STEC, INC.
Form 10-Q
November 08, 2011

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2011

or

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

For the transition period from ______ to ______

Commission File Number 000-31623

STEC, INC.

(Exact name of Registrant as specified in its charter)

CALIFORNIA **(State or other jurisdiction of** **incorporation or organization)**	**33-0399154** **(I.R.S. Employer** **Identification No.)**
3001 Daimler Street **Santa Ana, CA** **(Address of principal executive offices)**	**92705-5812** **(Zip Code)**

(949) 476-1180

(Registrant s telephone number, including area code)

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

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

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

Large Accelerated Filer x	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 x

The number of shares outstanding of the registrant s common stock, par value $0.001, as of October 24, 2011 was 46,011,753.

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STEC, INC.

INDEX TO FORM 10-Q FOR THE

QUARTERLY PERIOD ENDED SEPTEMBER 30, 2011

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

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PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

STEC, INC.

UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except per share amounts)

	September 30, 2011	December 31, 2010
ASSETS:		
Current Assets:		
Cash and cash equivalents	$ 161,185	$ 170,457
Accounts receivable, net of allowances of $3,663 at September 30, 2011 and $3,853 at December 31, 2010	47,617	47,831
Inventory	82,434	88,968
Other current assets	4,579	4,606
Total current assets	295,815	311,862
Leasehold interest in land	2,561	2,596
Property, plant and equipment, net	35,938	35,037
Goodwill	1,682	1,682
Other long-term assets	6,379	5,173
Deferred income taxes	13,929	9,304
Total assets	$ 356,304	$ 365,654
LIABILITIES AND SHAREHOLDERS EQUITY:		
Current Liabilities:		
Accounts payable	$ 13,740	$ 25,762
Accrued and other liabilities	15,570	13,470
Total current liabilities	29,310	39,232
Other long-term payables	6,561	4,248
Commitments and contingencies (Note 9)		
Shareholders Equity:		
Preferred stock, $0.001 par value, 20,000 shares authorized, no shares issued and outstanding		
Common stock, $0.001 par value, 100,000 shares authorized, 47,153 shares issued and outstanding as of September 30, 2011 and 51,046 shares issued and outstanding as of December 31, 2010	47	51
Additional paid-in capital	138,704	169,127
Retained earnings	181,682	152,996
Total shareholders equity	320,433	322,174
Total liabilities and shareholders equity	$ 356,304	$ 365,654

See accompanying notes to unaudited condensed consolidated financial statements.

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STEC, INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(in thousands, except per share amounts)

	For the Three Months Ended September 30, 2011	For the Three Months Ended September 30, 2010	For the Nine Months Ended September 30, 2011	For the Nine Months Ended September 30, 2010
Net revenues	$ 72,529	$ 86,074	$ 249,924	$ 186,231
Cost of revenues	39,317	46,151	139,592	107,000
Gross profit	33,212	39,923	110,332	79,231
Sales and marketing	5,835	5,090	17,554	13,693
General and administrative	7,332	7,068	22,646	21,106
Research and development	14,521	12,074	39,508	32,094
Special charges (Note 7)		625		577
Total operating expenses	27,688	24,857	79,708	67,470
Operating income	5,524	15,066	30,624	11,761
Other income	6	248	49	637
Income from continuing operations before income taxes	5,530	15,314	30,673	12,398
Provision for income taxes	(686)	(1,695)	(1,987)	(1,195)
Income from continuing operations	4,844	13,619	28,686	11,203
Discontinued operations (Note 8):				
Loss from operations of Consumer Division		(3)		(261)
Benefit for income taxes		1		109
Loss from discontinued operations		(2)		(152)
Net income	$ 4,844	$ 13,617	$ 28,686	$ 11,051
Net income per share:				
Basic:				
Continuing operations	$ 0.10	$ 0.27	$ 0.56	$ 0.22
Discontinued operations				
Total	$ 0.10	$ 0.27	$ 0.56	$ 0.22
Diluted:				
Continuing operations	$ 0.09	$ 0.26	$ 0.55	$ 0.22
Discontinued operations				
Total	$ 0.09	$ 0.26	$ 0.55	$ 0.22
Shares used in per share computation:				
Basic	50,610	50,843	51,108	50,612

Diluted	51,206	51,880	52,181	51,221

See accompanying notes to unaudited condensed consolidated financial statements.

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STEC, INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	For the Nine Months Ended September 30, 2011	2010
Cash flows from operating activities:		
Net income	$ 28,686	$ 11,051
Loss from discontinued operations		152
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	9,582	9,256
Loss on sale of property, plant and equipment	20	26
Non-cash special charges and impairment loss		539
Accounts receivable (benefit) provision	(156)	77
Deferred income taxes	(3,670)	(3,634)
Stock-based compensation expense	9,682	6,532
Excess tax benefits from share-based payment arrangements	(1,622)	(1,631)
Change in operating assets and liabilities:		
Accounts receivable	370	38,967
Inventory	6,534	(45,192)
Leasehold interest in land	35	(64)
Other assets	799	(932)
Accounts payable	(14,712)	1,958
Income taxes	4,904	1,356
Accrued and other liabilities	(630)	(3,168)
Cash flows used in discontinued operations		(261)
Net cash provided by operating activities	39,822	15,032
Cash flows from investing activities:		
Purchases of short-term investments		(4,998)
Sales of short-term investments		14,998
Purchases of property, plant and equipment	(8,741)	(4,963)
Other	(244)	220
Net cash (used in) provided by investing activities	(8,985)	5,257
Cash flows from financing activities:		
Repurchase of common shares	(43,721)	
Proceeds from exercise of stock options	2,916	2,979
Excess tax benefits from share-based payment arrangements	1,622	1,631
Taxes paid related to net-share settlement of equity awards	(926)	
Net cash (used in) provided by financing activities	(40,109)	4,610
Net (decrease) increase in cash and cash equivalents	(9,272)	24,899
Cash and cash equivalents at beginning of period	170,457	135,658
Cash and cash equivalents at end of period	$ 161,185	$ 160,557
Supplemental schedule of noncash investing activities:		
	$ 2,298	$ 156

Additions to property, plant and equipment acquired under accounts payable and accrued and other liabilities

See accompanying notes to unaudited condensed consolidated financial statements.

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STEC, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1 Basis of Presentation

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

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

Note 2 Sales Concentration

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

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2011	2010	2011	2010
Customer A	32%	52%	29%	37%
Customer B	22%	*	19%	12%
Customer C	16%	*	23%	*
Customer D	*	*	*	17%

* Less than 10%

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

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2011	2010	2011	2010
United States	37%	46%	32%	42%
Czech Republic	14%	17%	15%	12%
Malaysia	*	*	*	14%
Singapore	37%	17%	41%	18%
Other	12%	20%	12%	14%
Total	100%	100%	100%	100%

* Less than 10%

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

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STEC, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3 Financial Instruments

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

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

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

	September 30, 2011	December 31, 2010
Cash and cash equivalents:		
Cash	$ 90,665	$ 90,021
Money market funds	70,520	80,436
Total cash and cash equivalents	$ 161,185	$ 170,457

Note 4 Income Taxes

The Company recorded a provision for income taxes of $2.0 million and $1.2 million for the nine months ended September 30, 2011 and September 30, 2010, respectively. The Company s effective tax rates were 6.5% and 9.6% for the nine months ended September 30, 2011 and September 30, 2010, respectively. The difference between the Company s effective tax rate and the 35% federal statutory rate for the nine months ended September 30, 2011 and September 30, 2010 resulted primarily from foreign earnings taxed at rates lower than the federal statutory rate, partially offset by permanent differences between GAAP pre-tax income and taxable income. The decrease in the effective tax rate for the nine months ended September 30, 2011 from the same period in 2010 was due primarily to a change in the revenue composition, which resulted in increased international sales and earnings in jurisdictions outside of the U.S. that were taxed at rates lower than the U.S. federal statutory rate. The decrease was also due to federal research and development tax credits of $742,000 from which the Company received income tax benefits in the first nine months of 2011 but did not receive income tax benefits in the first nine months of 2010. As of September 30, 2010, the federal government had not extended the federal research and development tax credits for the 2010 tax year. In December 2010, the federal government retroactively applied the research and development tax credits for the full year 2010 and extended them through December 31, 2011.

The Company is currently under examination by the Internal Revenue Service (IRS) for the 2008 and 2009 tax years. In addition, the California Franchise Tax Board (FTB) is currently examining the 2006 through 2008 tax years. Management believes that an adequate provision has been made for any adjustments that may result from tax examinations. However, the outcome of tax audits cannot be predicted with certainty. If any issues addressed in the Company s tax audits are resolved in a manner not consistent with management s expectations, the Company could be required to adjust its provision for income tax in the period such resolution occurs. The Company anticipates that there will be changes to the unrecognized tax benefit associated with uncertain tax positions due to the expiration of statutes of limitation, payment of tax on amended returns, audit settlements and other changes in reserves. As of September 30, 2011, a current estimate of the range of changes that may occur within the next twelve months cannot be made due to the uncertainty regarding the timing of these events.

STEC, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

	For the Three Months Ended September 30, 2011	For the Three Months Ended September 30, 2010	For the Nine Months Ended September 30, 2011	For the Nine Months Ended September 30, 2010
Japan	$ 191	$ 121	$ 863	$ 256
Taiwan	204	183	529	430
United Kingdom	120	214	351	306
India	97		134	
China	38	23	111	94
Italy	(4)	51	73	119
Austria	(1)	28	35	72
Germany	(6)	23	34	74
	$ 639	$ 643	$ 2,130	$ 1,351

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

The Company has not provided for U.S. taxes or foreign withholding taxes on approximately $97 million of undistributed earnings from its foreign subsidiaries because the Company s intent is to reinvest such earnings for the foreseeable future. Determination of the amount of unrecognized deferred tax liability for temporary differences related to these undistributed earnings is not practicable; however, if these earnings were distributed, foreign tax credits may become available under current law to reduce the resulting U.S. income tax liability.

As an incentive to establish operations in Malaysia, the Company was provided a fifteen-year income tax holiday and certain grants by the Malaysian government subject to meeting certain conditions. This income tax holiday in Malaysia was originally effective through September 30, 2022. In May 2011, the Company accepted an additional incentive package from the Malaysian government as part of its plan to establish a research and development center in Malaysia. This incentive package includes a five-year extension through September 30, 2027 of the existing income tax holiday term and certain research and development grants.

The impact of the Malaysia income tax holiday on our provision for income taxes and earnings per share are as follows (in thousands, except per share amounts):

	For the Three Months Ended September 30, 2011	For the Three Months Ended September 30, 2010	For the Nine Months Ended September 30, 2011	For the Nine Months Ended September 30, 2010
Decrease in provision for income taxes	$ 1,035	$ 1,206	$ 5,211	$ 2,694
Benefit of income tax holiday on earnings per share	$ 0.02	$ 0.02	$ 0.10	$ 0.05

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STEC, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 5 Net Income Per Share

The following table sets forth the computation of basic and diluted net income per share (in thousands, except per share amounts):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2011	2010	2011	2010
Numerator: Income from continuing operations	$ 4,844	$ 13,619	$ 28,686	$ 11,203
Numerator: Loss from discontinued operations		(2)		(152)
Numerator: Net income	$ 4,844	$ 13,617	$ 28,686	$ 11,051
Denominator for net income per share (basic)	50,610	50,843	51,108	50,612
Effect of dilutive securities:				
Stock awards	596	1,037	1,073	609
Denominator for net income per share (diluted)	51,206	51,880	52,181	51,221
Net income per share (basic):				
Continuing operations	$ 0.10	$ 0.27	$ 0.56	$ 0.22
Discontinued operations				
Total	$ 0.10	$ 0.27	$ 0.56	$ 0.22
Net income per share (diluted):				
Continuing operations	$ 0.09	$ 0.26	$ 0.55	$ 0.22
Discontinued operations				
Total	$ 0.09	$ 0.26	$ 0.55	$ 0.22
Anti-dilutive shares excluded from net income per share calculation	4,544	3,042	2,754	1,872

Note 6 Supplemental Balance Sheet Information

Inventory consisted of the following (in thousands):

	September 30, 2011	December 31, 2010
Raw materials	$ 65,765	$ 62,026
Work-in-progress	2,407	507
Finished goods	14,262	26,435
Total	$ 82,434	$ 88,968

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

	As of September 30, 2011			As of December 31, 2010		
	Gross	Accumulated Amortization	Net	Gross	Accumulated Amortization	Net
Developed technology (five years)	$ 1,345	$ 1,087	$ 258	$ 1,070	$ 958	$ 112
Customer relationships (five years)	792	792		792	792	
Acquisition-related intangible assets	2,137	1,879	258	1,862	1,750	112
Technology licenses	8,517	2,396	6,121	6,771	1,710	5,061
Total	$ 10,654	$ 4,275	$ 6,379	$ 8,633	$ 3,460	$ 5,173

The Company recorded amortization expense of $258,000 and $269,000 for the three months ended September 30, 2011 and 2010, respectively, and $815,000 and $873,000 for the nine months ended September 30, 2011 and 2010, respectively. Other long-term assets are amortized on a straight-line basis over a period of three to five years. Estimated other long-term asset amortization expense for the remainder of the years ending December 31, 2011, 2012, 2013, 2014, 2015, and 2016 is $272,000, $1.5 million, $1.8 million, $1.8 million, $740,000 and $299,000, respectively. Amortization is estimated to be completed as of the end of 2016.

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STEC, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

	September 30, 2011	December 31, 2010
Payroll costs	$ 8,834	$ 10,028
Marketing	526	568
Other	6,210	2,874
Total	$ 15,570	$ 13,470

Note 7 Special Charges

Special charges consisted of the following (in thousands):

	For the Three Months Ended September 30, 2010	For the Nine Months Ended September 30, 2010
Employee severance and termination benefits	$ 625	$ 694
Gain on assets held for sale		(117)
Total special charges	$ 625	$ 577

There were no special charges incurred during the three and nine months ended September 30, 2011.

During the first quarter of 2009, the Company commenced the first phase of its restructuring plan that involved a reduction in its workforce primarily at its Santa Ana, California headquarters as part of the transition of certain of its operations to its facility in Penang, Malaysia. During the second quarter of 2010, the Company commenced the second phase of its restructuring plan that involved a reduction in its workforce, which also primarily impacted its Santa Ana, California headquarters. The first and second phases of the restructuring plan were completed as of March 31, 2010 and December 31, 2010, respectively. In connection with the second phase of the restructuring plan, the Company recorded charges for employee severance and termination benefits of approximately $625,000 during the three months ended September 30, 2010. In connection with both the first and second phases of the restructuring plan, the Company recorded charges for employee severance and termination benefits of approximately $694,000 during the nine months ended September 30, 2010. The Company recorded a gain on the sale of impaired assets of approximately $117,000 during the nine months ended September 30, 2010.

Activity and liability balances related to the restructuring plan during the nine months ended September 30, 2010 were as follows (in thousands):

Restructuring balance, December 31, 2009	$
Charged to costs and expenses	694
Cash payments	(107)
Restructuring balance, September 30, 2010	$ 587

All amounts accrued for employee severance and termination benefits were paid by December 31, 2010.

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

Note 8 Discontinued Operations

On February 9, 2007, the Company entered into an Asset Purchase Agreement (Purchase Agreement) with Fabrik, Inc. (Fabrik) and Fabrik Acquisition Corp. (together with Fabrik, the Purchasers) for the sale of assets relating to a portion of the Company s business which was engaged in the design, final assembling, sale, marketing and distribution of consumer-oriented products based on Flash memory, DRAM technologies and external storage solutions known as the Consumer Division of the Company. The consideration paid to the Company pursuant to the Purchase Agreement consisted of cash in the amount of approximately $43.0 million. The purchase price was subject to a post-closing adjustment for accrued expenses, reserves on inventory, reserves on accounts receivable and overhead capitalization of the Consumer Division

STEC, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Purchase Price Adjustment). Subsequent to the closing of the sale, the Purchasers disputed certain amounts calculated by the Company in regards to the Purchase Price Adjustment. The original claim amount was approximately $6.7 million. In accordance with the Purchase Agreement, both parties agreed to resolve their Purchase Price Adjustment disputes through a third-party arbitrator. During the arbitration proceeding, the Purchasers conceded approximately $4.0 million of their original disputed amounts. In January 2008, the arbitrator rejected substantially all of the Purchasers claims. In March 2010, Fabrik filed a petition to confirm the January 2008 arbitration ruling, claiming it was owed an additional $486,784 plus accrued interest from the Company. In April 2010, the Company filed a response to the petition defending its position that Fabrik was seeking additional amounts outside of the arbitration ruling and was time barred from its attempt to modify or correct the arbitration award. In May 2010, Fabrik withdrew its petition and the parties satisfactorily resolved their dispute in July 2010.

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

	For the Three Months Ended September 30, 2010		For the Nine Months Ended September 30, 2010	
Net revenues	$		$	
Loss from discontinued operations		(3)		(261)
Benefit for income taxes		1		109
Loss from discontinued operations	$	(2)	$	(152)

Note 9 Commitments and Contingencies

Class Action Litigation

From November 6, 2009 through March 2, 2010, seven purported class action complaints were filed against the Company and several of its senior officers and directors in the United States District Court for the Central District of California. The Court consolidated the complaints and appointed Lead Plaintiffs. The Court did not consider the sufficiency of Lead Plaintiff s initial consolidated complaint and instead replaced the former Lead Plaintiffs with a new Lead Plaintiff. The new Lead Plaintiff filed a consolidated amended complaint that the Court dismissed without prejudice. Thereafter, the new Lead Plaintiff filed a second amended complaint, purportedly on behalf of all persons and entities who acquired the Company s common stock between June 16, 2009 and February 23, 2010. The second amended complaint alleges claims against the Company and several of its senior officers and directors for violations of Section 10(b) of the Securities and Exchange Act of 1934 (the Exchange Act) and Rule 10b-5 thereunder, and claims against several of its senior officers and directors for violations of Section 20A and Section 20(a) of the Exchange Act. In addition, the second amended complaint alleges claims against the Company, several of its senior officers and directors, and four of its underwriters for violations of Section 11 and Section 12(a)(2) of the Securities Act of 1933 (the Securities Act), and claims against several of the Company s senior officers and directors for violations of Section 15 of the Securities Act. The second amended complaint seeks compensatory damages for all damages sustained as a result of the defendants alleged actions and further seeks reasonable costs and expenses, rescission, counsel fees, and other relief the Court deems just and proper. The defendants filed motions to dismiss and on June 17, 2011, the Court entered an order granting the underwriters motion to dismiss the Securities Act claims without prejudice and denying the Company s motion to dismiss the Exchange Act claims. As a result, the discovery stay imposed by the Private Securities Litigation Reform Act was lifted. The defendants answered the second amended complaint on July 15, 2011. At a status conference on October 11, 2011, the Court revised the schedule of pre-trial deadlines and set a new trial date of July 24, 2012. The Company believes the lawsuit is without merit and intends to vigorously defend itself. No amounts have been recorded in the consolidated financial statements for this matter as the Company believes it is too early in the proceedings to determine an outcome.

On July 1, 2011, a purported class action complaint was filed against the Company and several of its senior officers and directors in the Superior Court of Orange County, California. The complaint alleges claims against the Company, several of its senior officers and directors, and four of its underwriters for violations of Section 11 and Section 12(a)(2) of the Securities Act, and further alleges claims against several of the

Company s senior officers and directors for violations of Section 15 of the Securities Act. The complaint, which arises out of the same underlying factual allegations as the federal court class action discussed above, seeks compensatory damages and rescission or a rescissory measure of damages where applicable, reasonable costs and expenses, including counsel fees and expert fees, and other relief the Court may deem just and proper. On August 4, 2011, the defendants removed the action to the United States District Court for the Central District of California. The plaintiffs moved to remand and on October 7, 2011, the Court entered an order remanding the case back to the Superior Court of Orange County, California. The Company has not yet filed its response to the complaint. The Company

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STEC, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

believes the lawsuit is without merit and intends to vigorously defend itself. No amounts have been recorded in the consolidated financial statements for this matter as the Company believes it is too early in the proceedings to determine an outcome.

Shareholder Derivative Litigation

From November 12, 2009 through December 3, 2009, four shareholder derivative actions were filed purportedly on the Company s behalf against several of its senior officers and directors in the Superior Court of Orange County, California. These cases were consolidated and stayed until further order by the Court. Despite the stay, the Company and the individual defendants each filed demurrers to the consolidated complaint on July 28, 2010, pursuant to court order. The plaintiffs moved to lift the stay and on September 9, 2011, the Court denied the plaintiffs motion. Additionally, two shareholder derivative actions were filed purportedly on the Company s behalf against several of its senior officers and directors in the United States District Court for the Central District of California. These two federal lawsuits were consolidated on April 13, 2010, and stayed by order of the Court until a ruling was made on the defendants motions to dismiss the second amended complaint in the federal securities class action lawsuit. The consolidated complaints in both the state and federal actions allege claims for breach of fiduciary duties for insider selling and misappropriation of information, abuse of control, gross mismanagement, waste of corporate assets, unjust enrichment and violations of the California Corporations Code (with respect to the state court action only) related to allegedly false and misleading statements regarding the Company s business and alleged illegal stock sales. The shareholder derivative actions generally seek compensatory damages for all alleged losses sustained as a result of the defendants alleged actions, including interest, reasonable costs and expenses, corporate governance reforms, disgorgement of profits, treble damages (with respect to the state court action only), equitable relief (with respect to the federal court action only), and other relief as the Court may deem just and proper. No amounts have been recorded in the consolidated financial statements for these matters as the Company believes it is too early in the proceedings to determine an outcome.

Shareholder Demand

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

Patent Litigation

On September 7, 2011, Solid State Storage Solutions, Inc., filed a complaint against the Company and several other defendants in the U.S. District Court for the Eastern District of Texas. The lawsuit alleges that certain of our products and/or services infringe certain patents allegedly owned by Solid State Storage Solutions, Inc., including some or all of U.S. Patents: Nos. 6,701,471, 7,234,087, 7,721,165, 6,370,059, 7,366,016, 7,746,697, 7,616,485, 6,341,085, 6,567,334, 6,347,051, 7,064,995, and 7,327,624. According to the complaint and the patents, these patents relate to solid state drives employing a controller chip and a plurality of NAND flash devices. The complaint also alleges that the Company induces and contributes to patent infringement by others. The complaint seeks unspecified monetary damages, attorney fees and expenses, and injunctive relief against the Company. The Company believes the lawsuit is without merit and intends to vigorously defend itself. Due to the early stage of this lawsuit and the inherent uncertainties of litigation, the Company is not able to predict either the outcome or a potential range of losses, if any, at this time. Accordingly, the Company cannot estimate the effects of this complaint, if any, on the Company s financial condition.

STEC, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Other Legal Proceedings

As first disclosed in the Company s Annual Report on Form 10-K for the year ended December 31, 2009, the United States Securities and Exchange Commission (SEC) is conducting a formal investigation involving trading in the Company s securities. The Company and certain of the Company s officers and employees, including its CEO and President, have received subpoenas in connection with the SEC s investigation. The Company is fully cooperating with the SEC in regards to this matter. On July 19, 2011, the Company received a Wells Notice from the SEC, stating that the Staff of the SEC (the Staff) is considering recommending that the SEC initiate a civil injunctive action against the Company, its CEO and President, charging them with violations of the antifraud and reporting provisions of the federal securities laws. Under a process established by the SEC, the Company, its CEO and President have the opportunity to submit to the Staff any reasons of law, policy or fact why they believe that the civil action should not be brought (a Wells Submission) before the Staff makes its formal recommendation to the SEC regarding what action, if any, should be brought. On August 29, 2011, the Company, its CEO and President submitted a Wells Submission to the SEC. The Company, its CEO and President intend to continue to cooperate with the SEC to attempt to resolve the Staff s concerns, but there can be no assurance that the SEC will decide not to bring an action against them.

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

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

Note 10 Credit Facility

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

Note 11 Shareholders Equity

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

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STEC, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The 2010 Incentive Award Plan (the 2010 Plan) was adopted by the Company s board of directors on March 26, 2010, and was approved by its shareholders on May 27, 2010. The 2010 Plan provides for the direct issuance or sale of shares and the grant of options to purchase shares of the Company s common stock to officers and other employees, non-employee board members and consultants. On May 19, 2011, the Company s shareholders approved an amendment to the 2010 Plan to increase the number of shares reserved for issuance thereunder by 2,000,000 shares to 6,600,000 shares. The other terms and conditions of the 2010 Plan were not changed. Under the 2010 Plan, eligible individuals may be granted options to purchase shares of common stock at an exercise price not less than 100% of the fair market value of those shares on the grant date. Other types of equity awards that may be granted under the 2010 Plan include performance awards, dividend equivalents, deferred stock units, stock payments, restricted stock, restricted stock units, stock appreciation rights and other incentive awards. The Company s board of directors, its compensation committee, or its equity awards committee determines the eligibility and vesting schedules for awards granted under the 2010 Plan. Options expire within a period of not more than ten years from the date of grant. Restricted stock units are share awards that entitle the holder to receive shares of the Company s common stock upon vesting.

As of September 30, 2011, the 2010 Plan provided for the issuance of up to 1,408,029 shares of common stock.

A summary of the option activity under the 2000 Plan and 2010 Plan is as follows:

	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at December 31, 2010	4,745,005	$ 12.84		
Granted	1,893,600	$ 11.70		
Exercised	(433,357)	$ 6.73		
Expired/forfeited	(236,725)	$ 17.01		
Outstanding at September 30, 2011	5,968,523	$ 12.76	7.8	$ 5,540,384
Vested and expected to vest at September 30, 2011	5,411,346	$ 12.70	7.7	$ 5,339,006
Exercisable at September 30, 2011	2,024,373	$ 11.58	5.5	$ 4,114,872

The above intrinsic values are before applicable taxes, based on the Company s closing stock price of $10.15 on September 30, 2011.

During the nine months ended September 30, 2011, the Company received $2.9 million in cash proceeds from the exercise of 433,357 options and $1.6 million for excess tax benefits from share-based payment arrangements. The intrinsic value of stock options exercised during the nine months ended September 30, 2011 was $5.8 million.

A summary of the Company s weighted average fair value for stock option activity during the nine months ended September 30, 2011 is as follows:

	Options	Weighted Average Grant Date Fair Value	Total Unrecognized Compensation Expense	Weighted Average Remaining Years to Vest

Non-vested stock options at December 31, 2010	2,999,300	$ 8.78		
Granted	1,893,600	$ 7.19		
Vested	(739,625)	$ 8.58		
Forfeited	(209,125)	$ 9.97		
Non-vested stock options at September 30, 2011	3,944,150	$ 7.99	$ 27,884,859	3.0

The total fair value of stock options vested during the nine months ended September 30, 2011 was $6.3 million.

STEC, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The 2011 grants were awarded pursuant to the 2010 Plan with annual vesting of 25% and contractual lives that are consistent with those of prior years. The per share fair values of the options granted in the nine months ended September 30, 2011 were estimated with the following weighted average assumptions:

Expected term (years)	5.8
Risk-free interest rate	1.5%
Volatility	69.7%
Dividend rate	0.0%

The grant date fair value per share of the 2011 restricted stock units was determined by the closing price of the common stock on the issuance date. Each unit represents the right to receive one share of the Company s common stock as each restricted stock unit vests.

A summary of the restricted stock unit activity under the 2000 Plan and 2010 Plan is as follows:

	Restricted Stock Units	Weighted Average Grant Date Fair Value	Total Unrecognized Compensation Expense	Weighted Average Remaining Years to Vest
Non-vested restricted stock units at December 31, 2010	1,090,954	$ 14.38		
Granted	786,263	$ 11.55		
Vested	(196,104)	$ 13.74		
Forfeited	(64,400)	$ 14.20		
Non-vested restricted stock units at September 30, 2011	1,616,713	$ 13.09	$ 18,781,398	3.3

Of the 196,104 restricted stock units that vested during the nine months ended September 30, 2011, 147,268 were net-share settled such that the Company withheld shares with value equivalent to the employees minimum statutory obligation for the applicable income and other employment taxes. The number and value of the shares withheld were 57,361 shares and $926,000, respectively, during the nine months ended September 30, 2011. The value of the total shares was based on the value of the restricted stock units on their vesting date as determined by the Company s closing stock price. Total payments for the employees tax obligations to the tax authorities were $926,000 and are reflected as a financing activity within the Consolidated Statements of Cash Flows. These net-share settlements had the effect of share repurchases by the Company as they reduced and retired the number of shares that would have otherwise been issued as a result of the vesting and did not represent an expense to the Company.

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

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2011	2010	2011	2010
Cost of revenues	$ 154	$ 59	$ 391	$ 251
Sales and marketing	664	450	1,676	1,219
General and administrative	1,332	862	3,543	2,317
Research and development	1,522	1,129	4,072	2,745

Total stock-based compensation expense	$ 3,672	$ 2,500	$ 9,682	$ 6,532

From time to time, the Company s board of directors has authorized various programs to repurchase shares of its common stock depending on market conditions and other factors. In November 2009, the Company s board of directors approved a share repurchase program effective November 10, 2009, enabling the Company to repurchase up to $75 million of its common stock over an 18-month period that expired on May 9, 2011. The Company did not make any share repurchases under this program during 2010 or 2011.

STEC, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

On August 4, 2011, the Company s board of directors approved a share repurchase program that authorized the Company to repurchase up to $15 million (the $15 million Program) of its common stock effective from August 9, 2011 through August 31, 2011. During the three and nine months ended September 30, 2011, the Company repurchased 1,546,700 shares of common stock at an average price per share of $9.72, including commissions, to complete the authorized repurchases under the $15 million Program.

On August 29, 2011, the Company s board of directors approved a share repurchase program that authorized the Company to repurchase up to $40 million (the $40 million Program) of its common stock effective from September 15, 2011 through March 30, 2012. For the three and nine months ended September 30, 2011, the Company repurchased 2,919,074 shares of common stock at an average price per share of $9.83, including commissions, under the $40 million Program. In October 2011, the Company repurchased an additional 1,144,837 shares of its common stock at an average price per share of $9.95, including commissions, to complete the authorized repurchases under the $40 million Program.

Note 12 New Accounting Pronouncements

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

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
Cautionary Statement

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

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

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

Overview

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

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

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

We are focusing on certain revenue growth initiatives, including:

- Continuing to develop and qualify customized SSDs, including our ZeusIOPS® and MACH product families;

- Expanding our product portfolio to include software offerings;

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

Exploring new market opportunities that leverage our core SSD expertise.

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

Operating Results Volatility

We have experienced volatility in our quarterly operating results and we expect this trend to continue for several reasons. First, the majority of our sales are currently being generated from one product line (ZeusIOPS