

RICHARDSON ELECTRONICS LTD/DE  
Form 10-Q  
October 06, 2016

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

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**FORM 10-Q**

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**(Mark One)**

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

**For the quarterly period ended August 27, 2016**

**OR**

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

**For the transition period from \_\_\_\_\_ To \_\_\_\_\_**

**Commission File Number: 0-12906**

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**RICHARDSON ELECTRONICS, LTD.**

**(Exact name of registrant as specified in its charter)**

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**Delaware 36-2096643  
(State or other jurisdiction of (I.R.S. Employer**

**incorporation or organization) Identification No.)**

**40W267 Keslinger Road, P.O. Box 393**

**LaFox, Illinois 60147-0393**

**(Address of principal executive offices)**

**Registrant's telephone number, including area code: (630) 208-2200**

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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

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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

Accelerated Filer

Non-Accelerated Filer      (Do not check if a smaller reporting company) Smaller Reporting Company

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

As of October 3, 2016, there were outstanding 10,702,932 shares of Common Stock, \$0.05 par value and 2,140,631 shares of Class B Common Stock, \$0.05 par value, which are convertible into Common Stock of the registrant on a share for share basis.

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**PART I. FINANCIAL INFORMATION**  
**ITEM 1. FINANCIAL STATEMENTS**  
**Richardson Electronics, Ltd.**

**Consolidated Balance Sheets**

*(in thousands, except per share amounts)*

	Unaudited August 27, 2016	Audited May 28, 2016
Assets		
Current assets:		
Cash and cash equivalents	\$57,488	\$60,454
Accounts receivable, less allowance of \$380 and \$364	21,545	24,928
Inventories, net	45,187	45,422
Prepaid expenses and other assets	1,744	1,758
Deferred income taxes	—	1,078
Income tax receivable	30	17
Investments - current	6,392	2,268
Total current assets	132,386	135,925
Non-current assets:		
Property, plant and equipment, net	14,425	12,986
Goodwill	6,332	6,332
Intangible assets, net	3,714	3,818
Non-current deferred income taxes	1,304	1,270
Investments - non-current	2,410	7,799
Total non-current assets	28,185	32,205
Total assets	\$160,571	\$168,130
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	12,581	14,896
Accrued liabilities	8,000	9,135
Total current liabilities	20,581	24,031
Non-current liabilities:		
Non-current deferred income tax liabilities	237	1,457
Other non-current liabilities	1,196	967
Total non-current liabilities	1,433	2,424
Total liabilities	22,014	26,455
Stockholders' equity		
Common stock, \$0.05 par value; issued and outstanding 10,703 shares at August 27, 2016, and at May 28, 2016	535	535
Class B common stock, convertible, \$0.05 par value; issued and outstanding 2,141 shares at August 27, 2016, and at May 28, 2016	107	107
Preferred stock, \$1.00 par value, no shares issued	—	—
Additional paid-in-capital	59,072	58,969
Common stock in treasury, at cost, no shares at August 27, 2016, and at May 28, 2016	—	—

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Retained earnings	75,685	79,292
Accumulated other comprehensive income	3,158	2,772
Total stockholders' equity	138,557	141,675
Total liabilities and stockholders' equity	\$160,571	\$168,130

**Richardson Electronics, Ltd.****Unaudited Consolidated Statements of Comprehensive Loss***(in thousands, except per share amounts)*

	Three Months Ended	
	August 27, 2016	August 29, 2015
Statements of Comprehensive Loss		
Net sales	\$33,373	\$37,071
Cost of sales	23,133	25,809
Gross profit	10,240	11,262
Selling, general, and administrative expenses	12,327	12,267
Gain on disposal of assets	—	(1 )
Operating loss	(2,087 )	(1,004 )
Other (income) expense:		
Investment/interest income	(11 )	(191 )
Foreign exchange loss	278	182
Other, net	(1 )	36
Total other expense	266	27
Loss before income taxes	(2,353 )	(1,031 )
Income tax provision	497	368
Net loss	(2,850 )	(1,399 )
Foreign currency translation gain (loss), net of tax	379	(503 )
Fair value adjustments on investments gain (loss)	7	(60 )
Comprehensive loss	\$(2,464 )	\$(1,962 )
Loss per share:		
Common shares - Basic	\$(0.23 )	\$(0.10 )
Class B common shares - Basic	\$(0.20 )	\$(0.10 )
Common shares - Diluted	\$(0.23 )	\$(0.10 )
Class B common shares - Diluted	\$(0.20 )	\$(0.10 )
Weighted average number of shares:		
Common shares - Basic	10,703	11,486
Class B common shares - Basic	2,141	2,141
Common shares - Diluted	10,703	11,486
Class B common shares - Diluted	2,141	2,141
Dividends per common share	\$0.060	\$0.060
Dividends per Class B common share	\$0.054	\$0.054

**Richardson Electronics, Ltd.****Unaudited Consolidated Statements of Cash Flows***(in thousands)*

	Three Months Ended	
	August 27, 2016	August 29, 2015
Operating activities:		
Net loss	\$(2,850 )	\$(1,399 )
Adjustments to reconcile net loss to cash used in operating activities:		
Depreciation and amortization	715	485
Gain on sale of investments	(2 )	(11 )
Gain on disposal of assets	—	(1 )
Share-based compensation expense	103	90
Deferred income taxes	(158 )	1
Change in assets and liabilities, net of effect of acquired business:		
Accounts receivable	3,555	(2,525 )
Income tax receivable	(13 )	548
Inventories	411	(593 )
Prepaid expenses and other assets	41	(581 )
Accounts payable	(2,338 )	(1,521 )
Accrued liabilities	(1,144 )	(804 )
Non-current deferred income tax liabilities	—	228
Long-term liabilities-accrued pension	—	(465 )
Other	5	35
Net cash used in operating activities	(1,675 )	(6,513 )
Investing activities:		
Cash consideration paid for acquired business	—	(12,209)
Capital expenditures	(2,064 )	(984 )
Proceeds from maturity of investments	1,465	18,350
Proceeds from sales of available-for-sale securities	88	100
Purchases of available-for-sale securities	(88 )	(100 )
Other	(3 )	60
Net cash (used in) provided by investing activities	(602 )	5,217
Financing activities:		
Repurchase of common stock	—	(3,308 )
Cash dividends paid	(758 )	(806 )
Other	—	(4 )
Net cash used in financing activities	(758 )	(4,118 )
Effect of exchange rate changes on cash and cash equivalents	69	(695 )
Decrease in cash and cash equivalents	(2,966 )	(6,109 )
Cash and cash equivalents at beginning of period	60,454	74,535
Cash and cash equivalents at end of period	\$57,488	\$68,426





**Richardson Electronics, Ltd.****Unaudited Consolidated Statement of Stockholders' Equity***(in thousands)*

	Common	Class B Common	Par Value	Additional Paid In Capital	Common Stock in Treasury	Retained Earnings	Accumulated Other Comprehensive Income	Total
Balance May 28, 2016:	10,703	2,141	\$642	\$58,969	\$ —	\$79,292	\$ 2,772	\$141,675
Comprehensive loss								
Net loss	—	—	—	—	—	(2,850 )	—	(2,850 )
Foreign currency translation	—	—	—	—	—	—	379	379
Fair value adjustments on investments	—	—	—	—	—	—	7	7
Share-based compensation:								
Stock options	—	—	—	103	—	—	—	103
Dividends paid to:								
Common (\$0.06 per share)	—	—	—	—	—	(641 )	—	(641 )
Class B (\$0.054 per share)	—	—	—	—	—	(116 )	—	(116 )
Balance August 27, 2016:	10,703	2,141	\$642	\$59,072	\$ —	\$75,685	\$ 3,158	\$138,557

## **RICHARDSON ELECTRONICS, LTD.**

### **NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**

#### **1. DESCRIPTION OF THE COMPANY**

Richardson Electronics, Ltd. is a leading global provider of engineered solutions, power grid and microwave tubes and related consumables; power conversion and RF and microwave components; high value displays, flat panel detector solutions and replacement parts for diagnostic imaging equipment; and customized display solutions. We serve customers in the alternative energy, healthcare, aviation, broadcast, communications, industrial, marine, medical, military, scientific and semiconductor markets. The Company's strategy is to provide specialized technical expertise and "engineered solutions" based on our core engineering and manufacturing capabilities. The Company provides solutions and adds value through design-in support, systems integration, prototype design and manufacturing, testing, logistics, and aftermarket technical service and repair through its global infrastructure.

Our products include electron tubes and related components, microwave generators, subsystems used in semiconductor manufacturing, and visual technology solutions. These products are used to control, switch or amplify electrical power signals, or are used as display devices in a variety of industrial, commercial, medical, and communication applications.

We have three operating and reportable segments, which we define as follows:

Power and Microwave Technologies Group ("PMT") combines our core engineered solutions, power grid and microwave tube business with new RF and power technologies. As a manufacturer and authorized distributor, PMT's strategy is to provide specialized technical expertise and engineered solutions based on our core engineering and manufacturing capabilities. We provide solutions and add value through design-in support, systems integration, prototype design and manufacturing, testing, logistics, and aftermarket technical service and repair—all through our existing global infrastructure. PMT's focus is on products for power, RF and microwave applications for customers in alternative energy, aviation, broadcast, communications, industrial, marine, medical, military, scientific, and semiconductor markets. PMT focuses on various applications including broadcast transmission, CO2 laser cutting, diagnostic imaging, dielectric and induction heating, high energy transfer, high voltage switching, plasma, power conversion, radar, and radiation oncology. PMT also offers its customers technical services for both microwave and industrial equipment.

Canvys provides customized display solutions serving the corporate enterprise, financial, healthcare, industrial, and medical original equipment manufacturers ("OEM") markets.

Healthcare manufactures, distributes and services high value replacement parts for the healthcare market including hospitals, medical centers, independent service organizations, and multi-vendor service providers. Products include power grid tubes, hydrogen thyratrons, klystrons, magnetrons; Image Systems medical displays and workstations for picture archiving and communication systems ("PACS"); visual solutions for operating rooms/surgical environments; digital radiography solutions including replacement flat panel detectors and upgrades; and additional replacement components currently under development for the diagnostic imaging service market. Through a combination of newly developed products and partnerships, service offerings, and training programs, we believe we can help our customers

improve efficiency and deliver better clinical outcomes while lowering the cost of healthcare delivery.

We currently have operations in the following major geographic regions: North America, Asia/Pacific, Europe, and Latin America.

## **2. BASIS OF PRESENTATION**

The accompanying unaudited consolidated financial statements have been prepared in accordance with United States Generally Accepted Accounting Principles (“GAAP”) for interim financial information and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all the information and notes required by GAAP for complete financial statements.

Our fiscal quarter ends on the Saturday nearest the end of the quarter-ending month. The first three months of fiscal 2017 and 2016 contained 13 weeks, respectively.

In the opinion of management, all adjustments, which are of a normal and recurring nature, necessary for a fair presentation of the results of interim periods have been made. All inter-company transactions and balances have been eliminated. The unaudited consolidated financial statements presented herein include the accounts of our wholly owned subsidiaries. Certain information and note disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules and regulations. The results of our operations for the three months ended August 27, 2016, are not necessarily indicative of the results that may be expected for the fiscal year ending May 27, 2017.

The financial information contained in this report should be read in conjunction with our Annual Report on Form 10-K for the fiscal year ended May 28, 2016, that we filed on July 29, 2016.

### 3. CRITICAL ACCOUNTING POLICIES AND ESTIMATES

**Inventories:** Our consolidated inventories are stated at the lower of cost or market, generally using a weighted-average cost method. Our inventories include approximately \$39.7 million of finished goods, \$4.4 million of raw materials, and \$1.1 million of work-in-progress as of August 27, 2016, as compared to approximately \$40.0 million of finished goods, \$4.4 million of raw materials, and \$1.0 million of work-in-progress as of May 28, 2016.

At this time, we do not anticipate any material risks or uncertainties related to possible future inventory write-downs. Provisions for obsolete or slow moving inventories are recorded based upon regular analysis of stock rotation privileges, obsolescence, the exiting of certain markets, and assumptions about future demand and market conditions. If future demand, changes in the industry, or market conditions differ from management's estimates, additional provisions may be necessary. Inventory reserves were approximately \$3.4 million as of August 27, 2016, and as of May 28, 2016.

**Revenue Recognition:** Our product sales are recognized as revenue upon shipment, when title passes to the customer, when delivery has occurred or services have been rendered, and when collectability is reasonably assured. We also record estimated discounts and returns based on our historical experience. Our products are often manufactured to meet the specific design needs of our customers' applications. Our engineers work closely with customers to ensure that our products will meet their needs. Our customers are under no obligation to compensate us for designing the products we sell.

**Loss Contingencies:** We accrue a liability for loss contingencies when it is probable that a liability has been incurred and the amount can be reasonably estimated. When only a range of possible loss can be established, the most probable amount in the range is accrued. If no amount within this range is a better estimate than any other amount within the range, the minimum amount in the range is accrued. If we determine that there is at least a reasonable possibility that a loss may have been incurred, we will include a disclosure describing the contingency.

**Intangible Assets:** Intangible assets are initially recorded at their fair market values determined on quoted market prices in active markets, if available, or recognized valuation models. Intangible assets that have finite useful lives are amortized over their useful lives either on a straight-line basis or over their projected future cash flows and are tested for impairment when events or changes in circumstances occur that indicate possible impairment.

**Income Taxes:** We recognize deferred tax assets and liabilities based on the differences between financial statement carrying amounts and the tax bases of assets and liabilities. We regularly review our deferred tax assets for recoverability and determine the need for a valuation allowance based on a number of factors, including both positive and negative evidence. These factors include historical taxable income or loss, projected future taxable income or loss, the expected timing of the reversals of existing temporary differences, and the implementation of tax planning strategies. In circumstances where we, or any of our affiliates, have incurred three years of cumulative losses which constitute significant negative evidence, positive evidence of equal or greater significance is needed to overcome the negative evidence before a tax benefit is recognized for deductible temporary differences and loss carryforwards.

In November 2015, the FASB issued ASU 2015-17, "Balance Sheet Classification of Deferred Taxes." ASU 2015-17 eliminates the prior US GAAP guidance in Topic 740, Income Taxes, that required an entity to separate deferred tax liabilities and assets between current and noncurrent amounts in a classified balance sheet. The amendments in ASU 2015-17 require that all deferred tax liabilities and assets of the same tax jurisdiction or a tax filing group, as well as

any related valuation allowance, be offset and presented as a single noncurrent amount in a classified balance sheet. ASU 2015-17 is effective for annual periods beginning after December 15, 2016, and interim periods within those annual periods. In order to simplify presentation of deferred tax balances, the Company adopted this standard prospectively in the quarter ended August 27, 2016. Periods prior to August 27, 2016 were not retrospectively adjusted.

**Accrued Liabilities:** Accrued liabilities consist of the following (*in thousands*):

	<b>August 27, 2016</b>	<b>May 28, 2016</b>
Compensation and payroll taxes	\$3,510	\$ 4,054
Professional fees	406	775
Deferred revenue	1,831	1,879
Other accrued expenses	2,253	2,427
<b>Accrued Liabilities</b>	<b>\$8,000</b>	<b>\$ 9,135</b>

#### 4. ACQUISITION

On June 15, 2015, Richardson Electronics, Ltd (“the Company”), acquired certain assets of International Medical Equipment and Services, Inc. (“IMES”), for a purchase price of \$12.2 million. This includes the purchase of inventory, receivables, fixed assets, and certain other assets of the Company. The Company did not acquire any liabilities of IMES. The total consideration paid excludes transaction costs.

IMES, based in South Carolina, provides reliable, cost-saving solutions worldwide for major brands of CT and MRI equipment. This acquisition positions Richardson Healthcare to provide cost effective diagnostic imaging replacement parts and training to hospitals, diagnostic imaging centers, medical institutions, and independent service organizations. IMES offers an extensive selection of replacement parts, as well as an interactive training center, on-site test bays and experienced technicians who provide 24/7 customer support. Replacement parts are readily available and triple tested to provide peace of mind when uptime is critical. IMES core operations have remained in South Carolina. Richardson Healthcare plans to expand IMES’ replacement parts and training offerings geographically to leverage the Company’s global infrastructure. During the fourth quarter of fiscal 2016, IMES opened up their first foreign location in Amsterdam.

The consideration paid by the Company to IMES at closing was \$12.2 million in cash. The following table summarizes the fair values of the assets acquired at the date of the closing of the acquisition (*in thousands*):

Accounts receivable	\$737
Inventories	1,420
Property, plant and equipment	230
Goodwill	6,332
Other intangibles	3,490
<b>Net assets acquired</b>	<b>\$12,209</b>

Intangible assets include trade names with an estimated life of 3 years for \$0.6 million, customer relationships with an estimated life of 20 years for \$2.5 million, non-compete agreements with an estimated life of 5 years for \$0.2 million, and technology with an estimated life of 10 years for \$0.2 million.

Goodwill recognized represents value the Company expects to be created by combining the operations of IMES with the Company’s operations, including the expansion into markets within existing business segments and geographic regions, access to new customers and potential cost savings and synergies.

Goodwill related to the acquisition is deductible for tax purposes.

In connection with the acquisition of IMES, the Company also entered into an Employment, Non-Disclosure, and Non-Compete Agreement (“Employment Agreement”) with Lee A. McIntyre III as the Company’s Executive Vice President, IMES. During the term of his employment, Mr. McIntyre will earn an annual base salary of \$300,000. In addition to his base salary, he will be entitled to an annual bonus equal to 20% of the EBITDA of IMES provided that the EBITDA of the bus SFAS 156 requires that all recognized servicing assets and liabilities are initially measured at fair value, and subsequently measured at either fair value or by applying an amortization method for each class of recognized servicing assets and liabilities. SFAS 156 is effective in fiscal years beginning after September 15, 2006. The adoption of SFAS 156 is not expected to have a material impact on the Company’s consolidated financial statements.

In February 2006, the FASB issued SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments* an amendment of FASB Statements No. 133 and 140. This Statement amends SFAS No. 133 and SFAS No. 140, and improves the financial reporting of certain hybrid financial instruments by requiring more consistent accounting. Specifically, this Statement allows fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation. This Statement is effective for all financial instruments acquired or issued after the beginning of an entity’s first fiscal year that begins after September 15, 2006. The Company does not expect that adoption of this Statement will have a material impact on its consolidated financial statements.

**Table of Contents****MagnaChip Semiconductor LLC and Subsidiaries****Notes to Condensed Consolidated Financial Statements (Continued)****(Unaudited; tabular dollars in thousands, except unit data)****2. Inventories**

Inventories as of July 2, 2006 and December 31, 2005 consist of the following:

	<b>July 2, 2006</b>	<b>December 31, 2005</b>
Finished goods	\$ 23,135	\$ 28,414
Semi-finished goods and work-in-progress	46,221	60,095
Raw materials	6,565	5,814
Materials in-transit	1,984	1,966
Less: Valuation allowance	(15,748)	(7,612)
Inventories, net	\$ 62,157	\$ 88,677

**3. Property, plant and equipment**

Property, plant and equipment as of July 2, 2006 and December 31, 2005 comprise the following:

	<b>July 2, 2006</b>	<b>December 31, 2005</b>
Buildings and related structures	\$ 159,191	\$ 149,236
Machinery and equipment	342,751	472,388
Vehicles and others	37,435	32,438
	539,377	654,062
Less: Accumulated depreciation	(169,376)	(181,806)
Land	12,238	11,492
Construction in-progress	626	1,329
Property, plant and equipment, net	\$ 382,865	\$ 485,077

**4. Intangible Assets**

Intangible assets as of July 2, 2006 and December 31, 2005 are as follows:

	<b>July 2, 2006</b>	<b>December 31, 2005</b>
Technology	\$ 20,874	\$ 23,911
Customer relationships	167,821	193,958
Goodwill	15,095	15,095
Intellectual property assets	8,774	10,969
Less: Accumulated amortization	(59,197)	(52,544)



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Intangible assets, net	\$ 153,367	\$ 191,389
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**Table of Contents****MagnaChip Semiconductor LLC and Subsidiaries****Notes to Condensed Consolidated Financial Statements (Continued)****(Unaudited; tabular dollars in thousands, except unit data)****5. Product Warranties**

The Company records warranty liabilities for the estimated costs that may be incurred under its basic limited warranty in other current liabilities. This warranty covers defective products and related liabilities are accrued when product revenues are recognized. Factors that affect the Company's warranty liability include historical and anticipated rates of warranty claims on those repairs and cost per claim to satisfy the Company's warranty obligation. As these factors are impacted by actual experience and future expectations, the Company periodically assesses the adequacy of its recorded warranty liabilities and adjusts the amounts when necessary.

Changes in accrued warranty liabilities are as follows:

	Three months ended		Six months ended	
	July 2, 2006	July 3, 2005	July 2, 2006	July 3, 2005
Beginning balance	\$ 1,027	\$ 2,470	\$ 1,036	\$ 1,448
Addition to (reversal of) warranty reserve	(693)	1,878	(575)	3,018
Payments made	(140)	(1,357)	(308)	(1,518)
Translation adjustments	13	(66)	54	(23)
Ending balance	\$ 207	\$ 2,925	\$ 207	\$ 2,925

**6. Long-term Borrowings**

On December 23, 2004, two of the Company's subsidiaries, MagnaChip Semiconductor S.A. and MagnaChip Semiconductor Finance Company issued \$500 million aggregate principal amount of Second Priority Senior Secured Notes consisting of \$300 million aggregate principal amount of Floating Rate Second Priority Senior Secured Notes and \$200 million aggregate principal amount of 6<sup>7</sup>/<sub>8</sub>% Second Priority Senior Secured Notes. At the same time, such subsidiaries issued \$250 million aggregate principal amount of 8% Senior Subordinated Notes.

Concurrently with the issuance of the Second Priority Senior Secured Notes, the Company entered into a new senior credit agreement with a syndicate of banks, financial institutions and other entities providing for a \$100 million senior secured revolving credit facility. Interest is charged at current rates when drawn upon.

Details of long-term borrowings as of July 2, 2006 and December 31, 2005 are presented as below:

	Maturity	Annual interest rate (%)	Amount of principal
Floating Rate Second Priority Senior Secured Notes	2011	3 month LIBOR + 3.250	\$ 300,000
6 <sup>7</sup> / <sub>8</sub> % Second Priority Senior Secured Notes	2011	6.875	200,000
8% Senior Subordinated Notes	2014	8.000	250,000
			\$ 750,000

The senior secured revolving credit facility and Second Priority Senior Secured Notes are collateralized by substantially all of the assets of the Company. The notes will be paid in full upon maturity.

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Each indenture governing the notes contains covenants that limit the ability of the Company and its subsidiaries to (i) incur additional indebtedness, (ii) pay dividends or make other distributions on its capital stock or repurchase, repay or redeem its capital stock, (iii) make certain investments, (iv) incur liens, (v) enter into certain types of transactions with affiliates, (vi) create restrictions on the payment of dividends or other amounts to the Company by its subsidiaries, and (vii) sell all or substantially all of its assets or merge with or into other companies.

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**MagnaChip Semiconductor LLC and Subsidiaries**

**Notes to Condensed Consolidated Financial Statements (Continued)**

**(Unaudited; tabular dollars in thousands, except unit data)**

Borrowings under the senior secured credit facility are subject to significant conditions, including compliance with financial ratios and other covenants and obligations.

As of July 2, 2006, the Company and all of its subsidiaries except for MagnaChip Semiconductor (Shanghai) Company Limited have jointly and severally guaranteed each series of the Second Priority Senior Secured Notes on a second priority senior secured basis. As of July 2, 2006, the Company and its subsidiaries except for MagnaChip Semiconductor Ltd. (Korea) and MagnaChip Semiconductor (Shanghai) Company Limited have jointly and severally guaranteed the Senior Subordinated Notes on an unsecured, senior subordinated basis. In addition, the Company and each of its current and future direct and indirect subsidiaries (subject to certain exceptions) will be guarantors of Second Priority Senior Secured Notes and Senior Subordinated Notes.

On July 26, 2006, the Company entered into the Fourth Amendment to Credit Agreement (as amended, the Credit Agreement ), dated as of July 26, 2006 (the Amendment ), with MagnaChip Semiconductor S.A. and MagnaChip Semiconductor Finance Company, as borrowers, the Subsidiary Guarantors party thereto, the Lenders party thereto (the Lenders ), UBS AG, Stamford Branch, as administrative agent and collateral agent (the Agent ), and U.S. Bank National Association ( US Bank ).

Under the Amendment, among other things, (i) the Company agreed to furnish to the Agent and the Lenders monthly financial statements along with an officer's certificate with respect to the occurrence of any events of default under the Credit Agreement, (ii) certain restrictions were imposed on the Company's ability to make acquisitions and capital expenditures, (iii) the financial covenants set forth in Section 6.10 of the Credit Agreement were revised, (iv) the schedule of applicable margins under the Credit Agreement was revised, (v) the Lenders, the Agent and US Bank waived certain defaults and obligations, and (vi) the Agent consented to the Company's voting in favor of increasing the share capital of one of the Company's subsidiaries.

***Interest Rate Swap***

Effective June 27, 2005, the Company entered into an interest rate swap agreement (the Swap ) that converted the variable interest rate of three-month London Inter-bank Offering Rate ( LIBOR ) plus 3.25% to a fixed interest rate of 7.34% on the Company's Floating Rate Second Priority Senior Secured Notes (the Notes ). This Swap will be in effect until 15 June, 2008.

The Swap qualifies as a cash flow hedge under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended. The Company is utilizing the hypothetical derivative method to measure the effectiveness by comparing the changes in value of the actual derivative versus the change in fair value of the hypothetical derivative. Under this methodology, the actual swap was effective when compared to the hypothetical hedge.

For the six-month period ended July 2, 2006, the Company recorded changes in the fair value of the Swap amounting to \$3,310 thousand, under other comprehensive income in the accompanying condensed consolidated financial statements. In addition, during the same period, the Company recognized interest income of \$1,045 thousand, which represents the differences between fixed and variable rates.

**Table of Contents****MagnaChip Semiconductor LLC and Subsidiaries****Notes to Condensed Consolidated Financial Statements (Continued)****(Unaudited; tabular dollars in thousands, except unit data)****7. Accrued Severance Benefits**

Almost all of the accrual for severance benefits is for employees in the Company's Korean subsidiary. Pursuant to the Labor Standard Act of Korea, employees and most executive officers with one or more years of service are entitled to severance benefits upon the termination of their employment based on their length of service and rate of pay. As of July 2, 2006, 95% of all employees of the Company were eligible for severance benefits.

Changes in the carrying value of accrued severance benefits are as follows:

	Three months ended		Six months ended	
	July 2, 2006	July 3, 2005	July 2, 2006	July 3, 2005
Beginning balance	\$ 59,249	\$ 55,237	\$ 56,967	\$ 52,925
Provisions	2,320	4,470	5,357	8,126
Transferred from acquired company				196
Severance payments	(1,701)	(4,108)	(4,559)	(6,864)
Effect of foreign currency translation and other	925	(1,729)	3,028	(513)
Ending balance	60,793	53,870	60,793	53,870
Less: Cumulative contributions to the National Pension Fund	(888)	(1,041)	(888)	(1,041)
Group Severance insurance plan	(947)	(940)	(947)	(940)
	\$ 58,958	\$ 51,889	\$ 58,958	\$ 51,889

The severance benefits are funded approximately 3.02% and 3.68% as of July 2, 2006 and July 3, 2005, respectively, through the Company's national pension fund and group severance insurance deposit plan which will be used exclusively for payment of severance benefits to eligible employees. These amounts have been deducted from the accrued severance benefit balance.

In addition, the Company expects to pay the following future benefits to its employees upon their normal retirement age:

	Severance benefit
2006 - 2008	\$
2009	75
2010	218
2011 - 2015	1,765

The above amounts were determined based on the employees' current salary rates and the number of service years that will be accumulated upon their retirement dates. These amounts do not include amounts that might be paid to employees that will cease working with the Company before their normal retirement ages.

**Table of Contents****MagnaChip Semiconductor LLC and Subsidiaries****Notes to Condensed Consolidated Financial Statements (Continued)****(Unaudited; tabular dollars in thousands, except unit data)****8. Redeemable Convertible Preferred Unit**

The Company issued 49,727 units as Series A redeemable convertible preferred unit (the Series A ) and 447,420 units as Series B redeemable convertible preferred unit (the Series B ) on September 23, 2004 and additionally issued 364 units of Series A and 3,272 units of Series B on November 30, 2004, respectively. All of Series A were redeemed by cash on December 27, 2004 and parts of Series B were redeemed by cash on December 15, 2004 and December 27, 2004.

Changes in Series B for the three and six months ended July 2, 2006 are as follows:

	Three months ended			
	July 2, 2006		July 3, 2005	
	Units	Amount	Units	Amount
Beginning of period	93,997	\$ 109,095	93,997	\$ 98,929
Accrual of preferred dividends		2,706		2,478
End of period	93,997	\$ 111,801	93,997	\$ 101,407

	Six months ended			
	July 2, 2006		July 3, 2005	
	Units	Amount	Units	Amount
Beginning of period	93,997	\$ 106,462	93,997	\$ 96,534
Accrual of preferred dividends		5,339		4,873
End of period	93,997	\$ 111,801	93,997	\$ 101,407

The Series B were issued to the original purchasers of the Company in 2004. Holders of Series B receive dividends which are cumulative, whether or not earned or declared by the board of directors. The cumulative cash dividends accrue at the rate of 10% per unit per annum on the Series B original issue price, compounded semi-annually. Such dividends are payable in semi-annual installments in arrears commencing March 15, 2005.

**9. Earnings per Unit**

The following table illustrates the computation of basic and diluted loss per common unit for the three-month and six-month periods ended July 2, 2006 and July 3, 2005:

	Three months ended		Six months ended	
	July 2, 2006	July 3, 2005	July 2, 2006	July 3, 2005
Net loss	\$ (132,063)	\$ (33,484)	\$ (135,954)	\$ (64,762)
Dividends to preferred unitholders	2,706	2,478	5,339	4,873
Net loss attributable to common units	\$ (134,769)	\$ (35,962)	\$ (141,293)	\$ (69,635)

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Weighted-average common units outstanding	53,098,537	52,981,901	53,101,546	52,755,012
Basic and diluted loss per unit	\$ (2.54)	\$ (0.68)	\$ (2.66)	\$ (1.32)

The following outstanding redeemable convertible preferred units issued, options granted and warrants issued were excluded from the computation of diluted loss per unit as they would have an anti-dilutive effect on the calculation:

	July 2, 2006	July 3, 2005
Redeemable convertible preferred units	93,997	93,997
Options	5,107,886	3,589,580
Warrant	5,079,254	5,079,254

In connection with the acquisition of the Company's business from Hynix Semiconductor Inc. on October 6, 2004, by Citigroup Venture Capital Equity Partners, L.P., or CVC, Francisco Partners L.P., or Francisco Partners, CVC Asia Pacific Limited, or CVC Asia Pacific (the "Original Acquisition"), the Company issued a warrant to Hynix which enables Hynix to purchase 5,079,254 common units of the Company at an exercise price of \$1.00 per unit. This warrant has not been exercised and expires on October 6, 2006.

**Table of Contents****MagnaChip Semiconductor LLC and Subsidiaries****Notes to Condensed Consolidated Financial Statements (Continued)****(Unaudited; tabular dollars in thousands, except unit data)****10. Equity Incentive Plans**

The Company adopted two equity incentive plans effective October 6, 2004 and March 21, 2005, respectively, which are administered by the Compensation Committee designated by the board of directors. Employees, consultants and non-employee directors are eligible for the grant of options to purchase the Company's common units or restricted common units subject to terms and conditions determined by the Committee. The term of options in no event exceed ten years from the date of grant. As of July 2, 2006, an aggregate maximum of 7,890,864 common units were authorized and reserved for all future and outstanding grants of options.

Unit options are generally granted with exercise prices of no less than the fair market value of the Company's common units on the grant date. Generally, options vest and become exercisable in periodic installments, with 25% of the options vesting on the first anniversary of the grant date and 6.25% of options vesting on the last day of each calendar quarter thereafter. In most cases, the requisite service period, or the period during which a grantee is required to provide service in exchange for option grants, coincides with the vesting period.

Restricted units are issued upon the exercise of certain options to purchase restricted common units. Restricted units issued are subject to restrictions which generally lapse in installments over a four-year period.

The following summarizes unit option and restricted unit activities for the six months ended July 2, 2006:

	Number of restricted units	Number of options	Weighted average exercise price (in US dollar)	Weighted average remaining contractual life
Outstanding at January 1, 2006	1,726,062	3,780,643	1.6	
Granted		570,500	1.4	
Exercised		38,875	1.9	
Forfeited / Repurchased		175,688	2.1	
Released from restriction	156,631			
Outstanding at April 2, 2006	1,569,431	4,136,580	1.5	
Granted		1,238,000	1.4	
Exercised		2,813	2.9	
Forfeited / Repurchased	409,348	263,881	1.3	
Released from restriction	361,305			
Outstanding at July 2, 2006	798,778	5,107,886	1.5	9.0 years
Exercisable at July 2, 2006	n/a	1,297,216	1.6	8.3 years

Effective January 1, 2006, the Company adopted SFAS 123(R), *Share-Based Payment (revised 2004)*. As the Company elected to use the modified prospective application method, no restatement was made to the condensed consolidated statements of operations for prior interim periods or fiscal years. Under SFAS 123(R), the Company is required to measure compensation cost for all unit-based awards at fair value on the date of grant and recognize compensation expense over the grantee's requisite service period. As permitted under SFAS No. 123(R), the Company elected to recognize compensation expense for all options with graded vesting based on the graded attribution method.





**Table of Contents****MagnaChip Semiconductor LLC and Subsidiaries****Notes to Condensed Consolidated Financial Statements (Continued)****(Unaudited; tabular dollars in thousands, except unit data)**

Total compensation expense for the three and six months ended July 2, 2006 were \$28 thousand and \$102 thousand, respectively. As of July 2, 2006, total unrecognized compensation cost of \$548 thousand is expected to be recognized over a weighted average future period of 1.7 years.

Prior to the first quarter of 2006, the Company accounted for its unit-based compensation using the intrinsic value method prescribed in APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and provided the required pro forma disclosures of SFAS No. 123, *Accounting for Stock-Based Compensation*. The following presents pro forma net loss and per unit data as if the fair value based method had been applied to account for the unit-based compensation for three and six months ended July 3, 2005:

	Three months ended	Six months ended
	July 3, 2005	July 3, 2005
As reported net loss	\$ (33,484)	\$ (64,762)
Add: Amortization of non-cash deferred unit compensation expense determined under the intrinsic value method as reported in net loss, net of tax		
Deduct: Total unit-based compensation expense determined under the fair value method for all awards, net of tax	(84)	(218)
Pro forma net loss	\$ (33,568)	\$ (64,980)
Pro forma loss per unit	\$ (0.68)	\$ (1.32)

The Company utilizes the Black-Scholes option-pricing model to measure the fair value of each option grant. The following summarizes the grant-date fair value of options granted during the specified periods and assumptions used in the Black-Scholes option-pricing model on a weighted average basis:

	Three months ended	
	July 2, 2006	July 3, 2005
Grant-date fair value of options (in US dollar)	0.26	0.25
Expected term	2.2 Years	2.1 Years
Risk-free interest rate	5.0%	3.6%
Expected volatility	45.7%	57.0%
Expected dividends		

  

	Six months ended	
	July 2, 2006	July 3, 2005
Grant-date fair value of options (in US dollar)	0.25	0.22
Expected term	2.3 Years	2.1 Years
Risk-free interest rate	4.9%	3.0%
Expected volatility	46.7%	60.9%
Expected dividends		

The expected term of each option grant was based on employees' expected exercises and post-vesting employment termination behavior and the risk free interest rate was based on the U.S. Treasury yield curve for the period corresponding to the expected term at the time of grant. The

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expected volatility was estimated using historical volatility of share prices of similar public entities. No dividends were assumed for this calculation of option value.

The total cash received from employees as a result of option exercises was \$8 thousand and \$82 thousand for the three and six months ended July 2, 2006, respectively. None of the options exercised during these periods had any intrinsic value.

**Table of Contents****MagnaChip Semiconductor LLC and Subsidiaries****Notes to Condensed Consolidated Financial Statements (Continued)****(Unaudited; tabular dollars in thousands, except unit data)****11. Restructuring and Impairment Charges*****Assets impairment***

During the three months ended July 2, 2006, the Company recorded impairment charges of \$92,540 thousand related to one of the Company's fabrication facilities (the Fab ) and certain related technology and customer-based intangible assets (the asset group ) in accordance with SFAS 144, *Accounting for the Impairment or Disposal of Long-lived assets*.

SFAS 144 requires the Company to evaluate the recoverability of certain long-lived assets whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. From the fourth quarter of 2005 through the end of March 2006, the capacity utilization of the Fab had been under the level that the Company believes to be normal. This was primarily due to a transition in product mix coupled with a seasonal decrease in market demand, which the Company deemed to be temporary and recoverable. However, in the second quarter of 2006, the Company determined, based on revised forecasting, that the projected demand for certain of its products was significantly less than previously forecasted and that this decline was not temporary or seasonal. Therefore, the Company assessed whether there had been a material impairment on the asset group pursuant to SFAS 144 and recorded impairment charges based on such assessment. The net book value of the asset group before the impairment charges was approximately \$185,985 thousand.

The impairment charge was measured as an excess of the carrying value of the asset group over its fair value. The fair value of the asset group was estimated using a present value technique, where expected future cash flows from the use and eventual disposal of the asset group were discounted by an interest rate commensurate with the risk of the cash flows.

***Restructuring***

During the three months ended July 2, 2006, the Company recorded restructuring charges of \$1,144 thousand in accordance with SFAS 146, *Accounting for Costs Associated with Exit or Disposal Activities*. These charges were incurred in association with changes in certain of the Company's management and related severance agreements.

***Assets held-for-sale***

In connection with the sale of the Company's application processor business, which was finalized in January 2006, the Company identified and segregated related tangible assets as held-for-sale and ceased depreciating for such assets. As of July 2, 2006, the remaining amount of held-for-sale assets was \$4,437 thousand in total.

**12. Comprehensive Income**

Comprehensive income is as follows:

	Three months ended		Six months ended	
	July 2, 2006	July 3, 2005	July 2, 2006	July 3, 2005
Net loss	\$ (132,063)	\$ (33,484)	\$ (135,954)	\$ (64,762)
Change in fair value of derivatives	1,141		3,310	
Foreign currency translation effect	1,142	(2,232)	4,889	2,615
Comprehensive loss	\$ (129,780)	\$ (35,716)	\$ (127,755)	\$ (62,147)



**Table of Contents**

**MagnaChip Semiconductor LLC and Subsidiaries**

**Notes to Condensed Consolidated Financial Statements (Continued)**

**(Unaudited; tabular dollars in thousands, except unit data)**

**13. Condensed Consolidating Financial Statements**

The senior secured credit facility and Second Priority Senior Secured Notes are each fully and unconditionally guaranteed by the Company and all of its subsidiaries, except for MagnaChip Semiconductor (Shanghai) Company Limited. The Senior Subordinated Notes are fully and unconditionally guaranteed by the Company and all of its subsidiaries, except for MagnaChip Semiconductor, Ltd. (Korea) and MagnaChip Semiconductor (Shanghai) Company Limited. Below are condensed consolidating balance sheets as of July 2, 2006 and December 31, 2005, condensed consolidating statements of operations for the three and six months ended July 2, 2006 and July 3, 2005 and condensed consolidating statements of cash flows for the six months ended July 2, 2006 and July 3, 2005 of those entities that guarantee the Senior Subordinated Notes, those that do not, MagnaChip Semiconductor LLC, and the co-issuers.

**Table of Contents****MagnaChip Semiconductor LLC and Subsidiaries****Notes to Condensed Consolidated Financial Statements (Continued)****(Unaudited; tabular dollars in thousands, except unit data)****Condensed Consolidating Statement of Operations****For the three months ended July 2, 2006**

	<b>MagnaChip Semiconductor LLC</b>					
	<b>(Parent)</b>	<b>Co-Issuers</b>	<b>Non-Guarantors</b>	<b>Guarantors</b>	<b>Eliminations</b>	<b>Consolidated</b>
Net sales	\$	\$	\$ 189,395	\$ 101,591	\$ (93,373)	\$ 197,613
Cost of sales			174,434	93,489	(90,581)	177,342
Gross profit			14,961	8,102	(2,792)	20,271
Selling, general and administrative expenses	35	269	19,115	2,606		22,025
Research and development expenses			34,003	3,573	(3,642)	33,934
Restructuring and Impairment charges			93,459	225		93,684
Operating income (loss)	(35)	(269)	(131,616)	1,698	850	(129,372)
Other income (expenses)		6,106	2,058	(7,996)		168
Income (loss) before income taxes, equity in loss of related equity investment	(35)	5,837	(129,558)	(6,298)	850	(129,204)
Income tax expenses		41		2,818		2,859
Income (loss) before equity in loss of related Investment	(35)	5,796	(129,558)	(9,116)	850	(132,063)
Loss of related investment	(132,028)	(138,126)		(129,642)	399,796	
Net loss	\$ (132,063)	\$ (132,330)	\$ (129,558)	\$ (138,758)	\$ 400,646	\$ (132,063)
Dividends accrued on preferred units	2,706					2,706
Net loss attributable to common units	\$ (134,769)	\$ (132,330)	\$ (129,558)	\$ (138,758)	\$ 400,646	\$ (134,769)

**Table of Contents****MagnaChip Semiconductor LLC and Subsidiaries****Notes to Condensed Consolidated Financial Statements (Continued)****(Unaudited; tabular dollars in thousands, except unit data)****Condensed Consolidating Statement of Operations****For the six months ended July 2, 2006**

	<b>MagnaChip Semiconductor LLC</b>					
	<b>(Parent)</b>	<b>Co-Issuers</b>	<b>Non-Guarantors</b>	<b>Guarantors</b>	<b>Eliminations</b>	<b>Consolidated</b>
Net sales	\$	\$	\$ 397,823	\$ 200,385	\$ (187,452)	\$ 410,756
Cost of sales			346,877	185,853	(182,573)	350,157
Gross profit			50,946	14,532	(4,879)	60,599
Selling, general and administrative expenses	68	517	37,772	5,199		43,556
Research and development expenses			62,745	6,985	(5,878)	63,852
Restructuring and Impairment charges			93,459	225		93,684
Operating income (loss)	(68)	(517)	(143,030)	2,123	999	(140,493)
Other income (expenses)		10,421	13,268	(14,017)		9,672
Income (loss) before income taxes, equity in loss of related equity investment	(68)	9,904	(129,762)	(11,894)	999	(130,821)
Income tax expenses		82		5,051		5,133
Income (loss) before equity in loss of related Investment	(68)	9,822	(129,762)	(16,945)	999	(135,954)
Loss of related investment	(135,886)	(144,867)		(130,138)	410,891	
Net loss	\$ (135,954)	\$ (135,045)	\$ (129,762)	\$ (147,083)	\$ 411,890	\$ (135,954)
Dividends accrued on preferred units	5,339					5,339
Net loss attributable to common units	\$ (141,293)	\$ (135,045)	\$ (129,762)	\$ (147,083)	\$ 411,890	\$ (141,293)



**Table of Contents****MagnaChip Semiconductor LLC and Subsidiaries****Notes to Condensed Consolidated Financial Statements (Continued)****(Unaudited; tabular dollars in thousands, except unit data)****Condensed Consolidating Statement of Operations****For the three months ended July 3, 2005**

	<b>MagnaChip Semiconductor LLC</b>					
	<b>(Parent)</b>	<b>Co-Issuers</b>	<b>Non-Guarantors</b>	<b>Guarantors</b>	<b>Eliminations</b>	<b>Consolidated</b>
Net sales	\$	\$	\$ 226,550	\$ 109,527	\$ (100,054)	\$ 236,023
Cost of sales			171,005	104,776	(100,162)	175,619
Gross profit			55,545	4,751	108	60,404
Selling, general and administrative expenses	112	366	25,413	5,823	804	32,518
Research and development expenses			25,174	3,118	(804)	27,488
Restructuring and impairment charges			8,720			8,720
Operating loss	(112)	(366)	(3,762)	(4,190)	108	(8,322)
Other income (expenses)	2	(8,667)	(25,344)	7,223		(26,786)
Income (loss) before income taxes, equity in loss of related equity investment	(110)	(9,033)	(29,106)	3,033	108	(35,108)
Income tax expenses (benefits)		81		(1,705)		(1,624)
Income (loss) before equity in loss of related Investment	(110)	(9,114)	(29,106)	4,738	108	(33,484)
Loss of related investment	(33,374)	(20,131)		(29,231)	82,736	
Net loss	\$ (33,484)	\$ (29,245)	\$ (29,106)	\$ (24,493)	\$ 82,844	\$ (33,484)
Dividends accrued on preferred units	2,478					2,478
Net loss attributable to common units	\$ (35,962)	\$ (29,245)	\$ (29,106)	\$ (24,493)	\$ 82,844	\$ (35,962)

**Table of Contents****MagnaChip Semiconductor LLC and Subsidiaries****Notes to Condensed Consolidated Financial Statements (Continued)****(Unaudited; tabular dollars in thousands, except unit data)****Condensed Consolidating Statement of Operations****For the six months ended July 3, 2005**

	<b>MagnaChip Semiconductor LLC</b>					
	<b>(Parent)</b>	<b>Co-Issuers</b>	<b>Non-Guarantors</b>	<b>Guarantors</b>	<b>Eliminations</b>	<b>Consolidated</b>
Net sales	\$	\$	\$ 434,515	\$ 203,149	\$ (188,251)	\$ 449,413
Cost of sales			357,725	194,278	(188,946)	363,057
Gross profit			76,790	8,871	695	86,356
Selling, general and administrative expenses	115	586	50,774	8,383	1,139	60,997
Research and development expenses			51,608	3,118	(1,139)	53,587
Restructuring and impairment charges			8,720			8,720
Operating loss	(115)	(586)	(34,312)	(2,630)	695	(36,948)
Other income (expenses)	5	(16,829)	(24,652)	14,390		(27,086)
Income (loss) before income taxes, equity in loss of related equity investment	(110)	(17,415)	(58,964)	11,760	695	(64,034)
Income tax expenses		108		620		728
Income (loss) before equity in loss of related Investment	(110)	(17,523)	(58,964)	11,140	695	(64,762)
Loss of related investment	(64,652)	(43,136)		(60,164)	167,952	
Net loss	\$ (64,762)	\$ (60,659)	\$ (58,964)	\$ (49,024)	\$ 168,647	\$ (64,762)
Dividends accrued on preferred units	4,873					4,873
Net loss attributable to common units	\$ (69,635)	\$ (60,659)	\$ (58,964)	\$ (49,024)	\$ 168,647	\$ (69,635)

**Table of Contents****MagnaChip Semiconductor LLC and Subsidiaries****Notes to Condensed Consolidated Financial Statements (Continued)****(Unaudited; tabular dollars in thousands, except unit data)****Condensed Consolidating Balance Sheet****July 2, 2006****MagnaChip****Semiconductor****LLC**

	(Parent)	Co-Issuers	Non-Guarantors	Guarantors	Eliminations	Consolidated
<b>Assets</b>						
Current assets						
Cash and cash equivalents	\$ 278	\$ 441	\$ 65,812	\$ 19,957	\$	\$ 86,488
Restricted cash			1,118			1,118
Accounts receivable, net			125,269	50,820	(80,099)	95,990
Inventories, net			56,996	5,513	(352)	62,157
Other receivables	34,578	718	5,571	22,325	(55,849)	7,343
Other current assets		21,576	12,043	11,579	(33,057)	12,141
<b>Total current assets</b>	<b>34,856</b>	<b>22,735</b>	<b>266,809</b>	<b>110,194</b>	<b>(169,357)</b>	<b>265,237</b>
Property, plant and equipment, net						
Intangibles, net			381,532	1,333		382,865
Investments in subsidiaries	(101,827)	(178,798)		19,178	261,447	
Long-term inter-company loans		786,265		621,311	(1,407,576)	
Other non-current assets		26,265	44,627	10,876	(24,648)	57,120
<b>Total assets</b>	<b>\$ (66,971)</b>	<b>\$ 656,467</b>	<b>\$ 822,105</b>	<b>\$ 787,122</b>	<b>\$ (1,340,134)</b>	<b>\$ 858,589</b>
<b>Liabilities and Unitholders equity</b>						
Current liabilities						
Accounts payable	\$	\$	\$ 56,055	\$ 77,169	\$ (80,099)	\$ 53,125
Other accounts payable	1,035	5	59,474	20,444	(55,849)	25,109
Accrued expenses		3,332	25,748	23,802	(24,335)	28,547
Other current liabilities		243	2,112	11,086	(8,722)	4,719
<b>Total current liabilities</b>	<b>1,035</b>	<b>3,580</b>	<b>143,389</b>	<b>132,501</b>	<b>(169,005)</b>	<b>111,500</b>
Long-term borrowings						
Accrued severance benefits, net		750,000	621,311	786,265	(1,407,576)	750,000
Other non-current liabilities			58,637	321		58,958
			4,261	26,524	(24,648)	6,137
<b>Total liabilities</b>	<b>1,035</b>	<b>753,580</b>	<b>827,598</b>	<b>945,611</b>	<b>(1,601,229)</b>	<b>926,595</b>

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Commitments and contingencies						
Series A redeemable convertible preferred units						
Series B redeemable convertible preferred unites	111,801					111,801
Total redeemable convertible preferred units	111,801					111,801
Unitholders equity						
Common units	52,721	102,986	39,005	55,773	(197,764)	52,721
Additional paid-in capital	2,311	1,115	155,297	74,685	(231,097)	2,311
Accumulated deficit	(271,385)	(237,975)	(229,428)	(319,121)	786,524	(271,385)
Accumulated other comprehensive income	36,546	36,761	29,633	30,174	(96,568)	36,546
Total unitholders equity	(179,807)	(97,113)	(5,493)	(158,489)	261,095	(179,807)
Total liabilities, redeemable convertible preferred units and unitholders equity	\$ (66,971)	\$ 656,467	\$ 822,105	\$ 787,122	\$ (1,340,134)	\$ 858,589

**Table of Contents****MagnaChip Semiconductor LLC and Subsidiaries****Notes to Condensed Consolidated Financial Statements (Continued)****(Unaudited; tabular dollars in thousands, except unit data)****Condensed Consolidating Balance Sheet****December 31, 2005****MagnaChip****Semiconductor****LLC**

	(Parent)	Co-Issuers	Non-Guarantors	Guarantors	Eliminations	Consolidated
<b>Assets</b>						
Current assets						
Cash and cash equivalents	\$ 209	\$ 841	\$ 63,435	\$ 22,089	\$	\$ 86,574
Restricted cash			2,837			2,837
Accounts receivable, net			131,669	55,057	(74,673)	112,053
Inventories, net			82,348	7,638	(1,309)	88,677
Other receivables	35,013	718	7,792	20,097	(54,119)	9,501
Other current assets		22,382	9,987	6,063	(28,284)	10,148
Total current assets	35,222	23,941	298,068	110,944	(158,385)	309,790
Property, plant and equipment, net						
			484,019	1,058		485,077
Intangibles, net						
			165,369	26,020		191,389
Investments in subsidiaries	25,756	(38,942)		144,131	(130,945)	
Long-term inter-company loans		774,199		621,311	(1,395,510)	
Other non-current assets		24,153	45,370	11,131	(26,263)	54,391
Total assets	\$ 60,978	\$ 783,351	\$ 992,826	\$ 914,595	\$ (1,711,103)	\$ 1,040,647
<b>Liabilities and Unitholders equity</b>						
Current liabilities						
Accounts payable	\$	\$	\$ 94,581	\$ 74,003	\$ (74,673)	\$ 93,911
Other accounts payable	1,000	440	68,703	19,344	(54,119)	35,368
Accrued expenses		3,139	24,560	26,331	(25,062)	28,968
Other current liabilities		162	3,746	9,416	(3,222)	10,102
Total current liabilities	1,000	3,741	191,590	129,094	(157,076)	168,349
Long-term borrowings						
		750,000	621,311	774,199	(1,395,510)	750,000
Accrued severance benefits, net			54,854	270		55,124
Other non-current liabilities			5,272	28,187	(26,263)	7,196
Total liabilities	1,000	753,741	873,027	931,750	(1,578,849)	980,669

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Commitments and contingencies						
Series A redeemable convertible preferred units						
Series B redeemable convertible preferred unites	106,462					106,462
Total redeemable convertible preferred units	106,462					106,462
Unitholders equity						
Common units	53,092	102,986	39,005	58,364	(200,355)	53,092
Additional paid-in capital	2,169	1,027	155,212	71,989	(228,228)	2,169
Accumulated deficit	(130,092)	(102,930)	(99,666)	(172,038)	374,634	(130,092)
Accumulated other comprehensive income	28,347	28,527	25,248	24,530	(78,305)	28,347
Total unitholders equity	(46,484)	29,610	119,799	(17,155)	(132,254)	(46,484)
Total liabilities, redeemable convertible preferred units and unitholders equity	\$ 60,978	\$ 783,351	\$ 992,826	\$ 914,595	\$ (1,711,103)	\$ 1,040,647

**Table of Contents****MagnaChip Semiconductor LLC and Subsidiaries****Notes to Condensed Consolidated Financial Statements (Continued)****(Unaudited; tabular dollars in thousands, except unit data)****Condensed Consolidating Statement of Cash Flows****For the six months ended July 2, 2006**

	<b>MagnaChip Semiconductor LLC</b>					
	(Parent)	Co-Issuers	Non-Guarantors	Guarantors	Eliminations	Consolidated
<b>Cash flow from operating activities:</b>						
Net loss	\$ (135,954)	\$ (135,045)	\$ (129,762)	\$ (147,083)	\$ 411,890	\$ (135,954)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities						
Depreciation and amortization			100,410	2,099		102,509
Provision for severance benefits			5,315	42		5,357
Amortization of debt issuance costs		1,384	449			1,833
Gain on foreign currency translation, net		(12,067)	(42,554)	12,254		(42,367)
Impairment of long-lived assets			92,540			92,540
Loss of related investment	135,886	144,867		130,138	(410,891)	
Other			651	(1,802)	1,616	465
Changes in operating assets and liabilities:						
Accounts receivable			14,306	5,275	5,426	25,007
Inventories			30,250	2,247	(958)	31,539
Other receivables	434		2,689	(1,739)	1,730	3,114
Deferred tax assets				839		839
Accounts payable			(43,676)	1,925	(5,426)	(47,177)
Other accounts payable	35	(435)	(14,954)	1,088	(1,730)	(15,996)
Accrued expenses		193	(412)	(2,596)	727	(2,088)
Other current assets		807	(676)	(225)	(727)	(821)
Other current liabilities		82	(1,852)	(3,800)		(5,570)
Payment of severance benefits			(4,559)			(4,559)
Other		(186)	5,462	(1,862)	(1,616)	1,798
Net cash provided by (used in) operating activities	401	(400)	13,627	(3,200)	41	10,469
<b>Cash flows from investing activities:</b>						
Purchase of plant, property and equipment			(18,890)	(442)		(19,332)
Purchase of intangible assets			(1,178)			(1,178)
Proceeds from disposal of plant, property and equipment			2,201	1		2,202
Proceeds from disposal of intangible assets			2,794			2,794
Decrease in restricted cash			1,876			1,876
Increase in short-term inter-company loans				(5,500)	5,500	
Other			(946)	19		(927)

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Net cash used in investing activities			(14,143)	(5,922)	5,500	(14,565)
<b>Cash flows from financing activities:</b>						
Proceeds from short-term inter-company borrowings				5,500	(5,500)	
Exercise of unit options	82					82
Repurchase of common units	(414)					(414)
Net cash provided by (used in) financing activities	(332)			5,500	(5,500)	(332)
Effect of exchange rate on cash and cash equivalents			2,893	1,490	(41)	4,342
Net increase (decrease) in cash and cash equivalents	69	(400)	2,377	(2,132)		(86)
<b>Cash and cash equivalents:</b>						
Beginning of the period	209	841	63,435	22,089		86,574
End of the period	\$ 278	\$ 441	\$ 65,812	\$ 19,957	\$	\$ 86,488



**Table of Contents****MagnaChip Semiconductor LLC and Subsidiaries****Notes to Condensed Consolidated Financial Statements (Continued)****(Unaudited; tabular dollars in thousands, except unit data)****Condensed Consolidating Statement of Cash Flows****For the six months ended July 3, 2005**

	<b>MagnaChip Semiconductor LLC</b>					
	(Parent)	Co-Issuers	Non-Guarantors	Guarantors	Eliminations	Consolidated
<b>Cash flow from operating activities:</b>						
Net loss	\$ (64,762)	\$ (60,659)	\$ (58,964)	\$ (49,024)	\$ 168,647	\$ (64,762)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities						
Depreciation and amortization			102,760	4,024		106,784
Provision for severance benefits			8,083	43		8,126
Amortization of debt issuance costs		1,288	407			1,695
Loss (gain) on foreign currency translation, net		20,359	(2,494)	(19,210)		(1,345)
Impairment of long-lived assets			7,996			7,996
Loss(earnings) of related investment	64,652	43,136		60,164	(167,952)	
Other			(1,038)	(8)		(1,046)
Changes in operating assets and liabilities:						
Accounts receivable			(8,877)	(1,090)	(7,535)	(17,502)
Inventories			4,785	5,286	(700)	9,371
Other receivables	(263)	825	66,448	(1,807)	1,797	67,000
Deferred tax assets				(3,395)		(3,395)
Accounts payable			6,403	(10,474)	7,535	3,464
Other accounts payable	(161)	205	(73,517)	(112)	(1,797)	(75,382)
Accrued expenses		1,784	(2,256)	6,389	(10,865)	(4,948)
Other current assets		(7,591)	895	(2,654)	10,865	1,515
Other current liabilities		108	(4,819)	619		(4,092)
Long-term prepaid expense			26,205		(31,083)	(4,878)
Payment of severance benefits			(6,864)			(6,864)
Other			(58,564)	28,024	31,083	543
Net cash provided by (used in) operating activities	(534)	(545)	6,589	16,775	(5)	22,280
<b>Cash flows from investing activities:</b>						
Purchase of plant, property and equipment			(18,226)	(474)	401	(18,299)
Purchase of intangible assets			(1,172)			(1,172)
Acquisition of business	(1,870)			(9,961)		(11,831)
Proceeds from disposal of plant, property and equipment			113			113
Proceeds from disposal of intangible assets			112			112

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Increase in short-term inter-company loans				(14,000)		14,000
Increase in long-term inter-company loans		(1,009)		(1,009)		2,018
Decrease in restricted cash			7,065			7,065
Other			1,462	516	(401)	1,577
Net cash used in investing activities	(1,870)	(1,009)	(10,646)	(24,928)	16,018	(22,435)
<b>Cash flows from financing activities:</b>						
Proceeds from short-term inter-company borrowings				14,000		(14,000)
Proceeds from long-term inter-company borrowings			1,009	1,009		(2,018)
Repayment of short-term borrowings			(764)	(12,605)		(13,369)
Other	514	(378)	(217)			(81)
Net cash provided by financing activities	514	(378)	28	2,404	(16,018)	(13,450)
Effect of exchange rate on cash and cash equivalents			832	(807)	5	30
Net increase (decrease) in cash and cash equivalents	(1,890)	(1,932)	(3,197)	(6,556)		(13,575)
<b>Cash and cash equivalents:</b>						
Beginning of the period	2,386	3,201	29,671	23,138		58,396
End of the period	\$ 496	\$ 1,269	\$ 26,474	\$ 16,582	\$	\$ 44,821

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**Table of Contents****PART I. Financial Information (continued)****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following Management's Discussion and Analysis of Financial Condition and Results of Operations contain forward-looking statements within the meaning of the federal securities laws that involve risks and uncertainties. Our actual results may differ materially from those anticipated in these forward-looking statements as a result of certain factors set forth elsewhere in this Form 10-Q and in prior Company public filings with the SEC. In addition, other factors have been or may be discussed from time to time in the Company's SEC filings. These forward-looking statements are made based on management's expectations and beliefs concerning future events impacting the Company and, therefore, involve a number of risks and uncertainties. The Company's management cautions that forward-looking statements are not guarantees and that actual results could differ materially from those expressed or implied in the forward-looking statements. The following discussion should be read in conjunction with the unaudited condensed consolidated interim financial statements and related notes included elsewhere in this Form 10-Q. While the Company periodically reassesses material trends and uncertainties affecting the Company's results of operations and financial condition in connection with the preparation of Management's Discussion and Analysis of Financial Condition and Results of Operations and certain other sections contained in the Company's quarterly, annual or other reports filed with the SEC, the Company does not intend to review or revise any particular forward-looking statement in light of future events.

**Overview**

We are a leading designer, developer and manufacturer of mixed-signal and digital multimedia semiconductors addressing the convergence of consumer electronics and communication devices. We focus our core business on CMOS image sensors and flat panel display drivers, which are complex, high-performance mixed-signal semiconductors that capture images and enable and enhance the features and capabilities of both small and large flat panel displays. We also provide wafer foundry services whereby we leverage our specialized process technologies and low cost manufacturing facilities to produce semiconductors for third parties using their product designs. Our solutions are used in a wide variety of consumer and commercial mass market applications, such as mobile handsets, including camera-equipped mobile handsets, flat panel monitors and televisions, consumer home and mobile displays, portable and desktop computer displays, handheld gaming devices, PDAs and audio-visual equipment such as DVD players.

We derive our net sales from products and services in three principal areas: CMOS imaging solutions, display solutions, and semiconductor manufacturing services.

*CMOS imaging solutions:* Our CMOS image sensor solutions are used in image-capture applications such as camera-equipped mobile handsets and personal computer cameras. Our highly integrated image sensors are designed to be cost-effective and to provide brighter, sharper, more colorful, and thus enhanced, image quality.

*Display solutions:* Our flat panel display drivers are used in several major types of large and small flat panel displays, including TFT-LCD, Color-STN and OLED displays. Our flat panel display solutions are used in applications such as mobile handsets, flat panel televisions, displays for portable and desktop computers, handheld gaming devices and PDAs.

*Semiconductor manufacturing services:* We use our process technology and manufacturing facilities to manufacture semiconductor wafers for third parties based on their designs. Our five fabs have a combined capacity of over 116,000 eight-inch equivalent wafers per month and are located in Cheongju and Gumi, Korea. Our fabs provide us with large scale, cost-effective and flexible capacity enabling us to rapidly scale to high volume to meet shifts in demand by our end customers.

Our business was named MagnaChip Semiconductor when it was acquired from Hynix Semiconductor Inc. on October 6, 2004, by CVC, Francisco Partners, CVC Asia Pacific, certain members of management and other investors, following discussions with Hynix that began in late 2001 and the execution of a definitive agreement in June 2004. Previously, we were the System IC division within Hynix which, in 1999, had been formed from a merger between the Hyundai Electronics and LG Semiconductor System IC businesses and can trace its history back to the late 1970s. Although we were previously part of Hynix, our business had a history of operating autonomously within Hynix and had a separate global sales force and management structure.



**Table of Contents****Results of Operations - Comparison of Three-Month Periods Ended July 2, 2006 and July 3, 2005**

	Three months ended		Three months ended		Change	
	July 2, 2006		July 3, 2005			
	Amount	% of net sales	Amount	% of net sales	Amount	%
	<i>(in millions of US dollars; %)</i>					
Net sales	\$ 197.6	100.0	\$ 236.0	100.0	\$ (38.4)	(16.3)
Cost of sales	177.3	89.7	175.6	74.4	1.7	1.0
Gross profit	20.3	10.3	60.4	25.6	(40.1)	(66.4)
Selling, general and administrative expenses	22.0	11.1	32.5	13.8	(10.5)	(32.3)
Research and development expenses	33.9	17.2	27.5	11.7	6.4	23.3
Restructuring and impairment charges	93.7	47.4	8.7	3.7	85.0	977.0
Operating loss	(129.3)	(65.4)	(8.3)	(3.6)	(121.0)	1,457.8
Interest expense, net	(14.4)	(7.3)	(14.0)	(5.9)	(0.4)	2.9
Foreign currency gain, net	14.5	7.3	(12.8)	(5.4)	27.3	(213.3)
Loss before income taxes	(129.2)	(65.4)	(35.1)	(14.9)	(94.1)	268.1
Income tax expenses	2.9	1.5	(1.6)	(0.7)	4.5	(281.3)
Net loss	\$ (132.1)	(66.9)	\$ (33.5)	(14.2)	\$ (98.6)	294.3

*Net Sales.* Net sales for the three months ended July 2, 2006 were \$197.6 million, a \$38.4 million or 16.3% decrease from \$236 million for the three months ended July 3, 2005. The year-over-year decrease in net sales is mainly due to discontinuation of our application processor business and DRAM foundry service, coupled with new product introduction delays in our core business. We completed the divestiture of our application processor business in the first quarter of 2006 to focus on our core business.

Net sales from our core business for the three months ended July 2, 2006 was \$179.8 million, a decrease of \$25.4 million or 12.4% from \$205.2 million for the three months ended July 3, 2005. This decrease was primarily attributable to a revenue reduction of \$28.8 in our imaging solution business. Delays in the launch of new megapixel products and continued average selling price pressure for VGA products resulted in the revenue decrease in this business.

*Cost of Sales.* Cost of sales was \$177.3 million during the current quarter, relatively consistent, on an absolute dollar basis, with cost of sales of \$175.6 million in the prior year quarter. Marginal decrease in variable costs, which was driven by lower sales volume, was more than offset by inventory charges under SFAS No. 151 and increased provisions for inventory valuation reserves. In accordance with SFAS No. 151, certain manufacturing overhead costs were expensed rather than being capitalized as inventory due to under-utilization of certain fabrication facility. Inventory reserve provisions were increased mainly due to average selling price declines that resulted in lower of cost or market adjustments as well as excessive inventory in display driver products. Cost of sales as a percentage of net sales was 89.7% in the current quarter compared to 74.4% in the prior year quarter.

*Selling, General and Administrative Expenses.* Selling, general and administrative expenses were \$22.0 million or 11.1% of net sales for the three months ended July 2, 2006 compared to \$32.5 million or 13.8% for the three months ended July 3, 2005. The decrease of \$10.5 million or 32.3% from the prior year quarter was primarily due to lower amortization of intangible assets from the sale of our application processor business in the first quarter of 2006. In addition, a reduction in provisions for customer claims and returns was reflected during the quarter as a result of improvement in quality control and lower actual experience rates and projected claims.

*Research and Development Expenses.* Research and development expenses for the current quarter were \$33.9 million, an increase of \$6.4 million or 23.3% from \$27.5 million for the prior year quarter. This increase in research and development expenses was mainly attributable to increased technology license fees and additional research and development staffing and activity from the acquisition of ISRON Corporation and

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IC Media Corporation. As a percentage of net sales, research and development expense in the second quarter of 2006 increased to 17.2% from 11.7% of net sales in the second quarter of 2005.

*Restructuring and Impairment Charges.* During the three months ended July 2, 2006, we recorded restructuring and impairment charges totaling \$93.7 million, which included \$92.5 million of impairment under SFAS 144, *Accounting for the Impairment or Disposal of Long-lived assets* and \$1.2 million of restructuring under SFAS 146, *Accounting for Costs Associated with Exit or Disposal Activities*. The impairment charges were recorded against one of our fabrication facilities

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(the Fab ) and certain related technology and customer-based intangible assets (the asset group ) and the restructuring charges were incurred in association with changes in certain of our management.

From the fourth quarter of 2005 through the end of the first quarter of 2006, the capacity utilization of the Fab was under the level that we believe to be normal. This was primarily due to a transition in product mix coupled with a seasonal decrease in market demand, which was deemed to be temporary and recoverable. However, in the second quarter of 2006, our management determined, based on revised forecasting, that the projected demand for certain of its products was significantly less than previously forecasted and that this decline was not temporary or seasonal. Therefore, we assessed whether there had been a material impairment on the asset group pursuant to SFAS 144 and, based on the assessment, recorded impairment charges. The net book value of the tangible and intangible assets before the impairment charges was approximately \$131,815 million and \$54,170 thousand, respectively.

The restructuring and impairment charges of \$8.7 million for the prior year quarter were taken in connection with an impairment of certain tangible assets and an early retirement program.

*Operating Loss.* Operating loss for the three-month period ended July 2, 2006 was \$129.3 million compared to \$8.3 million in the prior year quarter. The increase of \$121 million in the operating loss was primarily attributable to restructuring and impairment charges of \$93.7 million taken in the second quarter of 2006 compounded by reduction in net sales. Operating loss as a percentage of net sales was 65.4% and 3.6% in the second quarter of 2006 and 2005, respectively.

*Net Interest Expense.* Net interest expense was \$14.4 million during the three-month period ended July 2, 2006, which is relatively consistent with \$14.0 million for the three-month period ended July 3, 2005. Our interest expense is mostly to serve the long-term borrowings of \$750.0 million, which include \$300 million of Floating Rate Second Priority Senior Secured Notes. As a result of an interest rate swap entered into in the second quarter of 2005, the variable interest rate of such Notes was effectively converted to a fixed rate and we are not exposed to changes in interest rates until the interest rate swap is unwound on June 15, 2008. Refer to Note 6. Long-term Borrowings for details.

*Income Tax Expenses.* Income tax expenses for the current quarter were \$2.9 million compared to income tax benefits of \$1.6 million for the same quarter of 2005. The income tax benefits in the second quarter of 2005 were primarily attributable to the initial recognition of deferred tax assets for the temporary difference between taxable and accounting income at one of our subsidiaries. Excluding the impact from deferred tax accounting, our income tax expenses are mostly composed of withholding taxes on the interest paid by one of our subsidiaries to its parent company. Due to the uncertainty of utilization for foreign tax credits, we treated this withholding tax as a current tax expense.

**Table of Contents****Results of Operations - Comparison of Six-Month Periods Ended July 2, 2006 and July 3, 2005**

	Six months ended		Six months ended		Change	
	July 2, 2006		July 3, 2005			
	Amount	% of net sales	Amount	% of net sales	Amount	%
<i>(in millions of US dollars; %)</i>						
Net sales	\$ 410.8	100.0	\$ 449.4	100.0	\$ (38.6)	(8.6)
Cost of sales	350.2	85.2	363.1	80.8	(12.9)	(3.6)
Gross profit	60.6	14.8	86.3	19.2	(25.7)	(29.8)
Selling, general and administrative expenses	43.6	10.6	61.0	13.6	(17.4)	(28.5)
Research and development expenses	63.9	15.6	53.6	11.9	10.3	19.2
Restructuring and impairment charges	93.7	22.8	8.7	1.9	85.0	977.0
Operating loss	(140.6)	(34.2)	(37.0)	(8.2)	(103.6)	280.0
Interest expense, net	(29.1)	(7.1)	(27.9)	(6.2)	(1.2)	4.3
Foreign currency gain, net	38.8	9.4	0.8	0.2	38.0	4,750.0
Loss before income taxes	(130.9)	(31.9)	(64.1)	(14.2)	(66.8)	104.2
Income tax expenses	5.1	1.2	0.7	0.2	4.4	628.6
Net loss	\$ (136.0)	(33.1)	\$ (64.8)	(14.4)	\$ (71.2)	109.9

*Net Sales.* Net sales for the six months ended July 2, 2006 were \$410.8 million. This represents a \$38.6 million or 8.6% decrease from \$449.4 million for the six months ended July 3, 2005. This decrease in net sales is primarily attributable to discontinuation of our application processor business and DRAM foundry service, coupled with new product introduction delays in our core business which we had forecasted would substitute for the lost volume from the discontinued business.

Revenues from our core business for the six months ended July 2, 2006 was \$375.3 million, a decrease of \$7.9 million or 2.1% from \$383.2 million for the six months ended July 3, 2005. Revenue increase driven by both semiconductor manufacturing services and display solution business was more than offset by a decrease in revenue from imaging solution business. Lower revenues in imaging solution business were due to delays in new products and continued ASP erosion.

*Cost of Sales.* Cost of sales was \$350.2 million for the six months ended July 2, 2006, a decrease of \$12.9 million or 3.6% from \$363.1 million for the six months ended July 3, 2005. Cost of sales for the first half of 2005 included an inventory charge of \$4.5 million related to fair value uplift from purchase accounting. Excluding this charge, the decrease of \$8.4 million in cost of sales was primarily due to reduction in variable costs driven by the decrease in sales volume. Cost of sales as a percentage of net sales was 85.2% in the current year period compared to 80.8% in the prior year period.

*Selling, General and Administrative Expenses.* Selling, general and administrative expenses were \$43.6 million or 10.6% of net sales for the six months ended July 2, 2006 compared to \$61.0 million or 13.6% for the six months ended July 3, 2005. This decrease of \$17.4 million or 28.5% from the prior year period was primarily attributable to lower amortization of intangible assets from the sale of our application processor business in the first quarter of 2006, a decrease in professional service fees and reduced provisions for customer claims and returns. These expenses were reduced as a result of operational efficiency and infrastructure improvements.

*Research and Development Expenses.* Research and development expenses for the current quarter were \$63.9 million, a \$10.3 million or 19.2% increase from \$53.6 million for the prior year period. This increase in research and development expenses represents increased technology license fees and additional research and development staffing and activity from the acquisition of ISRON Corporation and IC Media Corporation. As a percentage of net sales, research and development expense increased by 370 basis points to 15.6% compared to 11.9% in the first half of 2005.



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*Restructuring and Impairment Charges.* During the six months ended July 2, 2006, we recorded a one-time charge of \$93.7 million as restructuring and impairment charges. The amount included \$92.5 million of impairment charges under SFAS 144, *Accounting for the Impairment or Disposal of Long-lived assets* and \$1.2 million of restructuring charges under SFAS 146, *Accounting for Costs Associated with Exit or Disposal Activities*. As mentioned in the foregoing, the impairment charges were recorded against one of our fabrication facilities and certain related technology and customer-based intangible assets, and the restructuring charges were taken in association with changes in certain of our management. In the prior year period, \$8.7 million of restructuring and impairment charges were recorded in connection with an impairment of certain tangible assets and an early retirement program.

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*Operating Loss.* Operating loss for the six-month period ended July 2, 2006 was \$140.6 million, a \$103.6 million increase from the operating loss of \$37 million for the six-month period ended July 3, 2005. This increase in operating loss is primarily attributable to the one-time charge of restructuring and impairment charges taken during the current period.

*Net Interest Expense.* Net interest expense was \$29.1 million during the six-month period ended July 2, 2006, an increase of \$1.2 million from \$27.9 million for the six-month period ended July 3, 2005. The increase in net interest expense was primarily due to an increase in the interest rate on our Floating Rate Second Priority Senior Secured Notes of \$300.0 million. This floating interest rate was effectively converted to a fixed interest rate through an interest rate swap entered into in the second quarter of 2005. As a result, we are not exposed to changes in interest rates until the interest rate swap is unwound on June 15, 2008. Refer to Note 6. Long-term Borrowings for details.

*Income Tax Expenses.* Income tax expenses for the six months ended July 2, 2006 were \$5.1 million while income tax expenses were \$0.7 million for the prior year period. The lower income tax expenses in the prior year period were primarily attributable to the initial recognition of deferred tax assets for temporary difference between taxable and accounting income. Excluding the impact from deferred tax accounting, our income tax expenses are mostly composed of withholding taxes on the interest paid by one of our subsidiaries to its parent company. Due to the uncertainty of utilization for foreign tax credits, this withholding tax was treated as a current tax expense.

**Liquidity and Capital Resources**

Our principal capital requirements are to fund working capital needs, meet required debt payments, including debt service payments on our notes and, if drawn upon, the senior credit facility, to invest in research and development and capital equipment expenditures. We anticipate that operating cash flow, together with available borrowing capacity under our senior credit facility, will be sufficient to meet our working capital needs, and fund our research and development expenses, capital expenditures and service requirements on our debt obligations for the foreseeable future. As of July 2, 2006, we had total long-term debt outstanding of \$750.0 million.

During the six-month period ended July 2, 2006, we generated cash from operating activities of \$10.5 million, an \$11.8 million or 53.0% decrease from operating cash inflow of \$22.3 million during the first half of 2005. The operating cash inflows for the six-month periods reflected our net loss of \$135.9 million adjusted by non-cash items of \$160.3 million which consisted mostly of impairment charges, depreciation costs, and amortization costs. This cash inflow on an adjusted basis was partially offset by cash outlays of \$13.9 million, mainly due to an increase in working capital requirements during the six-month ended July 2, 2006.

Our working capital balance was \$153.7 million as of July 2, 2006 compared to \$141.4 million as of December 31, 2005. The increase of \$12.3 million or 8.7% was driven by a reduction of \$40.8 million in accounts payable, representing a decline in the days of accounts payable from 63 to 40. This increase of working capital balance was partially offset by a decrease of \$16.1 million in accounts receivable due to a decline in net sales during the six months ended July 2, 2006.

For investing activities, we used cash of approximately \$14.6 million for the six months ended July 2, 2006. This cash outlay principally represented \$20.5 million of capital expenditures on tangible and intangible assets, partially offset by a cash inflow from the sale of our application processor business and other tangible assets. During the prior year quarter, the net cash outlay for investing activities was \$22.4 million.

For the six months ended July 2, 2006, there were no significant financing activities. During the first six months of 2005, we used approximately \$13.4 million to repay short-term borrowings.

*Capital Expenditures.* For the six months ended July 2, 2006, capital expenditures were flat at \$20.5 million compared to \$19.5 million for the six months ended July 3, 2005. We will continue to manage the timing of our capital expenditures to support the growth of business from new customers and to optimize return on our investment.

*Future Financing Activities.* Our primary future capital requirements include funding of our working capital needs, meeting our required debt payments, and funding of research and development as well as capital equipment expenditures. We plan to add design resources in low cost locations in Asia. We anticipate that our operating cash flows, together with available borrowings under our senior credit facility, will be sufficient to meet these capital requirements for the foreseeable future.

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From time to time, we may need to incur additional debt or issue equity to make strategic acquisitions and investments. However, we cannot assure you that such financing will be available to us on acceptable terms or that such financing will be available at all.

**Contractual Obligations**

Summarized in the table below are our obligations and commitments to make future payments under debt obligations and minimum lease payment obligations as of July 2, 2006.

	Payments Due by Period							Interest expense
	Total	2006	2007	2008	2009	2010	Thereafter	
	<i>(in millions of US dollars)</i>							
Revolving credit facility								
Secured notes and subordinated notes(*)	750.0						750.0	
Operating lease	63.3	5.8	11.5	11.5	11.5	11.5	11.5	
Others	13.3	6.7	6.3	0.7			0.1	(0.5)

(\*) Excludes interest obligations on notes.

The Floating Rate Second Priority Senior Secured Notes of \$300 million and Second Priority Senior Secured Notes of \$200 million mature in 2011, while the Senior Subordinated Notes of \$250 million mature in 2014. Interest rates are 3 month LIBOR + 3.25%, 6<sup>7</sup>/<sub>8</sub>% and 8%, respectively. These notes will be paid in full upon maturity.

Each indenture governing the notes contains covenants that limit the ability of the Company and its subsidiaries to (i) incur additional indebtedness, (ii) pay dividends or make other distributions on its capital stock or repurchase, repay or redeem its capital stock, (iii) make certain investments, (iv) incur liens, (v) enter into certain types of transactions with affiliates, (vi) create restrictions on the payment of dividends or other amounts to the Company by its subsidiaries, and (vii) sell all or substantially all of its assets or merge with or into other companies.

On July 26, 2006, we entered into the Amendment with MagnaChip Semiconductor S.A. and MagnaChip Semiconductor Finance Company, as borrowers, the Subsidiary Guarantors party thereto, the Lenders, the Agent and US Bank.

Under the Amendment, among other things, (i) we agreed to furnish to the Agent and the Lenders monthly financial statements along with an officer's certificate with respect to the occurrence of any events of default under the Credit Agreement, (ii) certain restrictions were imposed on our ability to make acquisitions and capital expenditures, (iii) the financial covenants set forth in Section 6.10 of the Credit Agreement were revised, (iv) the schedule of applicable margins under the Credit Agreement was revised, (v) the Lenders, the Agent and US Bank waived certain defaults and obligations, and (vi) the Agent consented to our voting in favor of increasing the share capital of one of our subsidiaries.

**Off-Balance Sheet Arrangements**

On December 23, 2004, two of our subsidiaries, MagnaChip Semiconductor S.A. and MagnaChip Semiconductor Finance Company entered into a senior credit agreement with a syndicate of banks, financial institutions and other entities providing for a \$100 million senior secured revolving credit facility. The undrawn portion of such senior secured credit line as of July 2, 2006 and December 31, 2005 were \$88.2 million and \$83.0 million, respectively. The utilized portions of the credit line are related to the issuance of letters of credit under the credit facility.

Other than the senior credit facility, there are no material off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors.

**Recent accounting pronouncements**

In June 2006, the FASB issued FIN No. 48, *Accounting for Uncertainty in Income Taxes* - an interpretation of SFAS No. 109. FIN 48 clarifies the accounting for uncertain income tax positions accounted for in accordance with SFAS No. 109. The Interpretation stipulates recognition and measurement criteria in addition to classification, interim period accounting and significantly expanded disclosure provisions for uncertain tax

positions that are expected to be taken in a company's tax

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return. FIN 48 is effective for fiscal years beginning after December 15, 2006. The adoption of this Interpretation is not expected to have a material impact on our consolidated financial statements.

In March 2006, the FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets* an amendment of FASB Statement No. 140. This Statement addresses the accounting for recognized servicing assets and liabilities related to certain transfers of the servicer's financial assets and for acquisitions or assumptions of obligations to service financial assets that do not relate to the financial assets of the servicer and its related parties. SFAS 156 requires that all recognized servicing assets and liabilities are initially measured at fair value, and subsequently measured at either fair value or by applying an amortization method for each class of recognized servicing assets and liabilities. SFAS 156 is effective in fiscal years beginning after September 15, 2006. The adoption of SFAS 156 is not expected to have a material impact on our consolidated financial statements.

In February 2006, the FASB issued SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments* an amendment of FASB Statements No. 133 and 140. This Statement amends SFAS No. 133 and SFAS No. 140, and improves the financial reporting of certain hybrid financial instruments by requiring more consistent accounting. Specifically, this Statement allows fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation. This Statement is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. The adoption of this Statement is not expected to have a material impact on our consolidated financial statements.

## **Critical Accounting Policies and Estimates**

The preparation of financial statements and related disclosures in conformity with U.S. GAAP requires our management to make significant judgments and estimates that affect our financial position and results of operations.

### ***Revenue Recognition***

Our revenue is derived from the sale of semiconductor products we design and the manufacture of semiconductor wafers for third parties. We recognize revenue when persuasive evidence of an arrangement exists, the product has been delivered and title and risk of loss have transferred, the price is fixed and determinable, and collection of resulting receivables is reasonably assured. For certain distributors, standard products are sold to the distributors without rights to return products or stock rotation or price protection rights. Our policy is to recognize revenue upon shipment of products to customers, where shipment represents the point when the rights and risks of ownership have passed to the customer, when persuasive evidence of an arrangement exists, the product has been delivered, the price is fixed or determinable and collection of the resulting receivable is reasonably assured. Specialty foundry services are performed pursuant to manufacturing agreements and purchase orders. Standard products are shipped and sold based upon purchase orders from customers. All amounts billed to a customer related to shipping and handling are classified as sales, while all costs incurred by us for shipping and handling are classified as expenses.

We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make payment. If the financial condition of our customers were to deteriorate, additional allowances may be required. The establishment of reserves for sales discounts is based on judgment that requires significant estimates of a variety of factors, including forecasted demand, returns and industry pricing assumptions. We record warranty liabilities for the estimated costs that may be incurred under our limited warranty. This warranty covers product defects based on compliance to our specifications and is normally applicable for twelve months from the date of purchase. These liabilities are recorded when related revenue is recognized. Warranty costs include the costs to replace the defective product. Factors that affect our warranty liability include the historical and anticipated rate of warranty claims on those repairs and the cost per claim to satisfy our warranty obligations. As these factors are impacted by actual experience and future expectations, we periodically assess the adequacy of our recorded warranty liabilities and adjust the amounts as necessary.

### ***Inventory Valuation***

Inventories are stated at the lower of cost or market, using the average cost method, which approximates the first in, first out method. If net realizable value is less than cost at the balance sheet date, the carrying amount is reduced to the realizable value, and the difference is recognized as a loss on valuation of inventories under cost of sales. We estimate the net realizable value for such finished goods and work-in-progress based on current invoice prices. Inventory reserves are established when conditions indicate that the net realizable value is less than cost due to physical deterioration, obsolescence, changes in price levels, or other causes. Reserves are also established for excess inventory based on inventory levels in excess of six months of projected demand, as judged by management, for each specific product.



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### ***Useful Lives of Tangible and Intangible Assets***

Property, plant and equipment are stated at cost, less accumulated depreciation. Depreciation is computed using the straight-line method over the estimated useful lives of the assets. Buildings and related structures are depreciated over the 10 to 40 year periods. Machinery, equipment and other assets including vehicles are depreciated over the estimated useful lives ranging 5 to 10 years.

Our intellectual property assets represent rights under patents, trademarks and property use rights and are amortized over the periods of benefit, ranging up to 10 years, on a straight-line basis.

### ***Impairment of Long-Lived Assets***

We review the carrying value of fixed assets for impairment when events and circumstances indicate that the carrying value of an asset or group of assets may not be recoverable from the estimated future cash flows expected to result from its use and/or disposition. Factors which could trigger an impairment review include the following: (i) significant negative industry or economic trends, (ii) exiting an activity in conjunction with a restructuring of operations, (iii) current, historical or projected losses that demonstrated continuing losses associated with an asset, and (iv) management's assessment of future manufacturing capacity requirements. In cases where undiscounted expected future cash flows are less than the carrying value, an impairment charge is recognized equal to the amount by which the carrying value exceeds the estimated fair value of the assets. The estimation of future cash flows involves numerous assumptions, which require our judgment, including, but not limited to, future use of the assets for our operations versus sale or disposal of the assets, future-selling prices for our products and future production and sales volumes. In addition, we must use our judgment in determining the groups of assets for which impairment tests are separately performed.

### ***Income Taxes***

We account for income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes*. SFAS No. 109 requires recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been recognized in a company's financial statements or tax returns. Under this method, deferred tax assets and liabilities are determined based on the difference between the financial statement carrying amounts and the tax bases of assets and liabilities using enacted tax rates in effect in the years in which the differences are expected to reverse. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized. Income tax expense is the tax payable for the period and the change during the period in deferred tax assets and liabilities.

We established valuation allowances for deferred tax assets at most of our subsidiaries since, other than with respect to one particular subsidiary, it is not probable that a majority of the deferred tax assets will be realizable. The valuation allowance at this particular subsidiary was not set up since it is expected that the deferred tax assets at this subsidiary will be deemed realizable based on the current prospects for its future taxable income.

### ***Unit-based Compensation***

In 2006, we adopted SFAS No. 123(R) using the modified prospective application method and began to account for unit-based compensation based on a fair value method. Under the provision of SFAS No. 123(R), unit-based compensation cost is estimated at the grant date based on the fair-value of the award and is recognized as expense over the requisite service period of the award. Consistent with prior-period pro forma presentation under SFAS No. 123, we use the Black-Scholes option pricing model to value options. In developing assumptions for fair value calculation under SFAS No. 123(R), we use estimates based on historical data and market information. A small change in the assumptions used in the estimate can cause a relatively significant change in the fair value calculation.

The valuation of our common unit is based on an independent appraisal from a third party and is updated reflecting the changes in our financial results and prospects. Determination of the fair value of our common units involves complex and subjective judgments. If we make different judgments or adopt different assumptions, material differences could result in the timing and amount of the unit-based compensation expenses recorded because the estimated fair value of the underlying units for the options granted would be different.

### ***Contingencies and Litigation***

We are subject to the possibility of losses from various contingencies. Considerable judgment is necessary to estimate the probability and amount of any loss from such contingencies. An accrual is made when it is probable that a liability has been incurred or an asset has been impaired and the amount of loss can be reasonably estimated. In such case, we accrue a liability and charge operations for the estimated costs of adjudication or settlement of the applicable asserted and unasserted claims existing as of the balance sheet date.





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

Market risk is the risk that the value of a financial instrument will fluctuate due to changes in market conditions, including changes in interest rates and foreign exchange rates. In the normal course of our business, we are subject to market risk associated with interest rate movements and currency movements on our assets and liabilities.

*Foreign Currency Risk.* We have exposure to foreign currency exchange-rate fluctuations on net income from our subsidiaries denominated in currencies other than U.S. dollars, as our foreign subsidiaries in Korea, Taiwan, China, Japan and Hong Kong use local currency as their functional currency. From time to time these subsidiaries have cash and financial instruments in local currency. The amounts held in Japan, Taiwan, Hong Kong and China are not material in regards to foreign currency movements. However, based on the cash and financial instruments balance at July 2, 2006 for our Korean subsidiary, a 10% devaluation of the Korean Won against the U.S. dollar would have resulted in a decrease of \$6.1 million in our U.S. dollar financial instruments balance and cash balance.

*Interest Rate Risk.* The \$200 million 6<sup>7</sup>/<sub>8</sub>% Second Priority Senior Secured Notes due 2011 and the \$250 million 8% Senior Subordinated Notes due 2014 are subject to changes in fair value due to interest rate changes. If the market interest rate had decreased by 10% and all other variables were held constant from their levels at July 2, 2006, we estimate that we would have additional interest expense costs over the market rate of \$1.4 million for the six months ended July 2, 2006. The fair value of these fixed rate notes would have decreased by \$9.4 million or increased by \$9.8 million with a 10% increase or decrease in the interest rate, respectively.

*Cash Flow Interest Rate Risk.* In 2005, we entered into an interest rate swap agreement to convert the variable interest rate on our Floating Rate Second Priority Senior Secured Notes to a fixed interest rate for the periods to maturity date of June 2008. With this interest rate swap, cash flow interest rate risk was replaced with exposure to interest rate risk. For details, refer to Note 6. Long-term Borrowings.

**Item 4. Controls and Procedures**  
**Disclosure Controls and Procedures**

As required by the Securities Exchange Act of 1934, as amended (the Exchange Act), our management, including our Chief Executive Officer (CEO) and our Chief Financial Officer (CFO), conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report. As defined in Rule 13a-15(e) and 15d-15(e) under the Exchange Act, disclosure controls and procedures are controls and other procedures that we use that are designed to ensure that information required to be disclosed by us in the reports we file or submit under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports we file or submit under the Exchange Act is accumulated and communicated to our management, including our CEO and our CFO, as appropriate, to allow timely decisions regarding required disclosure.

Based upon that evaluation, our CEO and our CFO concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report.

**Changes in Internal Control Over Financial Reporting**

On June 2, 2006, the Board of Directors constituted an Audit Committee to oversee the accounting and financial reporting processes of the Company and audits of the financial statements of the Company and to assist the Board in oversight and monitoring of the integrity of the Company's financial statements, the Company's compliance with legal and regulatory requirements, the independent auditor's qualifications, independence and performance, and the Company's internal accounting and financial controls. The Company also established an internal audit function under the Audit Committee. The internal audit function is currently comprised of two auditors and is charged with, among other tasks, establishing appropriate internal controls to meet the requirements under Section 404 of the Sarbanes-Oxley Act of 2002.

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### **PART II OTHER INFORMATION**

#### **Item 1A. Risk Factors**

##### **The cyclical nature of the semiconductor industry may limit our ability to maintain or increase net sales and profit levels during industry downturns.**

The semiconductor industry is highly cyclical and periodically experiences significant economic downturns characterized by diminished product demand, resulting in production overcapacity and excess inventory in the markets we serve, which can result in rapid erosion of average selling prices. The industry has experienced significant downturns, often in connection with, or in anticipation of, maturing product cycles of both semiconductor companies and their customers' products and the decline in general economic conditions.

We have experienced these conditions in our business in the past and may experience renewed, and possibly more severe and prolonged, downturns in the future as a result of such cyclical changes. This may reduce our profitability and the value of our business.

##### **Customer demand is difficult to accurately forecast.**

We make significant decisions, including determining the levels of business that we will seek and accept, production schedules, component procurement commitments, personnel needs and other resource requirements, based on our estimates of customer requirements. The short-term nature of commitments by many of our customers and the possibility of rapid changes in demand for their products reduces our ability to accurately estimate future customer demand. On occasion, customers may require rapid increases in production, which can challenge our resources and reduce margins. We may not have sufficient capacity at any given time to meet our customers' increased demand for our product. Conversely, downturns in the semiconductor industry may cause and have caused our customers to significantly reduce the amount of products ordered from us. Because many of our costs and operating expenses are relatively fixed, a reduction in customer demand may decrease our gross margins and operating income.

##### **Our customers may cancel their orders, change production quantities or delay production.**

We generally do not obtain firm, long-term purchase commitments from our customers. Customers may cancel their orders, change production quantities or delay production for a number of reasons. Cancellations, reductions or delays by a significant customer or by a group of customers, which we have experienced as a result of the recent downturn in the semiconductor industry, have adversely affected and may continue to adversely affect our results of operations. In addition, while we do not obtain long-term purchase commitments, we generally agree to the pricing of a particular product for the entire lifecycle of the product, which can extend over a number of years. If we underestimate our costs when determining the pricing, our margins and results of operations would be adversely affected.

##### **A significant portion of our sales comes from a relatively limited number of customers.**

If we were to lose key customers or if customers cease to place orders for our high volume devices, our financial results will be adversely affected. While we served more than 214 customers in the six-month period ended July 2, 2006, net sales to our 10 largest customers represented approximately 60.1% of our net sales for the period. We had one individual customer and one group of affiliated customers that each represented greater than 10% of our net sales during the six-month period ended July 2, 2006. Significant reductions in sales to any of these customers, the loss of major customers or the curtailment of orders for our high-volume devices within a short period of time would adversely affect our business.

##### **Our industry is highly competitive.**

The semiconductor industry is highly competitive and includes hundreds of companies, a number of which have achieved substantial market share. Current and prospective customers for our products evaluate our capabilities against the merits of our direct competitors. Some of our competitors are well-established as independent companies and have substantially greater market share and manufacturing, financial, research and development and marketing resources than we do. We also compete with emerging companies that are attempting to sell their products in specialized markets, and with the internal capabilities of many of our significant customers. We expect to experience continuing competitive pressures in our markets from existing competitors and new entrants. Any consolidation among our competitors could enhance their product offerings and financial resources, further enhancing their competitive position. Our ability to compete successfully depends on a number of factors, including the following: our ability to offer cost effective products on a timely basis using our technologies; our ability to accurately identify and respond to emerging technological trends and demand for product features and performance characteristics; product introductions

by our competitors; our ability to adopt or adapt to emerging industry standards; and the number and nature of our competitors in a given market. Many of these factors are outside of our control. In the future, our competitors may capture our existing or potential customers and our customers may satisfy more of their requirements internally. As a result, we may experience declining revenues and profits.

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### **A decline in average selling prices could decrease our profits.**

In the past, our industry has experienced a decline in average selling prices. A decline in average selling prices for our products, if not offset by reductions in the costs of producing such products, would decrease our gross profits and could have a material adverse effect on our business, financial condition and results of operations.

### **Growth in the consumer electronics and other end markets for our products is an important component in our success.**

Our continued success will depend in part on the growth of various consumer electronics markets and other end markets that use our semiconductors and on general economic growth. To the extent that we cannot offset recessionary periods or periods of reduced growth that may occur in these markets through greater penetration of these markets, our sales may decline and our business, financial condition and results of operations may suffer as a result.

### **We depend on successful technological advances for growth.**

Our industry is subject to rapid technological change and product obsolescence as customers and competitors create new and innovative products and technologies. Products or technologies developed by other companies may render our products or technologies obsolete or noncompetitive and we may not be able to access leading edge process technologies or to license or otherwise obtain essential intellectual property required by our customers. Our inability to continue identifying new product opportunities, or manufacturing technologically advanced products on a cost-effective basis, may result in decreased revenues and a loss of market share to our competitors.

### **We may not be able to attract or retain the technical or management employees necessary to remain competitive in our industry.**

We depend on our ability to attract and retain skilled technical and managerial personnel. We could lose the services of, or fail to recruit, skilled personnel, which could hinder our research and product development programs or otherwise have a material adverse effect on our business.

### **If we encounter future labor problems, we may fail to deliver our products in a timely manner which could adversely affect our revenues and profitability.**

As of August 1, 2006, approximately 62% of our employees were represented by the MagnaChip Semiconductor Labor Union, which is a member of the Federation of Korean Metal Workers Trade Unions. We cannot assure you that issues with the labor union and other employees will be resolved favorably for us in the future, that we will not experience significant work stoppages in future years or that we will not record significant charges related to those work stoppages.

### **We may incur costs to engage in future business combinations or strategic investments and the anticipated benefits of those transactions may not be realized.**

As part of our business strategy, we may seek to enter into business combinations, investments, joint ventures and other strategic alliances with other companies in order to maintain and grow revenue and market presence as well as to provide us with access to technology, products and services. Those transactions would be accompanied by risks that may harm our business, such as difficulties in assimilating the operations, personnel and products of an acquired business or in realizing the projected benefits; disruption of our ongoing business; potential increases in our indebtedness and contingent liabilities; and charges if the acquired company or assets are later worth less than the amount paid for them in the Original Acquisition. In addition, our senior secured credit facility and the indentures governing our notes may prohibit us from making acquisitions that we may otherwise wish to pursue.

### **We depend on high utilization of our manufacturing capacity.**

As many of our costs are fixed, a reduction in capacity utilization, together with other factors such as yield and product mix, could reduce our profit margins and adversely affect our operating results. A number of factors and circumstances may reduce utilization rates, including periods of industry overcapacity, low levels of customer orders, operating inefficiencies, mechanical failures and disruption of operations due to expansion or relocation of operations, power interruptions, fire, flood or other natural disasters or calamities.

### **The failure to achieve acceptable manufacturing yields could adversely affect our business.**

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The manufacture of semiconductors requires precision, a highly-regulated and sterile environment and expensive equipment. We may have difficulty achieving acceptable yields in the manufacture of our products. Slight impurities or

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defects in the masks used to print circuits on a wafer or other factors can cause significant difficulties, particularly in connection with the production of a new product, the adoption of a new manufacturing process or any expansion of our manufacturing capacity and related transitions.

### **We rely on certain subcontractors.**

The majority of our net sales are derived from semiconductor devices assembled in advanced packages. The packaging of semiconductors is a complex process requiring, among other things, a high degree of technical skill and advanced equipment. We outsource our semiconductor packaging to subcontractors, most of which are located in Korea and Southeast Asia. We rely on these subcontractors to package our devices with acceptable quality and yield levels. If our semiconductor packagers experience problems in packaging our semiconductor devices or experience prolonged quality or yield problems, our operating results could be adversely affected.

### **We depend on successful parts and materials procurement for our manufacturing processes.**

We use a wide range of parts and materials in the production of our semiconductors, including silicon, processing chemicals, processing gases, precious metals and electronic and mechanical components. We procure materials and electronic and mechanical components from domestic and foreign sources and original equipment manufacturers. As a division of Hynix, we were able to take advantage of Hynix's size and purchasing power in procuring parts and materials. As an independent company, we are smaller and less diversified than Hynix, and we may be unable to obtain parts and materials at prices and on terms as favorable as those available to us prior to the separation from Hynix in October 2004. If we cannot obtain adequate materials in a timely manner or on favorable terms for the manufacture of our products, either or both of our revenues or profits will decline.

### **We face product liability risks and the risk of negative publicity if our products fail.**

Our semiconductors are incorporated into a number of end products, and our business is exposed to product liability risk and the risk of negative publicity if our products fail. Although we maintain insurance for product liability claims, the amount and scope of our insurance may not be adequate to cover a product liability claim that is asserted against us. In addition, product liability insurance could become more expensive and difficult to maintain and, in the future, may not be available on commercially reasonable terms or at all.

In addition, we are exposed to the product liability risk and the risk of negative publicity affecting our customers and suppliers. Our sales may decline if any of our customers are sued on a product liability claim. We may also suffer a decline in sales from the negative publicity associated with such a lawsuit or with adverse public perceptions in general regarding our customers' products.

### **Our ability to compete successfully and achieve future growth will depend, in part, on our ability to protect our proprietary technology, as well as our ability to operate without infringing the proprietary rights of others.**

We seek to protect our proprietary technologies and know-how through the use of patents, trade secrets, confidentiality agreements and other security measures. The process of seeking patent protection takes a long time and is expensive. We cannot assure you that patents will issue from pending or future applications or that, if patents issue, they will not be challenged, invalidated or circumvented, or that the rights granted under the patents will provide us with meaningful protection or any commercial advantage. Some of our technologies are not covered by any patent or patent application. The confidentiality agreements on which we rely may be breached and may not be adequate to protect our proprietary technologies. We cannot assure you that other countries in which we market our services will protect our intellectual property rights to the same extent as the United States.

Our ability to compete successfully depends on our ability to operate without infringing the proprietary rights of others. We have no means of knowing what patent applications have been filed in the United States until they are published. In addition, the semiconductor industry is characterized by frequent litigation regarding patent and other intellectual property rights. Litigation, which could result in substantial costs to us and diversion of our resources, may also be necessary to enforce our patents or other intellectual property rights or to defend against claimed infringement of the rights of others. In the event of an adverse outcome in any such litigation, we may be required to pay substantial damages, indemnify customers or licensees for damages they may suffer if the products they purchase from us or the technology they license from us violate the intellectual property rights of others; stop our manufacture, use, sale or importation of infringing products; expend significant resources to develop or acquire non-infringing technologies; discontinue processes; or obtain licenses to the intellectual property we are found to have infringed. We cannot assure you that we would be successful in such development or acquisition or that such licenses would be available under reasonable terms, or at all.



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As a business segment of Hynix, we were the beneficiary of some of Hynix's intellectual property arrangements, including cross-licensing arrangements with other leading semiconductor companies and licenses from third parties of technology incorporated in our products and used to operate our business. We are no longer a beneficiary under some of these agreements and arrangements. There may be third parties who had refrained from asserting intellectual property infringement claims against our products or processes while we were a business segment of Hynix that elect to pursue such claims against us now that we are an independent company. In addition, some of our technologies have been sublicensed from Hynix on a non-exclusive basis and Hynix may sublicense such technologies to others. We have cross-licensed most of our technologies to Hynix. This cross-license is subject to the non-competition provision of the Hynix business transfer agreement. Our competitors may develop, patent or gain access to similar know-how and technology. Failure to protect our existing intellectual property rights may result in the loss of valuable technologies or having to pay other companies for infringing on their intellectual property rights.

### **We are subject to many environmental laws and regulations that could affect our operations or result in significant expenses.**

We are subject to requirements of environmental, health and safety laws and regulations in each of the jurisdictions in which we operate, governing, among other things, air emissions, wastewater discharges, the generation, use, handling, storage and disposal of, and exposure to, hazardous substances (including asbestos) and wastes, soil and groundwater contamination and employee health and safety. These laws and regulations are complex, constantly changing and have tended to become more stringent over time. We cannot assure you that we have been, or will be at all times, in complete compliance with all these laws and regulations or that we will not incur material costs or liabilities in connection with these laws and regulations in the future. The adoption of new environmental, health and safety laws, the failure to comply with new or existing laws, or issues relating to hazardous substances could subject us to material liability (including substantial fines or penalties), impose the need for additional capital equipment or other process requirements upon us, curtail our operations, or restrict our ability to expand operations.

### **We could suffer adverse tax and other financial consequences as a result of changes in, or differences in the interpretation of, applicable tax laws.**

Our company organizational structure is based, in part, on assumptions about the various tax laws, including withholding tax, and other laws of applicable non-U.S. jurisdictions. In addition, MagnaChip Korea was granted a limited tax-holiday under Korean law in October 2004, which provides for certain tax exemptions for corporate taxes, withholding taxes, acquisition taxes, property and land taxes and other taxes for five years. Our interpretations and conclusions are not binding on any taxing authority, and, if our assumptions about tax and other laws are incorrect or if the authorities were to change or modify the relevant laws, we could suffer adverse tax and other financial consequences or have the anticipated benefits of our company organizational structure materially impaired.

### **A limited number of persons indirectly control us.**

CVC, Francisco Partners, and CVC Asia Pacific own approximately 34%, 34% and 18%, respectively, of the outstanding voting interests in MagnaChip. By virtue of their ownership of these voting interests, and the securityholders' agreement among MagnaChip and its unitholders, these entities have significant influence over our management and will be able to determine the outcome of all matters required to be submitted to the unitholders for approval, including the election of a majority of our directors and the approval of mergers, consolidations and the sale of all or substantially all of our assets.

### **We may need additional capital in the future and it may not be available on acceptable terms or at all.**

We may require more capital in the future to fund our operations, finance investments in equipment and infrastructure, and respond to competitive pressures and potential strategic opportunities. Additional capital may not be available when needed or, if available, may not be available on satisfactory terms. If we are unable to obtain capital on favorable terms, or if we are unable to obtain capital at all, we may have to reduce our operations or forego opportunities and it may have a material adverse effect on our business, financial condition and results of operations.

### **Our international operations are subject to various risks that may lead to decreases in financial results.**

We face risks inherent in international operations, such as unexpected changes in regulatory requirements, tariffs and other market barriers, political, social and economic instability, adverse tax consequences, war, civil disturbances and acts of terrorism, difficulties in accounts receivables collection, extended payment terms and differing labor standards, enforcement of contractual obligations and protection of intellectual property. These risks may lead to increased costs or decreased revenue growth, or both.





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**We are subject to risks associated with currency fluctuations.**

Our revenues are denominated in various currencies, specifically, the Korean Won, Japanese Yen, Euro and U.S. dollar. As a result, changes in the exchange rates of these currencies or any other applicable currencies to the U.S. dollar will affect the translated price of products and therefore operating margins and could result in exchange losses.

The majority of our costs are denominated in Korean Won and to a lesser extent in Japanese Yen, U.S. dollar and Euro. Therefore, changes in the exchange rates of these currencies or any other applicable currencies to the U.S. dollar will affect cost of goods sold and operating margins and could result in exchange losses.

We cannot fully predict the impact of future exchange rate fluctuations on our profitability. From time to time, we may have engaged in, and may continue to engage in, exchange rate hedging activities in an effort to mitigate the impact of exchange rate fluctuations. However, we cannot assure you that any hedging technique we implement will be effective. If it is not effective, we may experience reduced operating margins.

**Our historical financial information may not be representative of our results as a separate company.**

Prior to the Original Acquisition, we operated as a division of Hynix. Historical financial information for periods prior to September 30, 2004, was derived from Hynix's consolidated financial statements, has been presented on a carve-out basis and does not necessarily reflect what our financial position, results of operations or cash flows would have been had we been a separate, stand-alone company during the periods presented. As carve-out financial statements, the financial statements include allocations of the costs of shared activities and overhead of Hynix and of intangible assets and property, plant and equipment shared with Hynix. These allocations are based upon various assumptions and estimates, some of which are subjective. Actual results of our operations had we operated on a stand-alone basis, may differ from those allocations and estimates. Also, as part of the Original Acquisition we did not acquire certain assets that were included in the carve-out financial statements and we assumed certain additional costs and obligations that are not reflected in the carve-out financial statements. Accordingly, the carve-out financial statements should not be relied upon as being representative of our financial position or operating results had we operated on a stand-alone basis, nor may they be representative of our financial position or operating results following the Original Acquisition.

**Our expenses could increase if Hynix were unwilling or unable to provide certain services related to our shared facilities with Hynix.**

Because we share certain facilities with Hynix, a few services that are essential to our business are provided to us by or through Hynix. These services include electricity, bulk gasses and de-ionized water, campus facilities, wastewater and sewage management, and environmental safety. If any of our agreements with Hynix were terminated or if Hynix were unwilling or unable to fulfill its obligations to us under the terms of these agreements, we would have to procure these services on our own and as a result may experience an increase in our expenses.

In addition, we lease building and warehouse space from Hynix in Cheongju, Korea, and lease to Hynix some of the space we own in Cheongju, Korea. If Hynix were to become insolvent, we could lose our leases on some of our building and warehouse space.

**Research and development investments may not yield profitable and commercially viable products and thus will not necessarily result in increases in revenues for us.**

We invest significant resources in our research and development. However, research and development efforts may not yield commercially viable products. During each stage of research and development there is a substantial risk that we will have to abandon a potential product which is no longer marketable and in which we have invested significant resources. In the event we are able to develop viable new products, a significant amount of time will have elapsed between our investment in the necessary research and development effort and the receipt of any related revenues.

**Investor confidence may be adversely impacted if we are unable to comply with Section 404 of the Sarbanes-Oxley Act of 2002.**

Beginning with our fiscal year ending December 31, 2007, we will be subject to rules adopted by the SEC pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, which require us to include in our Annual Report on Form 10-K our management's report on, and assessment of the effectiveness of, our internal controls over financial reporting. In addition, our independent auditors will be required to attest to and report on management's assessment of the effectiveness of our internal controls over financial reporting. If we fail to achieve and maintain the adequacy of our internal controls, there is a risk that we will not comply with all of the requirements imposed by Section 404. Moreover, effective internal controls, particularly those related to revenue recognition, are necessary for us to produce reliable financial reports and are important



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to helping prevent financial fraud. Any of these possible outcomes could result in an adverse reaction in the financial marketplace due to a loss of investor confidence in the reliability of our financial statements, which ultimately could harm our business and could negatively impact the market price of our securities.

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

During the three-month period ended July 2, 2006, certain of our subsidiary's employees and former employees exercised options to acquire an aggregate of 2,812.50 of our common units at an aggregate purchase price of \$8,050.32. Because the offering transactions took place outside the U.S. and none of the optionees were U.S. persons, these securities were exempt from registration under Regulation S of the Securities Act of 1933, as amended.

**Item 4. Submission of Matters to a Vote of Security Holders.**

Effective May 27, 2006, R. Douglas Norby and Sang Park were elected to the Board of Directors of the Company to serve at the discretion of the unitholders of the Company until their successors are duly elected and qualified, as permitted under the Company's Third Amended and Restated Limited Liability Company Operating Agreement, by written consent of unitholders holding 41,840,446.51 common units of the Company constituting 78.8% of the then-outstanding common units of the Company.

Effective May 27, 2006, a proposal by the Company to reserve an additional 400,000 common units of the Company, for an aggregate of 7,890,864 common units of the Company, for issuance upon the exercise of Options or SARs granted or Restricted Unit awards offered under the MagnaChip Semiconductor LLC California Equity Incentive Plan and the MagnaChip Semiconductor LLC Equity Incentive Plan was approved, as permitted under the Company's Third Amended and Restated Limited Liability Operating Company Agreement, by written consent of unitholders holding 41,840,446.51 common units of the Company constituting 78.75% of the then-outstanding common units of the Company.

**Item 6. Exhibits.**

Exhibit Number	Description
10.3.d	Fourth Amendment to Credit Agreement, dated as of July 26, 2006, by and among MagnaChip Semiconductor S.A. and MagnaChip Semiconductor Finance Company, as borrowers, MagnaChip Semiconductor LLC, the Subsidiary Guarantors party thereto, the Lenders party thereto, UBS AG, Stamford Branch, as administrative agent and collateral agent, and U.S. Bank National Association.*
10.36	Service Agreement, dated as of May 27, 2006, by and between MagnaChip Semiconductor, Ltd. (Korea) and Sang Park.#
31.1	Certification pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934 of the Chief Executive Officer.
31.2	Certification pursuant to Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934 of the Chief Financial Officer.
32.1	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, of the Chief Executive Officer.
32.2	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, of the Chief Financial Officer.

\* Incorporated by reference to an identically numbered exhibit filed in response to Item 1.01, Entry into a Material Definitive Agreement, of the company's Current Report on Form 8-K dated July 25, 2006 (File No. 333-126019-09).

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# Incorporated by reference to an identically numbered exhibit filed in response to Item 1.01, Entry into a Material Definitive Agreement, of the company's Current Report on Form 8-K dated May 27, 2006 (File No. 333-126019-09).

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**SIGNATURE**

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

MAGNACHIP SEMICONDUCTOR LLC

Dated: August 14, 2006

By: /s/ Sang Park  
Sang Park  
Chief Executive Officer and President

Dated: August 14, 2006

By: /s/ Robert J. Krakauer  
Robert J. Krakauer  
Executive Vice President, Corporate Operations,  
  
and Chief Financial Officer

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INDEX TO EXHIBITS

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