to further reduce or slow spending on our products, which would delay and lengthen sales cycles. Furthermore, during challenging economic times our customers may face issues gaining timely access to sufficient credit, which could result in an impairment of their ability to make timely payments to us. If that were to occur, we may experience increased collection times or write-offs, which could have a material adverse effect on our revenues and cash flow. Similarly, our vendors may also face issues gaining timely access to sufficient credit, which could result in an impairment of their ability to supply us with components that are needed in the manufacture of our products. If that were to occur, we may experience delays in our production and increased costs associated with our qualification of additional new vendors and replacement of their components, which could have a material adverse effect on our revenues and cash flow. Finally, our ability to access the capital markets may be restricted, which could have an impact on our flexibility to pursue additional expansion opportunities and maintain our desired level of revenue growth in the future. These and other economic factors could have a material adverse effect on demand for our products and services and on our financial condition and operating results.

Failure to maintain effective internal control over financial reporting could cause our investors to lose confidence and adversely affect the market price of our common stock.

Section 404 of the Sarbanes-Oxley Act of 2002 requires that we maintain internal control over financial reporting that meets applicable standards. We may err in the design or operation of our controls, and all internal control systems, no matter how well designed and operated, can provide only reasonable assurance that the objectives of the control system are met. Because there are inherent limitations in all control systems, there can be no absolute assurance that all control issues have been or will be detected. In addition, a failure to maintain such controls could result in misstatements in our financial statements. If we are unable, or are perceived as unable, to produce reliable financial reports due to internal control deficiencies, investors could lose confidence in our reported financial information and operating results, which could result in a negative market reaction.

Failure to comply with governmental laws and regulations could harm our business.

Our business is subject to regulation by various U.S. federal, state, local and foreign governmental authorities and agencies. Such regulation includes employment and labor laws, workplace safety, product safety, environmental laws, consumer protection laws, import/export controls, federal securities laws and tax.

As a global company, we are subject to varied and complex laws, regulations and customs domestically and internationally. These laws and regulations relate to a number of aspects of our business, including trade protection, import and export control, data and transaction processing security, records management, gift policies, employment and labor relations laws, workplace safety, product safety, environmental laws, federal securities laws, tax regulations, and other regulatory requirements affecting our foreign operations. The application of these laws and regulations to our business is often unclear and may at times conflict. Compliance with these laws and regulations may involve significant costs or require changes in our business practices that result in reduced revenue and profitability. Non-compliance could also result in fines, damages, criminal sanctions against us, our officers, or our employees, prohibitions on the conduct of our business, and damage to our reputation. We incur additional legal compliance costs associated with our global operations and could become subject to legal penalties in foreign countries if we do not comply with local laws and regulations, which may be substantially different from those in the U.S. In many foreign countries, particularly in those with developing economies, it may be common to engage in business practices that are prohibited by U.S. regulations applicable to us, such as the U.S. Foreign Corrupt Practices Act. Although we implement policies and procedures designed to ensure compliance with these laws, there can be no assurance that all of our employees, contractors and agents, as well as those companies to which we outsource certain aspects of our business operations, including those based in foreign countries where practices which violate such U.S. laws may be customary, will not take actions in violation of our internal policies.

Table of Contents

Noncompliance with applicable regulations or requirements could subject us to investigations, sanctions, mandatory product recalls, enforcement actions, disgorgement of profits, fines, damages, civil and criminal penalties, or injunctions. These actions could harm our business, financial condition, results of operations and cash flows. If any governmental sanctions or fines are imposed, or if we do not prevail in any possible civil or criminal litigation, our business, financial condition, results of operations and cash flows could be materially adversely affected. In addition, responding to any action will likely result in a significant diversion of management's attention and resources and an increase in professional fees.

In addition, from time to time, we have received, and expect to continue to receive, complaints from former employees who threaten to bring claims against us alleging that we have violated one or more labor and employment regulations. In certain of these instances, the former employees have brought formal claims against us and we expect that we will encounter similar actions against us in the future. An adverse outcome in any such litigation could require us to pay contractual damages, compensatory damages, punitive damages, attorneys' fees and costs.

Compliance with evolving environmental regulations and standards could harm our business.

We may be required to meet and adjust to evolving environmental requirements relating to the material composition of our products. As environmental requirements change, substituting particular components with conforming components to meet new environmental standards may prove to be difficult or costly, and additional redesign efforts could result in production delays. Our operations may be affected by significant changes to existing or future environmental laws and regulations, including those imposed in response to climate change concerns and other actions commonly referred to as "green initiatives." Although we cannot predict the ultimate impact of any such new laws and regulations, they may result in additional costs or decreased revenue, which could have a material adverse effect on our business.

Changes in the applicable tax laws could materially affect our future results.

We operate in different countries throughout the world and are subject to taxation in a variety of jurisdictions. As a result, our future effective tax rates could be impacted by changes in the applicable tax laws of such jurisdictions or the interpretation of such tax laws. It is not possible to accurately determine the likelihood of changes in tax laws or in the administration of those laws, but any increase in our effective tax rate would adversely affect our future after-tax profits.

We may have exposure to greater than anticipated tax liabilities.

Our future income taxes could be adversely affected if earnings are higher than anticipated in jurisdictions where we have higher statutory tax rates, by changes in the valuation of our deferred tax assets and liabilities, or changes in tax laws, regulations, accounting principles, or interpretations thereof. We are subject to regular review and audit by both domestic and foreign tax authorities. Any adverse outcome of such a review or audit could negatively impact our operating results and financial condition. In addition, the determination of our global provision for income taxes and other tax liabilities requires significant judgment and in the ordinary course of our business, there are many transactions where the ultimate tax determination is uncertain. Additionally, our calculations of income taxes are based on our interpretations of applicable tax laws in the jurisdictions in which we file. Although we believe our tax estimates are reasonable, the ultimate tax outcome may differ from the amounts recorded in our financial statements and may materially affect our financial results in the period or periods for which such determination is made.

Two of our largest shareholders are executives and directors of our company and their interests may diverge from other shareholders.

Manouch Moshayedi and Mark Moshayedi are brothers who (along with a third brother Mike Moshayedi) founded our company. They have owned a substantial amount of shares since our inception. As of June 30, 2011, Manouch and Mark Moshayedi beneficially owned approximately 15% of our outstanding common stock. As shareholders, Manouch and Mark Moshayedi may have interests that diverge from those of other holders of our common stock. In addition, Manouch and Mark Moshayedi are executive officers and directors. As a result, they have the potential ability to control or influence all matters requiring approval by our shareholders, including approval of significant corporate transactions and the decision of whether a change in control will occur. This potential control could affect the price that certain investors may be willing to pay in the future for shares of our common stock.

Table of Contents

Certain provisions in our charter documents and stock option plan could prevent or delay a change in control and, as a result, negatively impact our shareholders.

We have taken a number of actions that could have the effect of discouraging a takeover attempt. For example, provisions in our articles of incorporation and bylaws could make it more difficult for a third party to acquire us, even if doing so would be beneficial to our shareholders. These provisions also could limit the price that certain investors might be willing to pay in the future for shares of our common stock.

These provisions include:

Limitations on who may call special meetings of shareholders;

Advance notice requirements for nominations for election to the board of directors or for proposing matters that can be acted upon by shareholders at shareholder meetings;

Elimination of cumulative voting in the election of directors;

The right of a majority of directors in office to fill vacancies on the board of directors; and

The ability of our board of directors to issue, without shareholder approval, blank check preferred stock to increase the number of outstanding shares and thwart a takeover attempt.

In addition, provisions of our 2000 Stock Incentive Plan and 2010 Incentive Award Plan allow for the automatic vesting of all outstanding equity awards granted under the 2000 Stock Incentive Plan and 2010 Incentive Award Plan upon a change in control under certain circumstances. Such provisions may also have the effect of discouraging a third party from acquiring us, even if doing so would be beneficial to our shareholders.

Our stock price is volatile.

Our common stock has been publicly traded since September 2000. The market price of our common stock has been subject to significant fluctuations since the date of our initial public offering. The stock market has from time to time experienced significant price and volume fluctuations that have affected the market prices of securities, particularly securities of technology companies. As a result, the market price of our common stock may materially decline, regardless of our operating performance.

In addition, the market prices of securities of other technology companies have been and remain volatile. This volatility has significantly affected the market prices of securities of many technology companies for reasons frequently unrelated to the operating performance of the specific companies. Accordingly, you may not be able to resell your shares of common stock at or above the price you paid. In the past, we and other companies that have experienced volatility in the market price of their securities have been, and we currently are, the subject of securities class action litigation. Litigation of this type is often expensive, diverts management's attention and resources and may have a material adverse effect on our business and operating results.

Table of Contents**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS***Issuer Purchases of Equity Securities*

The following is a summary of our common stock repurchased and average price paid per share for the three months ended June 30, 2011:

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Programs (1) | Maximum Dollar Value that May Yet be Purchased Under the Programs |
|--------------------------------|---|---|--|--|
| As of March 31, 2011 | | | | |
| April 1 through April 30, 2011 | | | | |
| May 1 through May 31, 2011 | | | | |
| June 1 through June 30, 2011 | | | | |
| Total | | \$ | | \$ (1) |

- (1) In November 2009, our board of directors authorized a share repurchase program effective November 10, 2009, enabling us to repurchase up to \$75 million of our common stock over an 18-month period that expired on May 9, 2011. There were no shares repurchased under this program.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. REMOVED AND RESERVED**ITEM 5. OTHER INFORMATION**

None.

Table of Contents**ITEM 6. EXHIBITS**

| Exhibit | | Incorporation by Reference | | |
|----------------|---|-----------------------------------|----------------|--------------------|
| | | Form | Exhibit | Filing Date |
| Index | Exhibit Description | | | |
| 10.1 | First Amendment to the Registrant's 2010 Incentive Award Plan | 8-K | 10.2 | May 24, 2011 |
| 31.1 | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 | | | Filed herewith |
| 31.2 | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 | | | Filed herewith |
| 32.1* | Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | | | Furnished herewith |
| 32.2* | Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | | | Furnished herewith |
| 101.INS** | XBRL Instance Document | | | |
| 101.SCH** | XBRL Taxonomy Extension Schema Document | | | |
| 101.CAL** | XBRL Taxonomy Extension Calculation Linkbase Document | | | |
| 101.LAB** | XBRL Taxonomy Extension Label Linkbase Document | | | |
| 101.PRE** | XBRL Taxonomy Extension Presentation Linkbase Document | | | |

Management contract or compensatory plan or arrangement.

* The information in Exhibits 32.1 and 32.2 shall not be deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended (the Exchange Act), or otherwise subject to the liabilities of that section, nor shall they be deemed incorporated by reference in any filing under the Securities Act of 1933, as amended, or the Exchange Act (including this Report), unless the Registrant specifically incorporates the foregoing information into those documents by reference.

** Pursuant to applicable securities laws and regulations, the Company is deemed to have complied with the reporting obligation relating to the submission of interactive data files in such exhibits and are not subject to liability under any anti-fraud provisions of the federal securities laws as long as the Company has made a good faith attempt to comply with the submission requirements and promptly amend the interactive data files after becoming aware that the interactive data files fail to comply with the submission requirements. Users of this data are advised that, pursuant to Rule 406T, these interactive data files are deemed not filed and otherwise are not subject to liability.

Table of Contents

SIGNATURES

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.

STEC, INC.,

a California corporation

Date: August 2, 2011

/s/ RAYMOND D. COOK
Raymond D. Cook

Chief Financial Officer

(Principal Financial Officer and Duly Authorized Signatory)

Table of Contents**STEC, INC.****Index to Exhibits**

| Exhibit Index | Exhibit Description | Incorporation by Reference | | |
|---------------|---|----------------------------|---------|--------------------|
| | | Form | Exhibit | Filing Date |
| 10.1 | First Amendment to the Registrant's 2010 Incentive Award Plan | 8-K | 10.2 | May 24, 2011 |
| 31.1 | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 | | | Filed herewith |
| 31.2 | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 | | | Filed herewith |
| 32.1* | Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | | | Furnished herewith |
| 32.2* | Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | | | Furnished herewith |
| 101.INS** | XBRL Instance Document | | | |
| 101.SCH** | XBRL Taxonomy Extension Schema Document | | | |
| 101.CAL** | XBRL Taxonomy Extension Calculation Linkbase Document | | | |
| 101.LAB** | XBRL Taxonomy Extension Label Linkbase Document | | | |
| 101.PRE** | XBRL Taxonomy Extension Presentation Linkbase Document | | | |

Management contract or compensatory plan or arrangement.

* The information in Exhibits 32.1 and 32.2 shall not be deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended (the Exchange Act), or otherwise subject to the liabilities of that section, nor shall they be deemed incorporated by reference in any filing under the Securities Act of 1933, as amended, or the Exchange Act (including this Report), unless the Registrant specifically incorporates the foregoing information into those documents by reference.

** Pursuant to applicable securities laws and regulations, the Company is deemed to have complied with the reporting obligation relating to the submission of interactive data files in such exhibits and are not subject to liability under any anti-fraud provisions of the federal securities laws as long as the Company has made a good faith attempt to comply with the submission requirements and promptly amend the interactive data files after becoming aware that the interactive data files fail to comply with the submission requirements. Users of this data are advised that, pursuant to Rule 406T, these interactive data files are deemed not filed and otherwise are not subject to liability.