

ULTRA CLEAN HOLDINGS INC
Form 10-Q
August 03, 2011
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended July 1, 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 000-50646

Ultra Clean Holdings, Inc.

(Exact name of registrant as specified in its charter)

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| | |
|--|--|
| Delaware (State or other jurisdiction of incorporation or organization) | 61-1430858 (I.R.S. Employer Identification No.) |
| 26462 Corporate Avenue, Hayward, California (Address of principal executive offices) | 94545 (Zip Code) |
| (510) 576-4400 | |

Registrant's telephone number, including area code

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

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

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

| | |
|--|---|
| Large accelerated filer <input type="checkbox"/> | Accelerated filer <input checked="" type="checkbox"/> |
| Non-accelerated filer <input type="checkbox"/> (Do not check if a smaller reporting company) | Smaller reporting company <input type="checkbox"/> |

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

Number of shares outstanding of the issuer's common stock as of July 27, 2011: 22,817,037

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ULTRA CLEAN HOLDINGS, INC.

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Table of Contents**PART I. FINANCIAL INFORMATION****ITEM 1. Financial Statements****ULTRA CLEAN HOLDINGS, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS****(Unaudited; in thousands, except share amounts)**

| | July 1, 2011 | December 31, 2010 |
|--|-------------------|----------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 37,636 | \$ 34,654 |
| Accounts receivable, net of allowance of \$125 and \$125, respectively | 57,779 | 54,589 |
| Inventory | 69,871 | 59,288 |
| Prepaid expenses and other | 8,858 | 5,935 |
| Total current assets | 174,144 | 154,466 |
| Equipment and leasehold improvements, net | 10,256 | 8,971 |
| Purchased intangibles, net | 8,987 | 8,987 |
| Other non-current assets | 598 | 571 |
| Total assets | \$ 193,985 | \$ 172,995 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Bank borrowings | \$ 3,333 | \$ 4,110 |
| Accounts payable | 48,916 | 45,957 |
| Accrued compensation and related benefits | 5,137 | 3,689 |
| Deferred rent, current portion | 833 | 770 |
| Other current liabilities | 5,973 | 3,195 |
| Total current liabilities | 64,192 | 57,721 |
| Long-term debt | 22,900 | 24,542 |
| Deferred rent and other liabilities | 2,791 | 3,223 |
| Total liabilities | 89,883 | 85,486 |
| Commitments and contingencies (See note 6) | | |
| Stockholders' equity: | | |
| Preferred stock \$0.001 par value, 10,000,000 authorized; none outstanding | | |
| Common stock \$0.001 par value, 90,000,000 authorized; 22,812,703 and 22,299,982 shares issued and outstanding, in 2011 and 2010, respectively | 106,611 | 102,796 |

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| | | |
|--|----------------|---------------|
| Common shares held in treasury, at cost, 601,944 shares in 2011 and 2010 | (3,337) | (3,337) |
| Retained earnings (deficit) | 828 | (11,950) |
| Total stockholders' equity | 104,102 | 87,509 |
| Total liabilities and stockholders' equity | \$ 193,985 | \$ 172,995 |

(See accompanying notes to condensed consolidated financial statements)

Table of Contents**ULTRA CLEAN HOLDINGS, INC.****CONDENSED CONSOLIDATED STATEMENTS OF INCOME****(Unaudited; in thousands, except per share data)**

| | Three months ended | | Six months ended | |
|---|---------------------------|-------------------------|-------------------------|-------------------------|
| | July 1, 2011 | July 2, 2010 | July 1, 2011 | July 2, 2010 |
| Sales | \$ 133,741 | \$ 105,878 | \$ 260,460 | \$ 204,345 |
| Cost of goods sold | 114,748 | 91,083 | 223,915 | 177,174 |
| Gross profit | 18,993 | 14,795 | 36,545 | 27,171 |
| Operating expenses: | | | | |
| Research and development | 1,437 | 1,390 | 3,042 | 2,447 |
| Sales and marketing | 2,018 | 1,895 | 4,075 | 3,528 |
| General and administrative | 6,045 | 4,941 | 11,748 | 10,004 |
| Total operating expenses | 9,500 | 8,226 | 18,865 | 15,979 |
| Income from operations | 9,493 | 6,569 | 17,680 | 11,192 |
| Interest and other income (expense), net | (367) | (145) | (735) | (300) |
| Income before provision for income taxes | 9,126 | 6,424 | 16,945 | 10,892 |
| Income tax provision | 2,168 | 770 | 4,167 | 1,388 |
| Net income | \$ 6,958 | \$ 5,654 | \$ 12,778 | \$ 9,504 |
| Net income per share: | | | | |
| Basic | \$ 0.31 | \$ 0.26 | \$ 0.57 | \$ 0.44 |
| Diluted | \$ 0.30 | \$ 0.25 | \$ 0.54 | \$ 0.41 |
| Shares used in computing net income per share: | | | | |
| Basic | 22,734 | 21,670 | 22,597 | 21,589 |
| Diluted | 23,482 | 23,016 | 23,528 | 22,905 |

(See accompanying notes to condensed consolidated financial statements)

Table of Contents**ULTRA CLEAN HOLDINGS, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(Unaudited; in thousands)**

| | Six months ended | |
|--|-------------------------|-------------------------|
| | July 1, 2011 | July 2, 2010 |
| Cash flows from operating activities: | | |
| Net income | \$ 12,778 | \$ 9,504 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | | |
| Depreciation and amortization | 1,361 | 1,114 |
| Excess tax benefit from stock-based compensation | (755) | (426) |
| Stock-based compensation | 2,166 | 1,577 |
| Changes in assets and liabilities: | | |
| Accounts receivable, net of allowance | (3,190) | (10,904) |
| Inventory | (10,583) | (8,082) |
| Prepaid expenses and other | (2,923) | 3,205 |
| Other non-current assets | (27) | 22 |
| Accounts payable | 2,969 | (2,822) |
| Accrued compensation and related benefits | 1,448 | 1,942 |
| Other liabilities | 3,166 | (694) |
| Net cash provided by (used in) operating activities | 6,410 | (5,564) |
| Cash flows used in investing activities: | | |
| Purchases of equipment and leasehold improvements | (2,656) | (2,024) |
| Proceeds from sale of equipment | | 46 |
| Net cash used in investing activities | (2,656) | (1,978) |
| Cash flows provided by (used in) financing activities: | | |
| Proceeds from revolving credit facility | | 4,000 |
| Principal payments on term debt and capital lease obligations | (2,421) | (998) |
| Excess tax benefit from stock-based compensation | 755 | 426 |
| Proceeds from issuance of common stock | 894 | 518 |
| Net cash provided by (used in) financing activities | (772) | 3,946 |
| Net increase (decrease) in cash | 2,982 | (3,596) |
| Cash and cash equivalents at beginning of period | 34,654 | 26,697 |
| Cash and cash equivalents at end of period | \$ 37,636 | \$ 23,101 |
| Supplemental items: | | |
| Cash paid/refunded during the period: | | |
| Income taxes paid | \$ 2,190 | \$ 1,798 |
| Income tax refunds | \$ (613) | \$ (5,005) |

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| | | | | |
|--|----|-----|----|-----|
| Interest | \$ | 616 | \$ | 412 |
| Non-cash investing activities: | | | | |
| Fixed asset purchases included in accounts payable | \$ | 0 | \$ | 47 |

(See accompanying notes to condensed consolidated financial statements)

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ULTRA CLEAN HOLDINGS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Organization, Basis of Presentation and Significant Accounting Policies

Organization Ultra Clean Holdings, Inc. (the Company) is a leading developer and supplier of critical subsystems, primarily for the semiconductor capital equipment industry. The Company also leverages the specialized skill sets required to support semiconductor capital equipment to serve the technologically similar markets in the flat panel, medical, energy and research industries, collectively referred to as Other Addressed Industries. The Company develops, designs, prototypes, engineers, manufactures and tests subsystems which are highly specialized and tailored to specific steps in the semiconductor manufacturing process as well as the manufacturing processes in Other Addressed Industries. Revenue is derived from the sale of gas delivery systems and other critical subsystems including chemical mechanical planarization (CMP) subsystems, chemical delivery modules, top-plate assemblies, frame assemblies, process modules and other high level assemblies.

The Company's customers are primarily original equipment manufacturers (OEMs) in industries it supports, providing customers complete subsystem solutions that combine the Company's expertise in design, test, component characterization and highly flexible manufacturing operations with quality control and financial stability. This combination helps the Company to drive down total manufacturing costs, reduce design-to-delivery cycle times and maintain high quality standards for our customers. The Company believes these characteristics, as well as the Company's standing as a leading supplier of gas delivery systems and other critical subsystems, place the Company in a strong position to benefit from the growing demand for subsystem outsourcing.

Basis of Presentation The unaudited condensed consolidated financial statements included in this quarterly report on Form 10-Q include the accounts of the Company and its wholly-owned subsidiaries and have been prepared in accordance with generally accepted accounting principles in the United States of America (GAAP). This financial information reflects all adjustments which are, in the opinion of the Company, normal, recurring and necessary to present fairly the statements of financial position, results of operations and cash flows for the dates and periods presented. The Company's December 31, 2010, balance sheet data was derived from audited financial statements as of that date.

The unaudited condensed consolidated financial statements should be read in conjunction with the Company's consolidated financial statements for the fiscal year ended December 31, 2010, included in its Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 16, 2011. The Company's results of operations for the three and six months ended July 1, 2011, are not necessarily indicative of the results to be expected for any future periods.

Principles of Consolidation The Company's consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries and all significant intercompany accounts and transactions have been eliminated in consolidation.

Foreign Currency Translation The Company has reviewed its non-U.S. subsidiaries that operate in a local currency environment to determine their functional currency by examining how and in what currency each subsidiary generates cash through billings and cash receipts and how and in what currency the subsidiary expends cash through payment of its vendors and payment of its workforce. Also, these subsidiaries individual assets and liabilities that are primarily denominated in the local foreign currency are examined for their impact on the Company's cash flows. All have been determined to have the U.S. dollar as its functional currency. All balance sheet accounts of these local functional currency subsidiaries are translated at the fiscal period-end exchange rate, and income and expense accounts are translated using average rates in effect for the period, except for costs related to those balance sheet items that are translated using historical exchange rates. The resulting translation adjustments are recorded as cumulative translation adjustments, and are a component of accumulated other comprehensive income (loss). Foreign currency transaction gains and losses are recorded in other income (expense), net.

Use of Accounting Estimates The presentation of financial statements in conformity with generally accepted accounting principles in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and disclosures of contingent liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The Company bases its estimates and judgments on historical experience and on various other assumptions that it believes are reasonable under the circumstances. However, future events are subject to change and the best estimates and judgments routinely require adjustment. Actual amounts may differ from those estimates.

Certain Significant Risks and Uncertainties The Company operates in a dynamic industry and, accordingly, can be affected by a variety of factors. For example, any of the following areas could have a negative effect on the Company in terms of its future financial position, results of

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operations or cash flows: the general state of the U.S. and world economies, the highly cyclical nature of the industries the Company serves; the loss of any of a small number of customers; ability to obtain additional financing; pursuing acquisition opportunities; regulatory changes; fundamental changes in the technology underlying semiconductor, flat panel, solar and medical device manufacturing processes or manufacturing equipment; the hiring, training and retention of key employees; successful and timely completion of product design efforts; and new product design introductions by competitors.

Concentration of Credit Risk Financial instruments which subject the Company to concentrations of credit risk consist principally of cash and cash equivalents and accounts receivable. The Company sells its products primarily to semiconductor capital equipment manufacturers in the United States. The Company performs credit evaluations of its customers' financial condition and generally requires no collateral.

Table of Contents**ULTRA CLEAN HOLDINGS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

Significant sales to customers The Company had significant sales to two customers- Applied Materials, Inc. and Lam Research Corporation , each of which accounted for 10% or more of sales for the six months ended July 1, 2011 and July 2, 2010. Sales to each of these customers as a percentage of total sales were as follows:

| | Six months ended | |
|--------------|-------------------------|-------------------------|
| | July 1, 2011 | July 2, 2010 |
| Customer A | 33.0% | 37.0% |
| Customer B | 26.0% | 27.0% |
| Total | 59.0% | 64.0% |

These two customers' accounts receivable balances were individually greater than 10% of accounts receivable and, in aggregate, represented approximately 63% and 63% of accounts receivable as of July 1, 2011 and December 31, 2010, respectively.

Fair Value of Financial Instruments The Company's financial instruments consist of cash and cash equivalents, accounts receivable, accounts payable and bank borrowings. The carrying value of these instruments approximates their fair value because of their short-term nature.

Fiscal Year The Company uses a 52-53 week fiscal year ending on the Friday nearest December 31. All references to quarters refer to fiscal quarters and all references to years refer to fiscal years.

Income Taxes The Company utilizes the asset and liability method of accounting for income taxes, under which deferred taxes are determined based on the temporary differences between the financial statement and tax basis of assets and liabilities using tax rates expected to be in effect during the years in which the basis differences reverse. A valuation allowance is recorded when it is more likely than not that some of the deferred tax assets will not be realized. As of July 1, 2011, the Company maintained a full valuation allowance on its U.S. deferred tax assets and a partial valuation allowance on its non-U.S. deferred tax assets. Income tax positions must meet a more-likely-than-not recognition threshold to be recognized. Income tax positions that previously failed to meet the more-likely-than-not threshold are recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not threshold are derecognized in the first subsequent financial reporting period in which that threshold is no longer met. The Company recognizes potential accrued interest and penalties related to unrecognized tax benefits within the condensed consolidated statements of operations as income tax expense. The calculation of tax liabilities involves significant judgment in estimating the impact of uncertainties in the application of complex tax laws. Resolution of these uncertainties in a manner inconsistent with the Company's expectations could have a material impact on its results of operations and financial position. Management believes that it has adequately provided for any adjustments that may result from these examinations; however, the outcome of tax audits cannot be predicted with certainty.

The Company files income tax returns in the U.S. federal jurisdiction, various states and foreign jurisdictions. The Company's 2005 and 2006 state income tax returns are currently under examination by the California Franchise Tax Board and the Company's state income tax returns are open to audit under the statute of limitations for the fiscal years 2005 through 2009. The Company is also subject to examination in various other jurisdictions for various periods. The Company's federal returns are still open under the statute of limitations for fiscal years 2004 through 2005.

Table of Contents**ULTRA CLEAN HOLDINGS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

Product Warranty The Company provides a warranty on its products for a period of up to two years and provides for warranty costs at the time of sale based on historical activity. The determination of such provisions requires the Company to make estimates of product return rates and expected costs to repair or replace the products under warranty. If actual return rates and/or repair and replacement costs differ significantly from these estimates, adjustments to cost of sales may be required in future periods. Components of the reserve for warranty costs consisted of the following (in thousands):

| | Six months ended | |
|----------------------------|-------------------------|-------------------------|
| | July 1, 2011 | July 2, 2010 |
| Beginning balance | \$ 204 | \$ 112 |
| Additions related to sales | 447 | 207 |
| Warranty claims | (328) | (152) |
| Ending balance | \$ 323 | \$ 167 |

Revenue Recognition Product revenue is generally recorded upon shipment. In arrangements which specify title transfer upon delivery, revenue is not recognized until the product is delivered. The Company recognizes revenue when persuasive evidence of an arrangement exists, shipment has occurred, price is fixed or determinable and collectability is reasonably assured. If the Company has not substantially completed a product or fulfilled the terms of a sales agreement at the time of shipment, revenue recognition is deferred until completion. The Company's standard arrangement for its customers includes a signed purchase order or contract, no right of return of delivered products and no customer acceptance provisions.

The Company assesses collectability based on the credit worthiness of the customer and past transaction history. The Company performs on-going credit evaluations of customers and generally does not require collateral from customers.

Research and Development Costs Research and development costs are expensed as incurred.

Net Income per Share Basic net income per share is computed by dividing net income by the weighted average number of shares outstanding for the period. Diluted net income per share is calculated by dividing net income by the weighted average number of common shares outstanding and common equivalent shares from dilutive stock options and restricted stock using the treasury stock method, except when such shares are anti-dilutive.

Comprehensive Income The Company reports by major components and as a single total, the change in its net assets during the period from non-owner sources. Comprehensive income for all periods presented was the same as net income.

Segments The Financial Accounting Standards Board's (FASB) guidance regarding disclosure about segments in an enterprise and related information establishes standards for the reporting by public business enterprises of information about reportable segments, products and services, geographic areas, and major customers. The method for determining what information to report is based on the manner in which management organizes the reportable segments within the Company for making operational decisions and assessments of financial performance. The Company's chief operating decision-maker is considered to be the Chief Executive Officer. The Company operates in one reporting segment.

Stock-Based Compensation Expense

The Company maintains stock-based compensation plans which allow for the issuance of equity-based awards to executives and certain employees. These equity-based awards include stock options, restricted stock awards and restricted stock units which can be either time-based or

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performance-based. The Company also maintains an employee stock purchase plan (ESPP) that provides for the issuance of shares to all eligible employees of the Company at a discounted price.

Stock-based compensation expense includes compensation costs related to estimated fair values of stock options and awards granted. The estimated fair value of the Company's equity-based awards, net of expected forfeitures, is amortized over the awards' vesting period on a straight-line basis over a weighted average period of four years for stock options, three years for restricted stock awards and will be adjusted for subsequent changes in estimated forfeitures and future option grants.

The Company applies the fair value recognition provisions based on the FASB's guidance regarding *stock-based compensation*. The exercise price of each stock option equals the market price of the Company's stock on the date of grant. The estimated fair value of the Company's equity-based awards, less expected forfeitures, is amortized over the awards' vesting periods on a straight-line basis over a weighted average period of four years and will be adjusted for subsequent changes in estimated forfeitures and future option grants. Most options are scheduled to vest over four years and expire no later than ten years from the grant date. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model. The determination of the fair value of share-based payment awards on the date of grant using an option-pricing model is affected by the Company's stock price as well as assumptions regarding a number of complex and subjective variables. These variables include the expected term of the awards; the Company's expected stock price volatility over the term of the awards, actual and projected employee stock option exercise behaviors, risk-free interest rate and expected dividends. The Company estimates the expected term of share-based awards granted based, in part, on the Company's historical option term experience. The Company estimates the volatility of its common stock based upon the Company's historical stock price volatility over the length of the expected term of the options. The Company bases the risk-free interest rate that it uses in the option valuation model on U.S. Treasury zero-coupon issues with remaining maturities similar to the expected term of the options. The Company does not anticipate paying any cash dividends in the foreseeable future and therefore uses an expected dividend yield of zero in the option valuation model. The Company is required to estimate forfeitures at the time of grant and revise those estimates in subsequent periods if actual forfeitures differ from those estimates. The Company uses historical data to estimate pre-vesting option forfeitures and records share-based compensation expense only for those awards that are expected to vest. Currently, the Company considers semi-annually whether there have been any significant changes in facts and circumstances that would affect its forfeiture rate.

Table of Contents**ULTRA CLEAN HOLDINGS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)*****Stock Options***

The assumptions used for stock option grants are outlined in the following table:

| | Three months ended | | Six months ended | |
|--------------------------|---------------------------|----------------|-------------------------|----------------|
| | July 1, | July 2, | July 1, | July 2, |
| | 2011 | 2010 | 2011 | 2010 |
| Dividend yield | | | | 0.0% |
| Expected volatility | | | | 75.0% |
| Risk-free interest rate | | | | 2.3% |
| Expected life (in years) | | | | 5.5 |

There were no options issued by the Company during the six month period ended July 1, 2011 and the three month period ended July 2, 2010.

The following table summarizes information with respect to options granted, exercised and canceled for the six months ended July 1, 2011 and outstanding at July 1, 2011:

| | Number of Shares |
|--|-----------------------------|
| Options outstanding at December 31, 2010 | 1,982,963 |
| Granted | |
| Exercised | (236,680) |
| Canceled | (26,269) |
| Options outstanding at July 1, 2011 | 1,720,014 |

The weighted-average exercise price, aggregate intrinsic value and weighted average remaining contractual life of outstanding options as of July 1, 2011 were \$6.39 per share, \$6.8 million and 5.6 years, respectively. As of July 1, 2011, 1,360,987 options with a weighted-average exercise price of \$7.62 per share, aggregate intrinsic value of \$4.0 million and a weighted average remaining contractual life of 5.0 years were exercisable. The total unamortized expense of the Company's unvested options, net of forfeitures, as of July 1, 2011, was \$0.3 million. The weighted average estimated fair value of employee stock option grants for the three months ended April 2, 2010 was \$4.27 per share.

Employee Stock Purchase Plan

The Company also maintains an employee stock purchase plan (ESPP) that provides for the issuance of shares to all eligible employees of the Company at a discounted price. Under the ESPP, substantially all employees may purchase the Company's common stock through payroll deductions at a price equal to 95 percent of the fair market value of the Company's stock at the end of each applicable purchase period.

Restricted Stock Units and Restricted Stock Awards

The Company grants Restricted Stock Units (RSU s) to employees and Restricted Stock Awards (RSA s) to non-employee directors as part of the Company's long term equity compensation plan.

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Restricted Stock Units RSU s are granted to employees with a per share or unit purchase price of zero dollars and either have time based or performance based vesting. RSU s typically vest over three years, subject to the employee s continued service with the Company. For purposes of determining compensation expense related to these RSU s, the fair value is determined based on the closing market price of the Company s common stock on the date of award. The expected cost of the grant is reflected over the service period, and is reduced for estimated forfeitures. The Company granted 443,500 RSU s (including 66,250 performance stock units) during the quarter ended April 1, 2011, with a weighted average fair value of \$10.30 per share and granted 249,550 RSU s during the quarter ended July 1, 2011, with a weighted average fair value of \$11.20 per share. The Company granted 614,500 RSU s during the first quarter ended April 2, 2010, with a weighted average fair value of \$8.87 per share and granted 12,500 RSU s during the second quarter ended July 2, 2010, with a weighted average fair value of \$9.33 per share. As of July 1, 2011, \$8.0 million of stock-based compensation cost, net of forfeitures, related to RSU s remains to be amortized, of which substantially all is expected to be recognized over an estimated period of less than three years. As of July 1, 2011, a total of 1,215,603 RSU s remain outstanding with an aggregate intrinsic value of \$11.4 million and a weighted average remaining contractual term of 1.6 years.

Restricted Stock Awards During the quarter ended July 1, 2011, the Company issued 37,500 shares of RSA s to its non-employee directors. The total unamortized expense of the Company s unvested RSA s as of July 1, 2011, was approximately \$0.4 million.

Table of Contents**ULTRA CLEAN HOLDINGS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

The following table summarizes the Company's restricted stock unit and restricted stock award activity for the six months ended July 1, 2011 (in thousands):

| | Number of Shares |
|--|-----------------------------|
| Unvested restricted stock units and restricted stock awards at December 31, 2010 | 797 |
| Granted | 731 |
| Vested | (269) |
| Forfeited | (13) |
| | |
| Unvested restricted stock units and restricted stock awards at July 1, 2011 | 1,246 |

The following table shows the Company's stock-based compensation expense included in the condensed consolidated statements of operations (in thousands):

| | Three months ended | | Six months ended | |
|---|---------------------------|-------------------------|-------------------------|-------------------------|
| | July 1, 2011 | July 2, 2010 | July 1, 2011 | July 2, 2010 |
| Cost of sales | \$ 329 | \$ 219 | \$ 650 | \$ 414 |
| Research and development | 79 | 108 | 158 | 101 |
| Sales and marketing | 93 | 116 | 214 | 185 |
| General and administrative | 663 | 467 | 1,144 | 877 |
| | | | | |
| Total stock-based compensation expense | 1,164 | 910 | 2,166 | 1,577 |
| Income tax benefit | (277) | (109) | (534) | (201) |
| | | | | |
| Total stock-based compensation expense, net of income tax benefit | \$ 887 | \$ 801 | \$ 1,632 | \$ 1,376 |

(1) As of July 1, 2011 and July 2, 2010, there were no stock-based compensation expenses capitalized in inventory.
Recently Issued Accounting Standards

In December 2010, the FASB amended its existing guidance for goodwill and other intangible assets. This authoritative guidance modifies Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts. For those reporting units, an entity is required to perform Step 2 of the goodwill impairment test if there are qualitative factors indicating that it is more likely than not that a goodwill impairment exists. The qualitative factors are consistent with the existing guidance which requires goodwill of a reporting unit to be tested for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. This authoritative guidance becomes effective for the Company in fiscal 2012. The implementation of this authoritative guidance is not expected to have a material impact on the Company's financial position or results of operations.

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In June 2011, the FASB issued new accounting guidance related to the presentation of comprehensive income that increases comparability between U.S. GAAP and IFRS. This guidance eliminates the current option to report other comprehensive income and its components in the statement of changes in equity and instead requires presenting in one continuous statement or two separate but consecutive statements. This guidance is effective for the Company's interim and annual periods beginning January 1, 2012. The Company does not believe the adoption of this guidance will have a material impact on its consolidated financial statements, as it only requires a change in the format of presentation.

Table of Contents**ULTRA CLEAN HOLDINGS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****2. Balance Sheet Information (in thousands)**

Inventory consisted of the following (in thousands):

| | July 1, 2011 | December 31, 2010 |
|---------------------------------|-------------------------|------------------------------|
| Raw materials | \$ 51,195 | \$ 43,522 |
| Work in process | 18,739 | 17,448 |
| Finished goods | 3,720 | 1,440 |
| | 73,654 | 62,410 |
| Reserve for excess and obsolete | (3,783) | (3,122) |
| Total | \$ 69,871 | \$ 59,288 |

Equipment and leasehold improvements, net, consisted of the following (in thousands):

| | July 1, 2011 | December 31, 2010 |
|---|-------------------------|------------------------------|
| Computer equipment and software | \$ 7,219 | \$ 6,516 |
| Furniture and fixtures | 1,614 | 1,522 |
| Machinery and equipment | 8,329 | 7,254 |
| Leasehold improvements | 10,879 | 10,094 |
| | 28,041 | 25,386 |
| Accumulated depreciation and amortization | (17,785) | (16,415) |
| Total | \$ 10,256 | \$ 8,971 |

3. Borrowing Arrangements

The Company has borrowing arrangements with its banking facility which includes a \$25.0 million revolving credit facility and two term loans. The aggregate amount of the revolving credit facility, which matures on December 31, 2013, is subject to a borrowing base equal to 80% of eligible accounts receivable and 45% of eligible inventory (total eligible inventory not to exceed \$3.0 million) and is secured by substantially all of the Company's assets. The revolving credit facility bears interest per annum at a variable rate equal to the greater of prime rate, as defined per the loan agreement, or 4%, plus a margin of 25 basis points. The interest rate during the second quarter of 2011 and on July 1, 2011 on outstanding loans under the revolving credit facility was 4.25%. The revolving credit facility contains certain reporting and financial covenants that must be met on a quarterly basis in order for the Company to remain in compliance. The Company was in compliance with all of its bank covenants as of July 1, 2011. The revolving credit facility balance as of July 1, 2011 was \$19.5 million.

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The Company has two term loans with its banking facility, one for \$3.0 million which matures on January 29, 2012 and one for \$8.0 million which matures on October 21, 2013. The term loans bear interest per annum at a variable rate equal to the greater of prime rate, as defined per the loan agreements, or 4%, plus a margin of 75 basis points. The interest rate during the second quarter of 2011 and on July 1, 2011 on the term loans was 4.75%. The combined balance of the term loans as of July 1, 2011 was \$6.8 million.

The Company also had a \$5.0 million equipment loan that was paid off during the quarter.

Total debt outstanding as of July 1, 2011, was \$26.3 million.

Table of Contents**ULTRA CLEAN HOLDINGS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)****4. Income Tax**

The Company's income tax provision and related effective tax rate for the three and six month periods ended July 1, 2011 was \$2,168,000 and 23.8%, and \$4,167,000 and 24.6%, respectively. The Company's income tax provision and related effective tax rate for the three and six month periods ended July 2, 2010 was \$770,000 and 12.0%, and \$1,388,000 and 12.7%, respectively. The change in respective rates reflects, primarily, changes in the Company's accrual for uncertain tax positions, deferred tax assets as well as changes in the geographic mix of worldwide earnings and financial results for the periods presented for 2011 compared to the same periods in 2010.

The following table summarizes the activity related to the Company's uncertain tax positions (in thousands):

| | Six months ended | |
|--|-------------------------|-------------------------|
| | July 1, 2011 | July 2, 2010 |
| Balance as of the beginning of period | \$ 39 | \$ 920 |
| Increases related to prior year tax positions | | 1 |
| Expiration of the statute of limitations for the assessment of taxes | (39) | |
| Finalization of tax audits | | (882) |
| Balance as of the end of period | \$ 0 | \$ 39 |

The determination of the Company's tax provision is subject to judgments and estimates. The carrying value of the Company's net deferred tax assets, which is made up primarily of tax deductions, assumes the Company will be able to generate sufficient future income to fully realize these deductions. In determining whether the realization of these deferred tax assets may be impaired, the Company makes judgments with respect to whether it is likely to generate sufficient future taxable income to realize these assets. In addition, the calculation of tax liabilities involves significant judgment in estimating the impact of uncertainties in the application of complex tax laws. Resolution of uncertainties in a manner inconsistent with the Company's expectations could have a material impact on its results of operations and financial position.

As of July 1, 2011, the Company maintained a full valuation allowance on its U.S. deferred tax assets and a partial valuation allowance on its non-U.S. deferred tax assets for a total valuation allowance of \$7.4 million. In order to reverse a valuation allowance, the Company is required to review its cumulative twelve-quarter income/loss as well as its ability to generate sufficient future taxable income to realize the Company's net deferred tax assets. The Company files income tax returns in the U.S. federal jurisdiction, various states and foreign jurisdictions. The Company's 2005 and 2006 state income tax returns are currently under examination by the California Franchise Tax Board and the Company's state income tax returns are open to audit under the statute of limitations for the fiscal years 2005 through 2009. The Company is also subject to examination in various other jurisdictions for various periods. During the second quarter of 2010, the Internal Revenue Service completed their audit of the Company's tax returns for the years 2006 through 2009. The Company's federal returns are still open under the statute of limitations for fiscal years 2004 through 2005.

The Company is currently experiencing a tax holiday related to its Singapore subsidiary that will expire for tax years beginning January 2015. The Company's Singapore subsidiary recorded a net profit for the quarter and six months ended July 1, 2011.

The undistributed earnings of the Company's foreign subsidiaries at July 1, 2011, are considered to be indefinitely reinvested and no distribution of those earnings in the form of dividends or otherwise, as well as related provisions for U.S. income taxes, have been provided thereon. The Company anticipates it has adequate liquidity and capital resources at the subsidiary level and would not need to repatriate earnings.

5. Net Income Per Share

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Basic net income per share excludes dilution and is computed by dividing net income by the weighted average number of common shares outstanding for the period. Diluted net income per share reflects the potential dilution that would occur if outstanding securities or other contracts to issue common stock were exercised or converted into common stock.

Table of Contents**ULTRA CLEAN HOLDINGS, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)**

The following is a reconciliation of the numerators and denominators used in computing basic and diluted net income per share (in thousands, except per share data):

| | Three months ended | | Six months ended | |
|--|---------------------------|-------------------------|-------------------------|-------------------------|
| | July 1, 2011 | July 2, 2010 | July 1, 2011 | July 2, 2010 |
| Numerator: | | | | |
| Net income | \$ 6,958 | \$ 5,654 | \$ 12,778 | \$ 9,504 |
| Denominator: | | | | |
| Shares used in computation basic: | | | | |
| Weighted average common shares outstanding | 22,764 | 21,700 | 22,627 | 21,619 |
| Weighted average common shares outstanding subject to repurchase | (30) | (30) | (30) | (30) |
| Shares used in computing basic net income per share | | | | |
| | 22,734 | 21,670 | 22,597 | 21,589 |
| Shares used in computation diluted: | | | | |
| Weighted average common shares outstanding | 22,734 | 21,670 | 22,597 | 21,589 |
| Dilutive effect of stock options, restricted stock units, restricted stock awards and employee stock purchase plan | | | | |
| | 748 | 1,346 | 931 | 1,316 |
| Shares used in computing diluted net income per share | | | | |
| | 23,482 | 23,016 | 23,528 | 22,905 |
| Net income per share basic | \$ 0.31 | \$ 0.26 | \$ 0.57 | \$ 0.44 |
| Net income per share diluted | \$ 0.30 | \$ 0.25 | \$ 0.54 | \$ 0.41 |

The Company had securities outstanding which could potentially dilute basic earnings per share in the future. Potentially dilutive securities include outstanding options, unvested RSU's and RSA's and shares to be purchased under the employee stock purchase plan. The dilutive effect of potentially dilutive securities is reflected in diluted earnings per common share by application of the treasury stock method.

6. Commitments and Contingencies

The Company had commitments to purchase inventory totaling approximately \$25.3 million at July 1, 2011.

The Company leases properties domestically in Hayward, California, Austin, Texas and South San Francisco, California and internationally in China and Singapore. The Company's total remaining future minimum lease payments as of July 1, 2011, over the remaining terms of these leases will be approximately \$13.3 million.

From time to time, the Company is subject to various legal proceedings and claims, either asserted or unasserted, that arise in the ordinary course of business. Although the outcome of the various legal proceedings and claims cannot be predicted with certainty, the Company has not had a history of outcomes to date that have been material to the statement of operations and does not believe that any of these proceedings or other claims will have a material adverse effect on its consolidated financial condition or results of operations.

7. Segment Information

The Company operates in one reportable segment and is engaged in the development, manufacture and supply of critical subsystems for the semiconductor capital equipment, flat panel, medical, energy and research industries. The nature of the Company's products and production processes as well as type of customers and distribution methods is consistent among all of the Company's products. The Company's foreign operations are conducted primarily through its wholly-owned subsidiary in China. The Company's principal markets include North America,

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Europe and Asia. Sales by geographic area represent sales to unaffiliated customers.

All information on sales by geographic area is based upon the location to which the products were shipped. The following table sets forth revenue by geographic area (in thousands):

| | Three months ended | | Six months ended | |
|---------------------------------|---------------------------|-------------------------|-------------------------|-------------------------|
| | July 1, 2011 | July 2, 2010 | July 1, 2011 | July 2, 2010 |
| United States | \$ 103,634 | \$ 97,065 | \$ 213,442 | \$ 192,773 |
| Export sales to Europe and Asia | 30,107 | 8,813 | 47,018 | 11,572 |
| | \$ 133,741 | \$ 105,878 | \$ 260,460 | \$ 204,345 |

At July 1, 2011 and July 2, 2010, approximately \$4.3 million and \$2.6 million, respectively, of the Company's long-lived assets were located in Asia, and the remaining balances were located in the United States.

Table of Contents**ITEM 2. Management's Discussion And Analysis of Financial Condition And Results Of Operations**

This section and other parts of this quarterly report on Form 10-Q contain forward-looking statements regarding future events and our future results. Forward-looking statements can also be identified by words such as anticipates, expects, believes, plans, predicts, and similar terms. Forward-looking statements are not guarantees of future performance and the Company's actual results may differ significantly from the result discussed in the forward-looking statements. Factors that might cause such differences include, but are not limited to, those discussed in Item 1A

Risk Factors below. The following discussion should be read in conjunction with the consolidated financial statement and notes thereto included in Item 1 of this report. The Company assumes no obligation to revise or update any forward-looking statements for any reason, except as required by law.

Overview

We are a leading developer and supplier of critical subsystems, primarily for the semiconductor capital equipment industry. We also leverage the specialized skill sets required to support semiconductor capital equipment to serve the technologically similar markets in the flat panel, medical, energy and research industries, collectively referred to as Other Addressed Industries. We develop, design, prototype, engineer, manufacture and test subsystems which are highly specialized and tailored to specific steps in the semiconductor manufacturing process as well as the manufacturing process in Other Addressed Industries. Our revenue is derived primarily from the sale of gas delivery systems and other critical subsystems including chemical mechanical planarization (CMP) subsystems, chemical delivery modules, top-plate assemblies, frame assemblies, process modules and other high level assemblies.

Our two largest customers accounted for approximately 59% of the Company's sales in the first six months of 2011.

Financial Highlights

Our operating results for the three months ended July 1, 2011, compared to the same period in the prior year reflects an increase in demand of our products. Sales for the three months ended July 1, 2011, were \$133.7 million, an increase of \$27.9 million, or 26.3%, from the comparable period of 2010. Gross profit for the three months ended July 1, 2011 increased \$4.2 million, to \$19.0 million, or 14.2% of sales, from \$14.8 million, or 14.0% of sales, during the same period in the prior year. Total operating expenses for the three months ended July 1, 2011 increased to \$9.5 million, or 7.1% of sales, compared to \$8.2 million, or 7.8% of sales, for the same period of the prior year. We earned net income of \$7.0 million for the three period ended July 1, 2011 compared to net income of \$5.7 million during the same period of the prior year as a result of an increase in sales and gross profits.

Results of Operations

For the periods indicated, the following table sets forth certain costs and expenses and other income items as a percentage of sales. The table and subsequent discussion should be read in conjunction with our condensed consolidated financial statements and notes thereto included elsewhere in our quarterly report.

| | Three months ended | | Six months ended | |
|----------------------------|--------------------|-----------------|------------------|-----------------|
| | July 1, 2011 | July 2, 2010 | July 1, 2011 | July 2, 2010 |
| Sales | 100.0% | 100.0% | 100.0% | 100.0% |
| Cost of goods sold | 85.8% | 86.0% | 86.0% | 86.7% |
| Gross profit | 14.2% | 14.0% | 14.0% | 13.3% |
| Operating expenses: | | | | |
| Research and development | 1.1% | 1.3% | 1.2% | 1.2% |
| Sales and marketing | 1.5% | 1.8% | 1.6% | 1.7% |
| General and administrative | 4.5% | 4.7% | 4.4% | 4.9% |
| Total operating expenses | 7.1% | 7.8% | 7.2% | 7.8% |
| Income from operations | 7.1% | 6.2% | 6.8% | 5.5% |

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| | | | | |
|--|--------|--------|--------|--------|
| Interest and other income (expense), net | (0.3)% | (0.1)% | (0.3)% | (0.1)% |
| Income before provision for income taxes | 6.8% | 6.1% | 6.5% | 5.4% |
| Income tax provision | 1.6% | 0.7% | 1.6% | 0.7% |
| Net income | 5.2% | 5.4% | 4.9% | 4.7% |

Sales

Sales for the three months ended July 1, 2011 increased \$27.8 million, or 26.3%, to \$133.7 million from \$105.9 million in the comparable period of 2010. Sales for the six months ended July 1, 2011 increased \$56.1 million, or 27.5%, to \$260.5 million from \$204.3 million in the comparable period of 2010. Substantially all of the revenue increase is attributable to volume increases at relatively constant prices with existing customers. We expect sales to decrease in the third quarter of 2011 primarily due to a slow down in the semiconductor industry.

Table of Contents*Gross Profit*

Cost of goods sold consists primarily of purchased materials, labor and overhead, including depreciation related to certain capital assets associated with the design and manufacture of products sold. Gross profit for the three months ended July 1, 2011 increased \$4.2 million to \$19.0 million, or 14.2% of sales, from \$14.8 million, or 14.0% of sales, for the same period in 2010. Gross profit for the six months ended July 1, 2011 increased \$9.4 million to \$36.6 million, or 14.0% of sales, from \$27.2 million, or 13.3% of sales, for the same period in 2010. Our gross margins for the three and six months ended July 1, 2011 increased from the comparable periods in 2010 due primarily to increased unit volume manufactured due to increased sales during the three and six months ended July 1, 2011, which provided for greater factory utilization.

Research and Development Expense

Research and development expense consists primarily of activities related to new component testing and evaluation, test equipment and fixture development, product design, and other product development activities. Research and development expense for the for the three months ended July 1, 2011 was \$1.4 million, or 1.1% of sales, compared to 1.4 million, or 1.3% of sales in the same quarter in 2010. Research and development expense for the for the six months ended July 1, 2011 was \$3.0 million, or 1.2% of sales, compared to 2.4 million, or 1.2% of sales in the comparable period in 2010. The increase in expense is due to an increase in headcount and associated costs and the reassignment of existing resources to new product development activities.

Sales and Marketing Expense

Sales and marketing expense consists primarily of salaries and commissions paid to our sales and service employees, salaries paid to our engineers who work with the sales and service employees to help determine the components and configuration requirements for new products and other costs related to the sales of our products. Sales and marketing expense for the three months ended July 1, 2011 increased \$0.1 million to \$2.0 million, or 1.5% of sales, compared to \$1.9 million, or 1.8% of sales, in the comparable quarter of 2010. Sales and marketing expense for the six months ended July 1, 2011 increased \$0.5 million to \$4.1 million, or 1.6% of sales, compared to \$3.5 million, or 1.7% of sales, in the comparable period of 2010. The decrease in percent of sales and marketing expense is due to an increase in sales for the three and six months ended July 1, 2011, as compared to comparable periods of 2010. The increase in expense is primarily due to increased payroll and related benefit costs resulting from an increase in headcount and commissions as a result of increased revenue.

General and Administrative Expense

General and administrative expense consists primarily of salaries and overhead associated with our administrative staff and professional fees. General and administrative expense for the three months ended July 1, 2011 increased approximately \$1.1 million, or 22.3% in the second quarter of 2011 to \$6.0 million, or 4.5% of sales, compared with \$4.9 million, or 4.7% of sales, in the comparable period of 2010. General and administrative expense for the six months ended July 1, 2011 increased approximately \$1.7 million, or 17.4% to \$11.7 million, or 4.5% of sales, compared with \$10.0 million, or 4.9% of sales, in the comparable period of 2010. The increase in dollars when comparing the three and six months ended July 1, 2011, with the comparable periods in 2010 is due to an increase in payroll and related benefit costs associated with an increase in headcount, offset by reductions in fees for certain outside professional services. The decrease in general and administrative expense as a percent of sales in the three and six months ended July 1, 2011, compared to comparable periods of 2010 is due to increased sales.

Interest and Other Income (Expense), net

Interest and other income (expense), net for the three and six months ended July 1, 2011 was \$(0.4) million and \$(0.7) million compared to \$(0.1) million and \$(0.3) million in the comparable periods of 2010, respectively. The increase in expense for the three and six months ended July 1, 2011 is primarily attributable to an increase in interest expense associated with an \$8.0 million term-loan the Company entered into in October 2010.

Income Tax Provision

Our effective tax rate for the three month periods ended July 1, 2011 and July 2, 2010, was 23.8% and 12.0%, respectively. Our effective tax rate for the six month periods ended July 1, 2011 and July 2, 2010, was 24.6% and 12.7%, respectively. The change in respective rates reflects, primarily, changes in our accrual for uncertain tax positions, deferred tax assets as well as a change in the geographic mix of worldwide earnings and financial results for the first half of 2011 compared to the comparable period in 2010.

The Company's ability to realize deferred tax assets depends on its ability to generate sufficient taxable income of the same character within the carryback or carry forward periods. In assessing future GAAP taxable income, the Company has considered all sources of taxable income

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available to realize its deferred tax assets including the future reversal of existing temporary differences, future taxable income exclusive of reversing temporary differences and carry forwards, taxable income in carryback years and tax-planning strategies. If changes occur in the assumptions underlying the Company's tax planning strategies or in the scheduling of the reversal of the Company's deferred tax liabilities, the valuation allowance may need to be adjusted in the future.

Liquidity and Capital Resources

We have required capital principally to fund our working capital needs, satisfy our debt obligations, maintain our equipment and purchase new capital equipment. As of July 1, 2011, we had cash of \$37.6 million compared to \$34.7 million as of December 31, 2010.

For the six months ended July 1, 2011, we generated cash from operating activities of \$6.4 million compared to using cash of \$5.6 million for the six months ended July 2, 2010. Operating cash flows generated in the first half of 2011 were from \$12.8 million of net income; net non-cash activity, including depreciation and amortization of \$1.4 million and stock-based compensation of \$2.2 million; and increases in accounts payable of \$3.0 million and accrued compensation and other liabilities of \$4.5 million, respectively, offset by an increase in accounts receivable of \$3.2 million, an increase in inventory of \$10.6 million and an increase in prepaid expenses and other current assets of \$2.9 million. The increases in accounts receivable and inventory are a result of increases in customer demand and related revenue. Our cash flows from operations in any given period are largely driven by the timing of sales, the collection of accounts receivable and the payment of accounts payable.

Net cash used in investing activities for the six months ended July 1, 2011, increased to \$2.7 million from \$2.0 million for the same period ended July 2, 2010. Capital expenditures for the six months ended July 1, 2011 reflect our continued investment in our Asian subsidiaries as well as our domestic operating units.

Net cash used in financing activities for the six months ended July 1, 2011 was \$0.8 million compared to net cash provided by financing activities of \$3.9 million for the six months ended July 2, 2010. For the six months ended July 1, 2011, our cash used in financing activities was due to payments on the Company's term debt and capital lease obligations of \$2.4 million, offset by proceeds from option exercises and the Company's stock purchase program of \$0.9 million and excess tax benefits from stock-based compensation of \$0.8 million.

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We anticipate that our existing cash balance and operating cash flow, together with available borrowings under our credit facility, will be sufficient to meet our working capital requirements and technology development projects for at least the next twelve months. The adequacy of these resources to meet our liquidity needs beyond that period will depend on our growth, the state of the worldwide economy, the cyclical expansion or contraction of the semiconductor capital equipment industry and the other industries we serve and capital expenditures required to meet possible increased demand for our products.

The undistributed earnings of our foreign subsidiaries at July 1, 2011 are considered to be indefinitely reinvested and no distribution of those earnings in the form of dividends or otherwise, as well as related provisions for U.S. income taxes, have been provided thereon. The Company anticipates it has adequate liquidity and capital resources at the subsidiary level and would not need to repatriate earnings.

Borrowing Arrangements

The Company has borrowing arrangements with its banking facility which includes a \$25.0 million revolving credit facility and two term loans. The aggregate amount of the revolving credit facility, which matures on December 31, 2013, is subject to a borrowing base equal to 80% of eligible accounts receivable and 45% of eligible inventory (total eligible inventory not to exceed \$3.0 million) and is secured by substantially all of the Company's assets. The revolving credit facility bears interest per annum at a variable rate equal to the greater of prime rate, as defined per the loan agreement, or 4%, plus a margin of 25 basis points. The interest rate during the second quarter of 2011 and on July 1, 2011 on outstanding loans under the revolving credit facility was 4.25%. The revolving credit facility contains certain reporting and financial covenants that must be met on a quarterly basis in order for the Company to remain in compliance. The Company was in compliance with all of its bank covenants as of July 1, 2011. The revolving credit facility balance as of July 1, 2011 was \$19.5 million.

The Company has two term loans with its banking facility, one for \$3.0 million which matures on January 29, 2012 and one for \$8.0 million which matures on October 21, 2013. The term loans bear interest per annum at a variable rate equal to the greater of prime rate, as defined per the loan agreements, or 4%, plus a margin of 75 basis points. The interest rate during the second quarter of 2011 and on July 1, 2011 on the term loans was 4.75%. The combined balance of the term loans as of July 1, 2011 was \$6.8 million.

The Company also had a \$5.0 million equipment loan that was paid off during the quarter.

Total debt outstanding as of July 1, 2011, was \$26.3 million.

Capital Expenditures

Capital expenditures were \$2.7 million for the six month period ended July 1, 2011, primarily due to domestic investment and continued investment in our Asian subsidiaries.

The Company's anticipated capital expenditures for the remainder of 2011 are approximately \$2.8 million.

Contractual Obligations

Other than operating leases for certain equipment and real estate and purchase order commitments primarily for inventory, we have no off-balance sheet transactions, unconditional purchase obligations or similar instruments and, other than the revolving credit facility described above, are not a guarantor of any other entities' debt or other financial obligations. The following table summarizes our future minimum lease payments and principal payments under debt obligations, principal payments under capital and operating leases and purchase order commitments as of July 1, 2011 (in thousands):

| | 2011 | 2012 | 2013 | 2014 | 2015 | Thereafter | Total |
|----------------------------|-----------|----------|-----------|----------|----------|------------|-----------|
| Capital leases | \$ 5 | \$ 10 | \$ 10 | \$ 7 | \$ | \$ | \$ 32 |
| Operating leases (1) | 2,000 | 3,595 | 3,286 | 3,060 | 1,275 | 311 | 13,527 |
| Borrowing arrangements | 1,578 | 2,843 | 21,812 | | | | 26,233 |
| Purchase order commitments | 25,250 | | | | | | 25,250 |
| Total (2) | \$ 28,833 | \$ 6,448 | \$ 25,108 | \$ 3,067 | \$ 1,275 | \$ 311 | \$ 65,042 |

- (1) Operating lease expense reflects (a) the lease for our headquarters facility in Hayward, California that expires in 2015; (b) the leases for manufacturing facilities in South San Francisco that expire in 2011 thru 2013 (c) the leases for manufacturing facilities in China and Singapore that expire in 2011 thru 2016 and; (d) the leases for manufacturing facilities in Austin, Texas that expire in 2016. We have options to renew certain of the leases in South San Francisco, Hayward and Austin which we expect to exercise.
- (2) As a result of the implementation of FASB's guidance regarding accounting for uncertainty in income taxes, we have recorded an additional tax liability to offset the recognition of previously recorded excess tax benefits. Because of the uncertainty surrounding the future payment of these liabilities, the amount has been excluded from the table above.

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Critical Accounting Policies, Significant Judgments and Estimates

Our condensed consolidated financial statements have been prepared in accordance with GAAP, which requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses and related disclosure at the date of our financial statements. Estimates and judgments are reviewed on an on-going basis, including those related to sales, inventories, intangible assets, stock compensation and income taxes. The estimates and judgments are based on historical experience and on various other factors that we believe to be reasonable under the circumstances, the results of which form the basis of the judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates. We consider certain accounting policies related to the purchase accounting, revenue recognition, inventory valuation, accounting for income taxes, valuation of intangible assets and goodwill and equity incentives to employees to be critical policies due to the estimates and judgments involved in each. Our significant accounting policies and critical estimates are disclosed in our 2010 Annual Report on Form 10-K as filed with the SEC on March 16, 2011. No material changes to our significant accounting policies and critical estimates have occurred subsequent to December 31, 2010.

Recently Issued Accounting Standards

See *Recently Issued Accounting Standards* in Note 1 of Notes to Condensed Consolidated Financial Statements.

ITEM 3. Quantitative and Qualitative Disclosures About Market Risk

Market risk represents the risk of changes in value of financial instruments caused by fluctuations in interest rates and foreign exchange rates.

Foreign Exchange Rates

Currently, a significant majority of our sales and arrangements with third-party suppliers provide for pricing and payment in U.S. dollars, and, therefore, are not subject to material exchange rate fluctuations. Therefore, we do not expect foreign currency exchange rate fluctuations to have a material effect on our results of operations. Increases in the value of the U.S. dollar relative to other currencies would make our products more expensive to our international customers, which could negatively impact our ability to compete. Conversely, decreases in the value of the U.S. dollar relative to other currencies could result in our suppliers raising their prices in order to continue doing business with us.

Recently, Chinese authorities have relaxed controls of its currency, the Renminbi, and allowed the currency to strengthen against other world currencies. The Company continues to monitor any potential impact of the Renminbi currency revaluation on its operations in China as well as globally.

Interest Rates

Our interest rate risk relates primarily to our outstanding debt which totals \$26.3 million as of July 1, 2011, and carries interest rates pegged to the LIBOR and PRIME rates, as defined. An immediate increase in interest rates of 100 basis points would increase our interest expense by approximately \$66,000 per quarter. This would be partially offset by increased interest income on our invested cash. Conversely, an immediate decline of 100 basis points in interest rates would decrease our interest expense by approximately \$66,000 per quarter. This would be partially offset by decreased interest income on our invested cash.

ITEM 4. Controls and Procedures

As required by Rule 13a-15(b) under the Securities Exchange Act of 1934 (the Exchange Act), management, including the Chief Executive Officer and Chief Financial Officer, conducted an evaluation as of the end of the period covered by this report, of the effectiveness of our disclosure controls and procedures as defined in Exchange Act Rule 13a-15(e). Based upon our evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective for the quarter ended July 1, 2011.

As required by Rule 13a-15(d), management, including the Chief Executive Officer and Chief Financial Officer, also conducted an evaluation of our internal control over financial reporting to determine whether any changes occurred during the fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. Based on that evidence, there has been no such change during the current quarter.

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Any system of controls, however well designed and operated, can provide only reasonable, and not absolute, assurance that the objectives of the system will be met. In addition, the design of any control system is based in part upon certain assumptions about the likelihood of future events.

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PART II. OTHER INFORMATION

ITEM 1. Legal Proceedings

From time to time, we are subject to various legal proceedings and claims, either asserted or unasserted, that arise in the ordinary course of business.

ITEM 1A. Risk Factors

We may not be able to respond quickly enough to increases in demand for our products.

Demand shifts in the industries we serve are rapid and difficult to predict, and we may not be able to respond quickly enough to an increase in demand. Our ability to increase sales of our products depends, in part, upon our ability to:

mobilize our supply chain in order to maintain component and raw material supply;

optimize the use of our design, engineering and manufacturing capacity in a timely manner;

deliver our products to our customers in a timely fashion;

expand, if necessary, our manufacturing capacity; and

maintain our product quality as we increase production.

If we are unable to respond to rapid increases in demand for our products on a timely basis or to manage any corresponding expansion of our manufacturing capacity effectively, our customers could increase their purchases from our competitors, which would adversely affect our business.

Our dependence on our suppliers may prevent us from delivering an acceptable product on a timely basis.

We rely on both single-source and sole-source suppliers, some of whom are relatively small, for many of the components we use in our products. In addition, our customers often specify components of particular suppliers that we must incorporate into our products. Our suppliers are under no obligation to provide us with components. As a result, the loss of or failure to perform by any of these providers could adversely affect our business and operating results. In addition, the manufacturing of certain components and subsystems is an extremely complex process.

Therefore, if a supplier were unable to provide the volume of components we require on a timely basis and at acceptable prices, we would have to identify and qualify replacements from alternative sources of supply. We and certain of our vendors also contract with suppliers in Japan, and disruption in supply resulting from the earthquakes, tsunami and related events may result in certain of our or our vendors' Japanese suppliers being unable to deliver sufficient quantities of components or raw materials at all or in a timely manner. If we, or our vendors, are unable to procure sufficient quantities of components or raw materials from suppliers in Japan or other sources, it could influence decisions by our customers to delay or cancel orders and decisions by our vendors to fulfill our purchase orders and, consequently, have a material adverse effect on our results of operations.

The process of qualifying new suppliers for these complex components is lengthy and could delay our production, which would adversely affect our business, operating results and financial condition. We may also experience difficulty in obtaining sufficient supplies of components and raw materials in times of significant growth in our business. For example, we have in the past experienced shortages in supplies of various components, such as mass flow controllers, valves and regulators, and certain prefabricated parts, such as sheet metal enclosures, used in the manufacture of our products. In addition, one of our competitors manufactures mass flow controllers that may be specified by one or more of our

customers. If we are unable to obtain these particular mass flow controllers from our competitor or convince a customer to select alternative mass flow controllers, we may be unable to meet that customer's requirements, which could result in a loss of market share.

The highly volatile nature of the industries we serve could harm our operating results.

Our business and operating results depend in significant part upon capital expenditures by manufacturers in the semiconductor capital equipment, flat panel, medical, energy and research industries, which in turn depend upon the current and anticipated market demand for such products. Historically, the industries we serve (in particular the semiconductor industry) have been highly cyclical, with recurring periods of over-supply of products that have had a severe negative effect on the demand for capital equipment used to manufacture such products. We have experienced and anticipate that we will continue to experience significant fluctuations in customer orders for our products through such cycles. Slowdowns in the industries we serve have had, and future slowdowns may also have, a material adverse effect on our operating results. During periods of decreasing demand for our products, we must be able to appropriately align our cost structure with prevailing market conditions, effectively manage our supply chain and motivate and retain employees. During periods of increased demand, we must increase manufacturing capacity and inventory to meet customer demands, effectively manage our supply chain and attract, retain and motivate a sufficient number of employees. If we are not able to timely and appropriately adapt to the changes in our business environment, our results of operations will be harmed. Also, the cyclical and volatile nature of the industries we serve make future revenues, results of operations and net cash flows difficult to estimate.

We rely on a small number of customers for a significant portion of our sales, and any impairment of our relationships with these customers would adversely affect our business.

A relatively small number of OEM customers have historically accounted for a significant portion of our sales, and we expect this trend to continue. As a group, three customers accounted for 72%, 79% and 81% of the Company's sales for fiscal years 2010, 2009 and 2008, respectively. Because of the small number of OEMs in the markets we serve, most of which are already our customers, it would be difficult to replace lost revenue resulting from the loss of, or the reduction, cancellation or delay in purchase orders by any one of these customers. Our customer contracts generally do not require them to place any orders with us. Consolidation among our customers, or a decision by any one or more of our customers to outsource all or most manufacturing and assembly work to a single equipment manufacturer, may further concentrate our business in a limited number of customers and expose us to increased risks relating to dependence on an even smaller number of customers.

In addition, by virtue of our customers' size and the significant portion of revenue that we derive from them, they are able to exert significant influence and pricing pressure in the negotiation of our commercial agreements and the conduct of our business with them. We may also be asked to accommodate customer requests that extend beyond the express terms of our agreements in order to maintain our relationships with our customers. If we are unable to retain and expand our business with these customers on favorable terms, our business and operating results will be adversely affected.

We have had to qualify, and are required to maintain our status, as a supplier for each of our customers. This is a lengthy process that involves the inspection and approval by a customer of our engineering, documentation, manufacturing and quality control procedures before that customer will place volume orders. Our ability to lessen the adverse effect of any loss of, or reduction in sales to, an existing customer through the rapid addition of one or more new customers is minimal because of these qualification requirements. Consequently, our business, operating results and financial condition would be adversely affected by the loss of, or any reduction in orders by, any of our significant customers.

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We are exposed to risks associated with the global economy.

Our sales were \$443.1 million for 2010 compared to \$159.8 million for 2009. We earned a net profit \$20.1 million in 2010 compared to a net loss of \$(20.0) million for the comparable period in the previous year. While it appears that the economy has entered a period of recovery, we may experience future economic slowdowns and fluctuations in customer orders. Also, as a result of the global economy, certain of our suppliers have been or may be forced out of business, which would require us to either procure products from high-cost suppliers, or if no additional suppliers exist, to reconfigure the design and manufacture of our products, and we may be unable to fulfill some customer orders.

We may not be able to fund our future capital requirements from our operations, and financing from other sources may not be available on favorable terms or at all.

We made capital expenditures of approximately \$2.7 million during the six months ended July 1, 2011, related to the development of our manufacturing facilities in the United States, China and Singapore. The amount of our future capital requirements will depend on many factors, including:

general worldwide financial market conditions;

the cost required to ensure access to adequate manufacturing capacity;

the timing and extent of spending to support product development efforts;

the timing of introductions of new products and enhancements to existing products;

changing manufacturing capabilities to meet new customer requirements; and

market acceptance of our products.

Although we amended our loan agreement and extended the maturity of our credit facility through December 31, 2013, we may need to raise additional funds through public or private equity or debt financing if our current cash and cash flow from operations are insufficient to fund our future activities. We may not be able to obtain additional debt financing when and if necessary in a timely manner. In addition, banks have sometimes been unable or unwilling to satisfy their obligations under existing credit arrangements. Access to capital markets has, in the past, been unavailable to companies such as ours and there can be no assurance that we would be able to complete an equity financing on terms satisfactory to us or at all. In addition, equity financings could be dilutive to holders of our common stock, and debt financings would likely involve covenants that restrict our business operations. If we cannot raise funds on acceptable terms, if and when needed, we may not be able to develop or enhance our products, take advantage of future opportunities, grow our business or respond to competitive pressures or unanticipated requirements, any of which could adversely affect our business, operating results and financial condition.

Our quarterly revenue and operating results fluctuate significantly from period to period, and this may cause volatility in our common stock price.

Our quarterly revenue and operating results have fluctuated significantly in the past, and we expect them to continue to fluctuate in the future for a variety of reasons which may include:

demand for and market acceptance of our products as a result of the cyclical nature of the industries we serve or otherwise, often resulting in reduced sales during industry downturns and increased sales during periods of industry recovery;

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overall economic conditions;

changes in the timing and size of orders by our customers;

cancellations and postponements of previously placed orders;

pricing pressure from either our competitors or our customers, resulting in the reduction of our product prices;

disruptions or delays in the manufacturing of our products or in the supply of components or raw materials that are incorporated into or used to manufacture our products, thereby causing us to delay the shipment of products;

decreased margins for several or more quarters following the introduction of new products, especially as we introduce new subsystems;

delays in ramp-up in production, low yields or other problems experienced at our manufacturing facilities in China;

changes in design-to-delivery cycle times;

inability to reduce our costs quickly in step with reductions in our prices or in response to decreased demand for our products;

changes in our mix of products sold;

write-offs of excess or obsolete inventory;

one-time expenses or charges associated with failed acquisition negotiations or completed acquisitions;

announcements by our competitors of new products, services or technological innovations, which may, among other things, render our products less competitive; and

geographic mix of worldwide earnings.

As a result of the foregoing, we believe that quarter-to-quarter comparisons of our revenue and operating results may not be meaningful and that these comparisons may not be an accurate indicator of our future performance. Changes in the timing or terms of a small number of transactions could disproportionately affect our operating results in any particular quarter. Moreover, our operating results in one or more future quarters may fail to meet the expectations of securities analysts or investors. If this occurs, we would expect to experience an immediate and significant decline in the trading price of our common stock.

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We have established, and as markets will allow, intend to expand our operations in Asia, which exposes us to risks associated with operating in a foreign country.

We intend to expand, as markets will allow, our operations in Asia, which includes China and Singapore. Our total assets in Asia as of July 1, 2011, were approximately \$67.0 million.

We are exposed to political, economic, legal and other risks associated with operating in Asia, including:

foreign currency exchange fluctuations;

political, civil and economic instability;

tariffs and other barriers;

timing and availability of export licenses;

disruptions to our and our customers' operations due to the outbreak of communicable diseases, such as SARS and avian flu;

disruptions in operations due to the weakness of China's domestic infrastructure, including transportation and energy;

difficulties in developing relationships with local suppliers;

difficulties in attracting new international customers;

difficulties in accounts receivable collections;

difficulties in staffing and managing a distant international subsidiary and branch operations;

the burden of complying with foreign and international laws and treaties;

difficulty in transferring funds to other geographic locations; and

potentially adverse tax consequences.

Our operations in Asia also subject us to U.S. laws governing the export of equipment. These laws are complex and require us to obtain clearances for the export to Asia of certain equipment. We may fail to comply with these laws and regulations, which could require us to cease use of certain equipment and expose us to fines or penalties.

Over the past several years the Chinese government has pursued economic reform policies, including the encouragement of private economic activity and greater economic decentralization. The Chinese government may not continue these policies or may significantly alter them to our detriment from time to time without notice. Changes in laws and regulations or their interpretation, the imposition of confiscatory taxation policies, new restrictions on currency conversion or limitations on sources of supply could materially and adversely affect our Chinese operations, which could result in the partial or total loss of our investment in that country and materially and adversely affect our future operating results.

We are subject to order and shipment uncertainties and any significant reductions, cancellations or delays in customer orders could cause our revenue to decline and our operating results to suffer.

Our revenue is difficult to forecast because we generally do not have a material backlog of unfilled orders and because of the short time frame within which we are often required to design, produce and deliver products to our customers. Most of our revenue in any quarter depends on customer orders for our products that we receive and fulfill in the same quarter. We do not have long-term purchase orders or contracts that contain minimum purchase commitments from our customers. Instead, we receive non-binding forecasts of the future volume of orders from our customers. Occasionally, we order and build component inventory in advance of the receipt of actual customer orders. Customers may cancel order forecasts, change production quantities from forecasted volumes or delay production for reasons beyond our control. Furthermore, reductions, cancellations or delays in customer order forecasts usually occur without penalty to or compensation from, the customer. Reductions, cancellations or delays in forecasted orders could cause us to hold inventory longer than anticipated, which could reduce our gross profit, restrict our ability to fund our operations and cause us to incur unanticipated reductions or delays in revenue. If we do not obtain orders as we anticipate, we could have excess component inventory for a specific product that we would not be able to sell to another customer, likely resulting in inventory write-offs, which could have a material adverse effect on our business, financial condition and operating results. In addition, because many of our costs are fixed in the short term, we could experience deterioration in our gross profit when our production volumes decline.

The manufacturing of our products is highly complex, and if we are not able to manage our manufacturing and procurement process effectively, our business and operating results will suffer.

The manufacturing of our products is a highly complex process that involves the integration of multiple components and requires effective management of our supply chain while meeting our customers' design-to-delivery cycle time requirements. Through the course of the manufacturing process, our customers may modify design and system configurations in response to changes in their own customers' requirements. In order to rapidly respond to these modifications and deliver our products to our customers in a timely manner, we must effectively manage our manufacturing and procurement process. If we fail to manage this process effectively, we risk losing customers and damaging our reputation. In addition, if we acquire inventory in excess of demand or that does not meet customer specifications, we could incur excess or obsolete inventory charges. These risks are even greater during an economic downturn as we are currently experiencing and as we continue to expand our business beyond gas delivery systems into new subsystems. In this economic downturn, certain of our suppliers may be forced out of business, which would require us to either procure product from higher-cost suppliers or, if no additional suppliers exist, reconfigure the design and manufacture of our products. This could limit our growth and have a material adverse effect on our business, financial condition and operating results.

OEMs may not continue to outsource other critical subsystems, which would adversely impact our operating results.

The success of our business depends on OEMs continuing to outsource the manufacturing of critical subsystems. Most of the largest OEMs have already outsourced production of a significant portion of their critical subsystems. If OEMs do not continue to outsource critical subsystems for their capital equipment, our revenue would be significantly reduced, which would have a material adverse effect on our business, financial condition and operating results. In addition, if we are unable to obtain additional business from OEMs, even if they continue to outsource their production of critical subsystems, our business, financial condition and operating results could be adversely affected.

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If our new products are not accepted by OEMs or if we are unable to maintain historical margins on our new products, our operating results would be adversely impacted.

We design, develop and market critical subsystems to OEMs. Sales of new products are expected to make up an increasing part of our total revenue. The introduction of new products is inherently risky because it is difficult to foresee the adoption of new standards, coordinate our technical personnel and strategic relationships and win acceptance of new products by OEMs. We may not be able to recoup design and development expenditures if our new products are not accepted by OEMs. Newly introduced products typically carry lower gross margins for several or more quarters following their introduction. If any of our new subsystems is not successful in the market, or if we are unable to obtain gross margins on new products that are similar to the gross margins we have historically achieved, our business, operating results and financial condition could be adversely affected.

We may not be able to integrate efficiently the operations of past and future acquired businesses.

We have made, and may in the future consider making, acquisitions of, or significant investments in, businesses that offer complementary products, services, technologies or market access. For example, we acquired Sieger Engineering, Inc. in June 2006. If we are to realize the anticipated benefits of past and future acquisitions or investments, the operations of these companies must be integrated and combined efficiently with our own. The process of integrating supply and distribution channels, computer and accounting systems, and other aspects of operations, while managing a larger entity, have and will present a significant challenge to our management. In addition, it is not certain that we will be able to incorporate different financial and reporting controls, processes, systems and technologies into our existing business environment. The difficulties of integration may increase because of the necessity of combining personnel with varied business backgrounds and combining different corporate cultures and objectives. We may assume substantial debt and incur substantial costs associated with these activities and we may suffer other material adverse effects from these integration efforts which could materially reduce our earnings, even over the long-term. We may not succeed with the integration process and we may not fully realize the anticipated benefits of the business combinations. The dedication of management resources to such integration or divestitures may detract attention from the day-to-day business, and we may need to hire additional management personnel to manage our acquisitions successfully.

In addition, we frequently evaluate acquisitions of, or significant investments in, complementary companies, assets, businesses and technologies. Even if an acquisition or other investment is not completed, we may incur significant management time and effort and financial cost in evaluating such acquisition or investment, which has in the past had, and could in the future have, an adverse effect on our results of operations. Furthermore, due to the limited liquidity in the credit market, the financing of any such acquisition may be difficult to obtain, and the terms of such financing may be less favorable.

Our business is largely dependent on the know-how of our employees, and we generally do not have a protected intellectual property position.

Our business is largely dependent upon our design, engineering, manufacturing and testing know-how. We rely on a combination of trade secrets and contractual confidentiality provisions and, to a much lesser extent, patents, copyrights and trademarks to protect our proprietary rights. Accordingly, our intellectual property position is more vulnerable than it would be if it were protected by patents. If we fail to protect our proprietary rights successfully, our competitive position could suffer, which could harm our operating results. We may be required to spend significant resources to monitor and protect our proprietary rights, and, in the event we do not detect infringement of our proprietary rights, we may lose our competitive position in the market if any such infringement occurs. In addition, competitors may design around our technology or develop competing technologies and know-how.

If we do not keep pace with developments in the industries we serve and with technological innovation generally, our products may not be competitive.

Rapid technological innovation in the markets we serve requires us to anticipate and respond quickly to evolving customer requirements and could render our current product offerings and technology obsolete. Technological innovations are inherently complex. We must devote resources to technology development in order to keep pace with such rapidly evolving technologies. We believe that our future success will depend upon our ability to design, engineer and manufacture products that meet the changing needs of our customers. This requires that we successfully anticipate and respond to technological changes in design, engineering and manufacturing processes in a cost-effective and timely manner. If we are unable to integrate new technical specifications into competitive product designs, develop the technical capabilities necessary to manufacture new products or make necessary modifications or enhancements to existing products, our business prospects could be harmed.

The timely development of new or enhanced products is a complex and uncertain process which requires that we:

design innovative and performance-enhancing features that differentiate our products from those of our competitors;

identify emerging technological trends in the industries we serve, including new standards for our products;

accurately identify and design new products to meet market needs;

collaborate with OEMs to design and develop products on a timely and cost-effective basis;

ramp-up production of new products, especially new subsystems, in a timely manner and with acceptable yields;

successfully manage development production cycles; and

respond effectively to technological changes or product announcements by others.

The industries in which we participate are highly competitive and rapidly evolving, and if we are unable to compete effectively, our operating results would be harmed.

Although we have not faced competition in the past from the largest subsystem and component manufacturers in the industries we serve, these suppliers could compete with us in the future. Increased competition has in the past resulted, and could in the future result, in price reductions, reduced gross margins or loss of market share, any of which would harm our operating results. We are subject to pricing pressure as we attempt to increase market share with our existing customers. Competitors may introduce new products for the markets currently served by our products. These products may have better performance, lower prices and achieve broader market acceptance than our products. Further, OEMs typically own the design rights to their products and may provide these designs to other subsystem manufacturers. If our competitors obtain proprietary rights to these designs such that we are unable to obtain the designs necessary to manufacture products for our OEM customers, our business, financial condition and operating results could be adversely affected.

Our competitors may have greater financial, technical, manufacturing and marketing resources than we do. As a result, they may be able to respond more quickly to new or emerging technologies and changes in customer requirements, devote greater resources to the development, promotion, sale and support of their products, and

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reduce prices to increase market share. Moreover, there may be merger and acquisition activity among our competitors and potential competitors that may provide our competitors and potential competitors an advantage over us by enabling them to expand their product offerings and service capabilities to meet a broader range of customer needs. Further, if one of our customers develops or acquires the internal capability to develop and produce critical subsystems that we produce, the loss of that customer could have a material adverse effect on our business, financial condition and operating results. The introduction of new technologies and new market entrants may also increase competitive pressures.

We must achieve design wins to retain our existing customers and to obtain new customers.

New capital equipment typically has a lifespan of several years, and OEMs frequently specify which systems, subsystems, components and instruments are to be used in their equipment. Once a specific system, subsystem, component or instrument is incorporated into a piece of capital equipment, it will likely continue to be incorporated into that piece of equipment for at least several months before the OEM switches to the product of another supplier.

Accordingly, it is important that our products are designed into the new capital equipment of OEMs, which we refer to as a design win, in order to retain our competitive position with existing customers and to obtain new customers.

We incur technology development and sales expenses with no assurance that our products will ultimately be designed into an OEM's capital equipment. Further, developing new customer relationships, as well as increasing our market share at existing customers, requires a substantial investment of our sales, engineering and management resources without any assurance from prospective customers that they will place significant orders. We believe that OEMs often select their suppliers and place orders based on long-term relationships. Accordingly, we may have difficulty achieving design wins from OEMs that are not currently our customers. Our operating results and potential growth could be adversely affected if we fail to achieve design wins with leading OEMs.

Defects in our products could damage our reputation, decrease market acceptance of our products, cause the unintended release of hazardous materials and result in potentially costly litigation.

A number of factors, including design flaws, material and component failures, contamination in the manufacturing environment, impurities in the materials used and unknown sensitivities to process conditions, such as temperature and humidity, as well as equipment failures, may cause our products to contain undetected errors or defects. Problems with our products may:

cause delays in product introductions and shipments;

result in increased costs and diversion of development resources;

cause us to incur increased charges due to unusable inventory;

require design modifications;

decrease market acceptance of, or customer satisfaction with, our products, which could result in decreased sales and product returns;
or

result in lower yields for semiconductor manufacturers.

If any of our products contain defects or have reliability, quality or compatibility problems, our reputation might be damaged and customers might be reluctant to buy our products. We may also face a higher rate of product defects as we increase our production levels. Product defects could result in the loss of existing customers or impair our ability to attract new customers. In addition, we may not find defects or failures in our products until after they are installed in a manufacturer's fabrication facility. We may have to invest significant capital and other resources to correct these problems. Our current or potential customers also might seek to recover from us any losses resulting from defects or failures in our

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products. Hazardous materials flow through and are controlled by our products and an unintended release of these materials could result in serious injury or death. Liability claims could require us to spend significant time and money in litigation or pay significant damages.

We have outstanding indebtedness; the restrictive covenants under our debt agreements may limit our ability to expand or pursue our business strategy; if we are forced to prepay some or all of this indebtedness our financial position would be severely and adversely affected.

We have outstanding indebtedness. As of July 1, 2011, the long-term portion of our debt was \$22.9 million and the short-term portion of \$3.3 million, for an aggregate total of \$26.2 million. Our loan agreement, as amended on October 21, 2010, contains certain reporting and financial covenants that must be met on a quarterly basis in order for the Company to remain in compliance. The covenants contained in our line of credit with the bank also restrict our ability to take certain actions, including our ability to:

incur additional indebtedness;

pay dividends and make distributions in respect of our capital stock;

redeem capital stock;

make investments or other restricted payments outside the ordinary course of business;

engage in transactions with stockholders and affiliates;

create liens;

sell or otherwise dispose of assets;

make payments on our other debt, other than in the ordinary course; and

engage in certain mergers and acquisitions.

We cannot assure you that we will meet these financial covenants in subsequent periods. If we are unable to meet any covenants, we cannot assure you that the bank will grant waivers or amend the covenants, or that the bank will not terminate the agreement, preclude further borrowings or require us to immediately repay any outstanding borrowings. As long as our indebtedness remains outstanding, the restrictive covenants could impair our ability to expand or pursue our business strategies or obtain additional funding. Forced prepayment of some or all of our indebtedness would reduce our available cash balances and have an adverse impact on our operating and financial performance.

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The technology labor market is very competitive, and our business will suffer if we are unable to hire and retain key personnel.

Our future success depends in part on the continued service of our key executive officers, as well as our research, engineering, sales, manufacturing and administrative personnel, most of whom are not subject to employment or non-competition agreements. In addition, competition for qualified personnel in the technology industry is intense, and we operate in geographic locations in which labor markets are particularly competitive.

Our business is particularly dependent on expertise which only a very limited number of engineers possess. The loss of any of our key employees and officers, including our Chief Executive Officer or any of our Senior Vice Presidents, or the failure to attract and retain new qualified employees, could adversely affect our business, operating results and financial condition.

Fluctuations in currency exchange rates may adversely affect our financial condition and results of operations.

Our international sales are denominated primarily, though not entirely, in U.S. dollars. Many of the costs and expenses associated with our Chinese subsidiaries and Singapore subsidiary are paid in Chinese Renminbi and Singapore dollars, respectively, and we expect our exposure to Chinese Renminbi and Singapore dollars to increase as we ramp up production in those facilities. In addition, purchases of some of our components are denominated in Japanese Yen and Euro. Changes in exchange rates among other currencies in which our revenue or costs are denominated and the U.S. dollar may affect our revenue, cost of sales and operating margins. While fluctuations in the value of our revenue, cost of sales and operating margins as measured in U.S. dollars have not materially affected our results of operations historically, we do not currently hedge our exchange exposure, and exchange rate fluctuations could have an adverse effect on our financial condition and results of operations in the future.

If environmental contamination were to occur in one of our manufacturing facilities, we could be subject to substantial liabilities.

We use substances regulated under various foreign, domestic, federal, state and local environmental laws in our manufacturing facilities. Our failure or inability to comply with existing or future environmental laws could result in significant remediation liabilities, the imposition of fines or the suspension or termination of the production of our products. In addition, we may not be aware of all environmental laws or regulations that could subject us to liability.

If our facilities were to experience catastrophic loss due to natural disasters, our operations would be seriously harmed.

Our facilities could be subject to a catastrophic loss caused by natural disasters, including fires and earthquakes. We have facilities in areas with above average seismic activity, such as our manufacturing facility in South San Francisco, California and our new manufacturing and headquarters facilities in Hayward, California. If any of our facilities were to experience a catastrophic loss, it could disrupt our operations, delay production and shipments, reduce revenue and result in large expenses to repair or replace the facility. In addition, we have in the past experienced, and may in the future experience, extended power outages at our facilities. We do not carry insurance policies that cover potential losses caused by earthquakes or other natural disasters or power loss.

Third parties have claimed and may in the future claim we are infringing their intellectual property, which could subject us to litigation or licensing expenses, and we may be prevented from selling our products if any such claims prove successful.

We have in the past and may in the future receive claims that our products, processes or technologies infringe the patents or other proprietary rights of third parties. In addition, we may be unaware of intellectual property rights of others that may be applicable to our products. Any litigation regarding our patents or other intellectual property could be costly and time-consuming and divert our management and key personnel from our business operations, any of which could have a material adverse effect on our business and results of operations. The complexity of the technology involved in our products and the uncertainty of intellectual property litigation increase these risks. Claims of intellectual property infringement may also require us to enter into costly license agreements. However, we may not be able to obtain licenses on terms acceptable to us, or at all. We also may be subject to significant damages or injunctions against the development, manufacture and sale of certain of our products if any such claims prove successful.

Changes in tax rates or tax assets and liabilities could affect results of operations.

As a global company, we are subject to taxation in the United States and various other countries. Significant judgment is required to determine and estimate worldwide tax liabilities. Our future annual and quarterly tax rates could be affected by numerous factors, including changes in the: (1) applicable tax laws; (2) amount and composition of pre-tax income in countries with differing tax rates; or (3) valuation of our deferred tax assets and liabilities.

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In addition, we are subject to regular examination by the Internal Revenue Service and other tax authorities, and from time to time we initiate amendments to previously filed tax returns. We regularly assess the likelihood of favorable or unfavorable outcomes resulting from these examinations and amendments to determine the adequacy of its provision for income taxes, which requires estimates and judgments. Although we believe our tax estimates are reasonable, there can be no assurance that the tax authorities will agree with such estimates. We may have to engage in litigation to achieve the results reflected in the estimates, which may be time-consuming and expensive. There can be no assurance that we will be successful or that any final determination will not be materially different from the treatment reflected our historical income tax provisions and accruals, which could materially and adversely affect our financial condition and results of operations.

The market for our stock is subject to significant fluctuation.

The size of our public market capitalization is relatively small, and the volume of our shares that are traded is low. The market price of our common stock could be subject to significant fluctuations. Among the factors that could affect our stock price are:

quarterly variations in our operating results;

our ability to successfully introduce new products and manage new product transitions;

changes in revenue or earnings estimates or publication of research reports by analysts;

speculation in the press or investment community;

strategic actions by us or our competitors, such as acquisitions or restructurings;

announcements relating to any of our key customers, significant suppliers or the semiconductor manufacturing and capital equipment industry generally;

general market conditions;

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the effects of war and terrorist attacks; and

domestic and international economic factors unrelated to our performance.

The stock markets in general, and the markets for technology stocks in particular, have experienced extreme volatility that has often been unrelated to the operating performance of particular companies. These broad market fluctuations may adversely affect the trading price of our common stock.

ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

ITEM 3. Defaults Upon Senior Securities

None.

ITEM 4. (Removed and Reserved)

None.

ITEM 5. Other Information

None.

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ITEM 6. Exhibits

(a) Exhibits

The following exhibits are filed with this current Report on Form 10-Q for the quarter ended July 1, 2011:

| Exhibit | |
|----------------|--|
| Number | Description |
| 31.1 | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | Certification of the Chief Executive Officer and the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 101.INS | XBRL Instance Document |
| 101.SCH | XBRL Taxonomy Extension Schema Document |
| 101.CAL | XBRL Taxonomy Calculation Linkbase Document |
| 101.LAB | XBRL Taxonomy Label Linkbase Document |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document |

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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.

ULTRA CLEAN HOLDINGS, INC.
(Registrant)

Date: August 3, 2011

By: */s/ CLARENCE L. GRANGER*
Name: **Clarence L. Granger**
Title: **Chairman and Chief Executive Officer**

(Principal Executive Officer)

Date: August 3, 2011

By: */s/ KEVIN C. EICHLER*
Name: **Kevin C. Eichler**
Title: **Chief Financial Officer**

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Exhibit Index

| Exhibit | |
|----------------|--|
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| 31.1 | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | Certification of the Chief Executive Officer and the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 101.INS | XBRL Instance Document |
| 101.SCH | XBRL Taxonomy Extension Schema Document |
| 101.CAL | XBRL Taxonomy Calculation Linkbase Document |
| 101.LAB | XBRL Taxonomy Label Linkbase Document |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document |