

CATALYST SEMICONDUCTOR INC  
Form 10-Q  
September 10, 2008  
Table of Contents

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**

**FORM 10-Q**

**□ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended July 27, 2008

OR

**□ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

0-21488

(Commission File Number)

**CATALYST SEMICONDUCTOR, INC.**

(Exact name of Registrant as specified in its charter)

Edgar Filing: CATALYST SEMICONDUCTOR INC - Form 10-Q

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**77-0083129**  
(I.R.S. Employer  
Identification No.)

**2975 Stender Way**

**Santa Clara, California, 95054**

(Address of Registrant's principal executive offices)

**(408) 542-1000**

(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 Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant 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

Smaller reporting company

(Do not check if a smaller

reporting company)

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

The number of shares outstanding of the registrant's common stock as of September 5, 2008 was 15,496,612.

**Table of Contents**

**CATALYST SEMICONDUCTOR, INC.**

**TABLE OF CONTENTS**

	<b>Page</b>
<b>PART I. FINANCIAL INFORMATION</b>	
<b>Item 1.</b> <u>Financial Statements:</u>	
<u>Unaudited Condensed Consolidated Balance Sheets at July 27, 2008 and April 27, 2008</u>	3
<u>Unaudited Condensed Consolidated Statements of Operations for the three months ended July 27, 2008 and July 29, 2007</u>	4
<u>Unaudited Condensed Consolidated Statements of Cash Flows for the three months ended July 27, 2008 and July 29, 2007</u>	5
<u>Notes to Unaudited Condensed Consolidated Financial Statements</u>	6
<b>Item 2.</b> <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	18
<b>Item 3.</b> <u>Quantitative and Qualitative Disclosures About Market Risk</u>	25
<b>Item 4.</b> <u>Controls and Procedures</u>	25
<b>PART II. OTHER INFORMATION</b>	
<b>Item 1.</b> <u>Legal Proceedings</u>	26
<b>Item 1A.</b> <u>Risk Factors</u>	26
<b>Item 2.</b> <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	36
<b>Item 3.</b> <u>Default upon Senior Securities</u>	36
<b>Item 4.</b> <u>Submission of Matters to a Vote of Security Holders</u>	36
<b>Item 5.</b> <u>Other Information</u>	36
<b>Item 6.</b> <u>Exhibits</u>	36
<b><u>SIGNATURES</u></b>	37
<b><u>EXHIBIT INDEX</u></b>	38

**Table of Contents****Part I. Financial Information****Item 1. Financial Statements****CATALYST SEMICONDUCTOR, INC.****UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS****(In thousands, except share and par value data)**

	July 27, 2008	April 27, 2008
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 20,490	\$ 17,171
Short-term investments	6,964	12,454
Accounts receivable, net	11,399	10,471
Inventories	15,289	13,174
Deferred tax assets	1,334	1,025
Other current assets	544	620
<b>Total current assets</b>	<b>56,020</b>	<b>54,915</b>
Property, plant and equipment, net	11,189	11,595
Deferred tax assets	4,742	5,051
Other assets	25	25
<b>Total assets</b>	<b>\$ 71,976</b>	<b>\$ 71,586</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 9,066	\$ 9,043
Accounts payable - related parties	195	250
Accrued expenses	2,003	2,680
Deferred gross profit on shipments to distributors	1,887	2,127
<b>Total current liabilities</b>	<b>13,151</b>	<b>14,100</b>
Other non-current liabilities	168	166
<b>Total liabilities</b>	<b>13,319</b>	<b>14,266</b>
Commitments and contingencies (Note 8)		
Stockholders' equity:		
Preferred stock, \$0.001 par value, 2,000 shares authorized; no shares issued and outstanding		
Common stock, \$0.001 par value, 45,000 shares authorized; 23,704 shares issued and 15,381 shares outstanding at July 27, 2008 and 23,644 shares issued and 15,321 shares outstanding at April 27, 2008	24	24
Additional paid-in-capital	77,625	76,765
Treasury stock, 8,323 shares at July 27, 2008 and April 27, 2008	(35,652)	(35,652)
Retained earnings	16,663	16,174
Accumulated other comprehensive income (loss)	(3)	9
<b>Total stockholders' equity</b>	<b>58,657</b>	<b>57,320</b>

Edgar Filing: CATALYST SEMICONDUCTOR INC - Form 10-Q

Total liabilities and stockholders' equity

\$ 71,976    \$ 71,586

*See accompanying notes to unaudited condensed consolidated financial statements.*

**Table of Contents****CATALYST SEMICONDUCTOR, INC.****UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(In thousands, except per share data)**

	<b>Three Months Ended</b>	
	<b>July 27, 2008</b>	<b>July 29, 2007</b>
Net revenues	\$ 18,621	\$ 19,856
Cost of revenues (A)	11,466	12,674
Gross profit	7,155	7,182
Operating expenses:		
Research and development (A)	2,158	2,103
Selling, general and administrative (A)	4,402	4,337
Income from operations	595	742
Interest income and other, net	117	429
Income before income taxes	712	1,171
Income tax provision	223	451
Net income	\$ 489	\$ 720
Net income per share:		
Basic	\$ 0.03	\$ 0.04
Diluted	\$ 0.03	\$ 0.04
Weighted average common shares outstanding:		
Basic	15,355	16,334
Diluted	16,410	17,390

(A) Results for the three months ended July 27, 2008 and July 29, 2007 include stock-based compensation expense as follows (in thousands):

	<b>Three Months Ended</b>	
	<b>July 27, 2008</b>	<b>July 29, 2007</b>
Cost of revenues	\$ 14	\$ 13
Research and development	\$ 311	\$ 120
Sales, general and administrative	\$ 442	\$ 318

*See accompanying notes to unaudited condensed consolidated financial statements.*

**Table of Contents****CATALYST SEMICONDUCTOR, INC.****UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(In thousands)**

	<b>Three months ended</b>	
	<b>July 27, 2008</b>	<b>July 29, 2007</b>
<b>Cash flows from operating activities:</b>		
Net income	\$ 489	\$ 720
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization on property, plant and equipment	477	514
Stock-based compensation	767	451
Benefit from sales of inventory previously written down	(163)	(96)
Provision for excess and obsolete inventory	186	279
Deferred tax provision		416
Changes in assets and liabilities:		
Accounts receivable	(928)	(1,636)
Inventories	(2,138)	646
Other assets	76	(309)
Accounts payable (including related parties)	(32)	(100)
Accrued expenses	(677)	527
Deferred gross profit on shipments to distributors	(240)	(77)
Other non-current liabilities	2	157
<b>Net cash provided by (used in) operating activities</b>	<b>(2,181)</b>	<b>1,492</b>
<b>Cash flows from investing activities:</b>		
Purchases of short-term investments		(2,174)
Proceeds from sales and maturities of short-term investments	5,478	6,731
Acquisitions of property, plant and equipment	(71)	(358)
<b>Net cash provided by investing activities</b>	<b>5,407</b>	<b>4,199</b>
<b>Cash flows from financing activities:</b>		
Common stock issuances from exercises of options	93	204
Treasury stock repurchases		(98)
<b>Net cash provided by financing activities</b>	<b>93</b>	<b>106</b>
<b>Net increase in cash and cash equivalents</b>	<b>3,319</b>	<b>5,797</b>
Cash and cash equivalents at beginning of the period	17,171	16,626
<b>Cash and cash equivalents at end of the period</b>	<b>\$ 20,490</b>	<b>\$ 22,423</b>

*See accompanying notes to unaudited condensed consolidated financial statements.*

---

**Table of Contents**

**CATALYST SEMICONDUCTOR, INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Note 1 Basis of Presentation**

Catalyst Semiconductor, Inc. (the Company) designs, develops and markets a broad line of reprogrammable non-volatile memory and analog/mixed-signal products. The Company was incorporated in October 1985 in California and reincorporated in Delaware in May 1993.

In the opinion of the management of the Company, the unaudited condensed consolidated interim financial statements included herein have been prepared on the same basis as the Company's April 27, 2008 audited consolidated financial statements and include all adjustments, consisting of only normal recurring adjustments, necessary to fairly state the information set forth herein. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K for the year ended April 27, 2008. The year-end condensed consolidated balance sheet data was derived from audited financial statements, but does not include all of the disclosures required by accounting principles generally accepted in the United States of America (U.S. GAAP). The condensed consolidated statements of operations for the periods presented are not necessarily indicative of results to be expected for any future period, nor for the entire year.

The Company's fiscal year is the 52 or 53-week period ending on the Sunday closest to April 30. In a 52 week year, each fiscal quarter consists of 13 weeks. Fiscal year 2008 was comprised of 52 weeks. Fiscal year 2009 will be comprised of 53 weeks and will end on May 3, 2009. The quarters ended July 27, 2008 and July 29, 2007 consisted of 13 weeks.

On July 16, 2008, the Company entered into an Agreement and Plan of Merger and Reorganization (the Merger Agreement) with ON Semiconductor Corporation, a Delaware Corporation (ON), and Centaur Acquisition Corporation, a Delaware corporation and a wholly-owned subsidiary of ON, pursuant to which ON has agreed to acquire the Company subject to the terms and conditions set forth in the Merger Agreement (the Merger) in an all-stock transaction with an equity value of approximately \$115 million. Based on the July 16, 2008 closing stock price of ON, this represents a value to the Company's stockholders of approximately \$6.24 per share.

Subject to the terms and conditions of the Merger Agreement, each share of the Company's common stock that is outstanding at the effective time of the Merger shall be converted into the right to receive 0.706 of a share of ON's common stock. The Merger is intended to be a tax-free reorganization for federal income tax purposes, and it therefore is expected that no gain or loss will be recognized by the holders of Company common stock with respect to the shares of ON common stock they receive in exchange for their shares of Company common stock.

Although the Company's board of directors is permitted to terminate the merger agreement in response to an unsolicited third party proposal to acquire Catalyst, which the Company's board of directors determines to be more favorable than the merger with ON, if the Company's board of directors determines that a failure to do so would result in a breach of its fiduciary duties, its doing so would entitle ON to collect a \$3.27 million termination fee from the Company. In addition, ON is entitled to be paid the termination fee by the Company if (i) either ON or the Company terminates the merger agreement because the Company does not obtain the required stockholder vote, (ii) at the time of the merger termination, a third party has publicly announced an acquisition proposal for the Company that was not absolutely and unconditionally withdrawn and abandoned more than ten business days prior to the stockholders meeting, and (iii) within twelve months of the date of the merger termination, the Company consummates an acquisition transaction or enters into an acquisition agreement relating to an acquisition proposal.

The transaction is subject to the approval of the Company's stockholders as well as customary closing conditions and regulatory approvals. The companies expect the transaction to close in the fourth calendar quarter of 2008.

***Principles of Consolidation***

The consolidated financial statements are prepared in accordance with U.S. GAAP, and include the accounts of Catalyst Semiconductor, Inc. and its wholly owned subsidiaries. All significant intercompany accounts and transactions are eliminated in consolidation.



## **Table of Contents**

### *Uses of Estimates*

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Significant estimates used in these consolidated financial statements include inventory valuation, stock-based compensation, reserves for stock rotation on sales to distributors, the original equipment manufacturers ( OEMs ) sales return reserve, reserve for warranty costs, allowance for doubtful accounts receivable and income taxes. Actual results could differ from those estimates.

### **Note 2 Significant Accounting Policies**

#### *Cash and Cash Equivalents*

All highly liquid investments purchased with a remaining maturity of 90 days or less are considered cash equivalents.

#### *Short-term Investments*

All of the Company's short-term investments are classified as available-for-sale. Investments in available-for-sale securities are reported at fair value with unrealized gains and losses, being recorded net of related tax, as a component of accumulated other comprehensive income (loss) in the condensed consolidated balance sheet.

The Company monitors its investments for impairment periodically and records appropriate reduction in carrying value when the declines are determined to be other than temporary.

#### *Accounts Receivable*

The Company's accounts receivable are reported net of an allowance for doubtful accounts. The Company estimates the collectibility of its accounts receivable at the end of each reporting period. The Company analyzes the aging of accounts receivable and bad debt history, payment history, customer concentration, customer credit worthiness and current economic trends when evaluating the adequacy of the allowance for doubtful accounts. The Company maintains an allowance for doubtful accounts, which is created by charges to selling, general and administrative expenses in the condensed consolidated statements of operations.

#### *Fair Value of Financial Instruments*

The Company measures its financial assets and liabilities in accordance with U.S. GAAP. For financial instruments, including cash equivalents, short-term investments, accounts receivable, accounts payable and accrued expenses, the carrying amounts approximate fair value due to their short maturities.

#### *Foreign Currency Translation*

The Company uses the U.S. dollar as its functional currency. All of the Company's sales and a substantial majority of its costs are transacted in U.S. dollars. The Company purchases wafers and has test and assembly activities in Asia and supports sales and marketing activities in various countries outside of the United States. Research and development costs in Romania are paid in Romanian leu. Sales and marketing activities in Japan are paid in Japanese yen. Operational expenses in Thailand are paid in Thai baht. Foreign currency transaction gains and losses, from remeasuring local currency to the U.S. dollar, are included in determining net income (loss) for the period. Foreign exchange gains and losses were not material for the periods presented.

#### *Revenue Recognition*

The Company generally recognizes revenues as products are shipped if evidence of a sales arrangement exists, the customer has taken title to the products, services, if any, have been rendered, the sales price is fixed or determinable, collection of the resulting receivable is reasonably assured and product returns are reasonably estimable.

The Company markets and sells its products through its direct sales force and sales representatives to OEMs and indirectly through distributors and resellers who sell to their end customers. Revenues are recognized upon transfer of title to OEMs and resellers who have no, or limited, product return rights and no price protection rights. Reserves for estimated returns and allowances are provided against net revenues at the time

## Edgar Filing: CATALYST SEMICONDUCTOR INC - Form 10-Q

of recognition of revenues. The Company also sells products to certain distributors under agreements that provide for product return and price protection rights. These agreements generally permit the distributor to return up to 10% by value of the total products they purchased from the Company every six months, in exchange for credit on a replacement order of the same value. As a result, the Company defers recognition of revenues until the time the distributor sells the product to an end-customer, at which time the sales price becomes fixed. Upon shipment to a distributor, the Company records an account receivable from the distributor, relieves

## **Table of Contents**

inventory for the cost of the product shipped, and records the gross profit, which equals revenues less the cost of revenues, on the condensed consolidated balance sheet as deferred gross profit on shipments to distributors until such time as the inventory is resold by the distributor to its end-customers.

In assessing the timing of revenue recognition from sales to distributors and resellers, the Company considers both direct and indirect risks of returns and price protection associated in the Company's business dealings with them. The Company recognizes that it may accept returns or grant price protection to certain resellers, even though the sales contracts do not explicitly provide for such rights. Accordingly, the Company accounts for sales to such resellers on a sell through basis.

### ***Inventories***

Inventories are stated at the lower of standard cost or net realizable value. Standard cost approximates actual cost on a first-in, first-out basis. The Company periodically reviews its inventory for slow moving or obsolete items and writes down the related products to estimated net realizable value. Inventory writedown or provisions once established are not reversed until the related inventory has been sold or physically scrapped. Purchases of inventory from three of the Company's vendors represented 84.5% and 76.6% of total purchases of inventory for the three months ended July 27, 2008 and July 29, 2007, respectively.

### ***Shipping and Handling Costs***

The Company charges inbound freight shipments within the supply chain and associated handling costs to the cost of revenues on its condensed consolidated statements of operations. The Company charges outbound freight shipments and associated handling costs to selling, general and administrative on its condensed consolidated statements of operations. Such outbound freight costs aggregated to \$185,000 and \$225,000 for the three months ended July 27, 2008 and July 29, 2007, respectively.

### ***Property, Plant and Equipment***

Property, plant and equipment are stated at cost less accumulated depreciation and amortization. Depreciation and amortization are calculated on a straight-line basis over the estimated useful lives of the assets. Furniture, office equipment and engineering/test equipment are depreciated over five years with the exception of production mask sets which are depreciated over two years. Computer hardware is depreciated over three years. Computer software is depreciated over three or five years. Buildings are generally depreciated over 30 years. Amortization of leasehold improvements is computed on a straight-line basis and amortized over the shorter of the remaining lease term or the estimated useful lives of the assets. Company evaluates the carrying value of its property, plant and equipment when events or changes in circumstances indicate that the carrying value of such assets may be impaired. There were no adjustments for impairment in the three months ended July 27, 2008 and July 29, 2007.

### ***Income Taxes***

The provision for income taxes is determined using the asset and liability approach of accounting for income taxes. Under this approach, deferred taxes represent the future tax consequences expected to occur when the reported amounts of assets and liabilities are recovered or paid. The provision for income taxes represents income taxes paid or payable for the current year plus the change in deferred taxes during the year. Deferred taxes result from differences between the financial and tax basis of the Company's assets and liabilities and are adjusted for changes in tax rates and tax laws when changes are enacted. Valuation allowances are recorded to reduce deferred tax assets when it is more likely than not that a tax benefit will not be realized.

The Company has not provided for U.S. income taxes and foreign withholding taxes on a cumulative total of approximately \$1.3 million of undistributed earnings for certain non-U.S. subsidiaries as of July 27, 2008. The Company intends to reinvest these earnings indefinitely in operations outside the United States. These earnings include 100% of the accumulated undistributed earnings of the Company's subsidiaries in Japan, Romania and Thailand. The calculation of the taxes that would be payable on these undistributed earnings is impracticable at present. The Company's internal test operations in Thailand operate under a tax holiday granted to the Company based on its investment in property, plant and equipment in Thailand. The tax holiday expires in October 2014.

The calculation of tax liabilities involves dealing with uncertainties in the application of complex global tax regulations. The Company recognizes potential liabilities for anticipated tax audit issues in the U.S. and other tax jurisdictions based on its estimate of whether, and the extent to which, additional taxes will be due. If payment of these amounts ultimately proves to be unnecessary, the reversal of the liabilities would result in tax benefits being recognized in the period when the Company determines the liabilities are no longer necessary. If the estimate of tax liabilities proves to be less than the ultimate assessment, a further charge to expense would result.



## **Table of Contents**

The Company adopted the provisions of Financial Accounting Standards Board ( FASB ) Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 ( FIN 48 ) effective April 30, 2007. FIN 48 clarifies the accounting for uncertainty in income taxes in an enterprise s financial statements in accordance with FASB Statement No. 109 Accounting for Income Taxes.

### ***Concentration of Credit Risk***

Financial instruments, which potentially subject the Company to concentrations of credit risk, consist principally of cash and cash equivalents, short-term investments and accounts receivable. Cash and cash equivalents and short-term investments are maintained with high quality financial institutions. The Company s accounts receivable are denominated in U.S. dollars and are derived from sales to customers located principally in North America, Europe, Japan and other regions in Asia. The Company performs ongoing credit evaluations of its customers and generally does not require collateral.

As of July 27, 2008, two customers accounted for 13.6% and 11.1% of gross accounts receivable. As of April 27, 2008, two customers accounted for 12.6% and 11.7% of gross accounts receivable.

For the three months ended July 27, 2008, the Yosun Group, a Taiwan-based distributor with offices throughout Asia, represented 12.3% of the Company s net revenues. For the three months ended July 29, 2007, Hynix Semiconductor, Inc., an OEM, and Avnet, Inc., an international distributor, represented 11.4% and 10.6% of the Company s net revenues, respectively.

### ***Concentration of Other Risks***

The semiconductor industry is characterized by rapid technological change, competitive pricing pressures and cyclical market patterns. The Company s financial results are affected by a wide variety of factors, including general economic conditions worldwide, economic conditions specific to the semiconductor industry, the timely implementation of new manufacturing process technologies and the ability to safeguard patents and intellectual property in a rapidly evolving market. In addition, the semiconductor market has historically been cyclical and subject to significant economic downturns at various times. As a result, the Company may experience significant period to period fluctuations in operating results due to the factors mentioned above or other factors.

### ***Accumulated Other Comprehensive Income (Loss)***

Accumulated other comprehensive income (loss) includes all changes in stockholders equity during a period from non-owner sources. Accumulated other comprehensive income (loss) for the Company is comprised of unrealized gains (losses) on securities available-for-sale, net of tax.

### ***Stock-Based Compensation***

The Company accounts for stock-based compensation under the provisions of Statement of Financial Accounting Standards ( SFAS ) No. 123 (revised 2004), *Share-Based Payment*, ( SFAS No. 123(R) ) and related interpretations which requires the measurement and recognition of expense related to the fair value of stock-based compensation awards. Accordingly, stock-based compensation is measured at the grant date and re-measured upon modification, as appropriate, based on the fair value of the award using the Black-Scholes option pricing model ( Black-Scholes model ), and is recognized as expense over the requisite services period of the award. Performance-based awards that are expected to vest are expensed on a straight-line basis over the vesting period. The Black-Scholes model requires the use of highly subjective, complex assumptions, including expected term and the price volatility of the Company s stock. See Note 3 of Notes to Unaudited Condensed Consolidated Financial Statements for further discussion.

### ***Segment Reporting***

The Company reports in accordance with SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information* ( SFAS No. 131 ). SFAS No. 131 requires the management approach in identifying reportable segments. The management approach designates the internal organization that is used by management for making operating decisions and assessing performance as the source of the company s reportable segments. Based on its operating structure and management reporting, the Company has concluded it has one reporting segment: the semiconductor manufacturing segment.



---

**Table of Contents**

***New Accounting Pronouncements***

***Adoption of Statement of Financial Accounting Standards No. 157***

In September 2006, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 157, *Fair Value Measurements* ( SFAS No. 157 ). SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. In February 2008, the FASB issued Staff Position No. 157-2, *Effective Date of FASB Statement No. 157*, which provides a one-year deferral of the effective date of SFAS No. 157 for non-financial assets and non-financial liabilities, except those that are recognized or disclosed in the financial statements at fair value at least annually. However, the effective date for financial assets and liabilities remains intact. Effective April 28, 2008, the Company has adopted the provisions of SFAS No. 157 with respect to its financial assets and liabilities only. SFAS No. 157 defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles and enhances disclosures about fair value measurements. Fair value is defined under SFAS No. 157 as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Valuation techniques used to measure fair value under SFAS No. 157 must maximize the use of observable inputs and minimize the use of unobservable inputs. The standard describes a fair value hierarchy based on the following three levels of inputs, of which the first two are considered observable and the last unobservable, that may be used to measure fair value:

Level 1 - Quoted prices in active markets for identical assets or liabilities;

Level 2 - Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities; and

Level 3 - Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The Company's total financial assets as of July 27, 2008 were \$25.0 million, which were comprised of cash equivalents of \$18.0 million and short-term investments of \$7.0 million. The Company's cash equivalents, comprised of money market funds, as of July 27, 2008 were based on Level 1 inputs. Short-term investments, comprised of U.S. government agency notes, were based on Level 2 inputs. The Company did not have any financial liabilities as of July 27, 2008.

The partial adoption of SFAS No. 157 did not have a material impact on the Company's financial position and results of operations. The Company is currently assessing the impact of the adoption of SFAS No. 157 as it relates to non-financial assets and non-financial liabilities and has not yet determined the impact that the adoption will have on its financial position and results of operations.

***Other Recent Pronouncements***

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment of FASB Statement No. 115* ( SFAS No. 159 ). SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. SFAS No. 159 does not affect any existing accounting literature that requires certain assets and liabilities to be carried at fair value. The Company's adoption of the provisions of SFAS No. 159 effective April 28, 2008 did not have a material effect on the Company's consolidated results of operations and financial condition.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations* ( SFAS No. 141(R) ). SFAS No. 141(R) requires an acquiring entity in a business combination to recognize all (and only) the assets acquired and liabilities assumed in the transaction; establishes the acquisition-date fair value as the measurement objective for all assets acquired and liabilities assumed; and requires the acquirer to disclose to investors and other users all of the information they need to evaluate and understand the nature and financial effect of the business combination. SFAS No. 141(R) is effective for fiscal years beginning after December 15, 2008. The Company does not expect the adoption of this standard to have a material effect on the Company's consolidated results of operations and financial condition.

**Table of Contents**

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements* ( SFAS No. 160 ). SFAS No. 160 clarifies that a noncontrolling or minority interest in a subsidiary is considered an ownership interest and, accordingly, requires all entities to report such interests in subsidiaries as equity in the consolidated financial statements. SFAS No. 160 is effective for fiscal years beginning after December 15, 2008. The Company does not expect the adoption of this standard to have a material effect on the Company's consolidated results of operations and financial condition.

**Note 3 Stock-Based Compensation**

The Company measures employee stock-based compensation cost using the provisions of SFAS No. 123(R). Accordingly, stock-based compensation cost is measured at the grant date, based on the fair value of the awards, and is recognized as expense over the requisite employee service period using the straight-line attribution method.

The effect of recording stock-based compensation for the three months ended July 27, 2008 and July 29, 2007 was as follows (in thousands):

	Three Months Ended	
	July 27, 2008	July 29, 2007
Stock-based compensation expense:		
Employee stock options	\$ 448	\$ 391
Restricted stock	319	60
Tax effect of stock-based compensation	(168)	(100)
Net stock-based compensation expense	\$ 599	\$ 351

During the three months ended July 27, 2008, the Company granted approximately 112,000 stock options with an estimated total grant date fair value of \$156,000 and a weighted average grant date fair value of \$1.40 per share and during the three months ended July 29, 2007, the Company granted approximately 128,000 stock options with an estimated total grant date fair value of \$147,000 and a weighted average grant date fair value of \$1.15 per share.

During the three months ended July 27, 2008, the Company granted approximately 340,000 shares of restricted stock with an estimated total grant date fair value of \$1.7 million and a weighted average grant date fair value of \$5.11 per share and during the three months ended July 29, 2007, there were no grants of restricted stock.

As of July 27, 2008, the aggregate amount of unrecognized stock-based compensation expense, net of estimated forfeitures, related to stock options was \$2.6 million, which the Company will recognize over an estimated weighted average amortization period of 2.3 years.

As of July 27, 2008, the aggregate amount of unrecognized stock-based compensation expense, net of estimated forfeitures, related to restricted stock was \$1.8 million, which the Company will recognize over an estimated weighted average amortization period of 1.9 years.

Stock-based compensation expense capitalized in inventory at July 27, 2008 and April 27, 2008 was immaterial.

**Valuation Assumptions**

During the three months ended July 27, 2008 and July 29, 2007, the Company utilized the Black-Scholes model for calculating the estimated fair value of stock-based compensation awards granted under stock option plans. Option-pricing models require the input of highly subjective assumptions, including the option's expected life and the price volatility of the underlying stock. The expected life of each option was determined by analyzing historical exercise and post-vest forfeiture patterns. The risk-free interest rate was determined using the rates for United States Treasury notes for similar terms. The expected stock price volatility assumption was determined using the historical volatility of the Company's common stock.

**Equity Incentive Programs**

The Company's 2003 Stock Incentive Plan ( SIP ), 2003 Director Stock Option Plan ( DSOP ) and 1998 Special Equity Incentive Plan ( SEIP ) that were outlined in the Company's Form 10-K for the year ended April 27, 2008 did not change during the three months ended July 27, 2008.





**Table of Contents**

A summary of stock option activity under the SIP, the DSOP and the SEIP is as follows (in thousands, except per share amounts):

	Shares Available for Grant	Options Outstanding	Weighted Average Exercise Price	Restricted Stock Outstanding
Balances, April 27, 2008	409	5,567	\$ 3.63	127
Additional shares authorized	750			
Granted	(452)	112	4.35	340
Exercised		(35)	3.19	
Restricted stock vested				(24)
Cancelled	31	(31)	3.67	
Expired	12	(13)	6.09	
Balances, July 27, 2008	750	5,600	\$ 3.64	443
Options exercisable at July 27, 2008		3,561	\$ 3.42	

The aggregate intrinsic value of the options exercisable at July 27, 2008 was \$9.9 million, based on the \$6.17 closing stock price of the Company's common stock on the NASDAQ Global Market at July 27, 2008, which would have been received by holders of vested in-the-money options had they exercised their options as of that date. As of July 27, 2008, the total number of in-the-money options outstanding was 5,432,000, of which 3,393,000 options were exercisable.

In August 2007, the Company issued to Sutter Securities a stock warrant to purchase 75,000 shares of common stock, in connection with Sutter Securities' agreement to act as financial advisor to the Strategy Committee of the Company's Board of Directors. The exercise price of \$4.62 per share was based on the closing price of the Company's common stock on the NASDAQ Global Market on the date of issuance. The warrant will vest and become exercisable only if a change of control (as such term is defined in the warrant agreement) occurs during a two year period which expires on July 31, 2009.

**Common Stock Repurchase Programs**

In September 2001 and subsequent periods, the Company's board of directors authorized programs for the open market repurchase of up to 5.5 million shares of the Company's common stock. In January 2008, the Company's board of directors amended the current program and increased the aggregate number of authorized shares by 3.2 million. The purpose of the share repurchase programs is to reduce the long-term potential dilution in earnings per share that might result from issuances under the Company's stock option plans and to take advantage of the relatively low price of the Company's common stock. The Company accounts for treasury stock using the cost method.

The following table summarizes the activity under the common stock repurchase program for the stated periods:

	Three months ended	
	July 27, 2008	July 29, 2007
Shares repurchased in open market		22,800
Total cost of shares	\$	\$ 98,643
Average cost per share	\$	\$ 4.33

Through July 27, 2008 (excluding repurchases of shares from Elex N.V.) the Company has repurchased 6,222,815 shares under the authorized repurchase programs at a total cost of \$26,902,344 or an average cost of \$4.32 per share. As of July 27, 2008, approximately 2,526,500 authorized shares remained available for repurchase.

**Note 4 Net Income Per Share**

Basic net income per share is computed by dividing net income available to common stockholders (numerator) by the weighted average number of common shares outstanding (denominator) during the period. Diluted net income per share is computed using the weighted number of common shares and potentially dilutive common shares outstanding during the period under the treasury stock method. Under the treasury stock

## Edgar Filing: CATALYST SEMICONDUCTOR INC - Form 10-Q

method, the effect of stock options outstanding is not included in the computation of diluted net income per share for periods when their effect is anti-dilutive. In computing diluted net income per share, the average stock price for the period is used in determining the number of shares assumed to be purchased from the exercise of stock options.

**Table of Contents**

A reconciliation of the basic and diluted per share computations was as follows (in thousands, except per share data):

	Three Months Ended					
	July 27, 2008			July 29, 2007		
	Net Income	Shares	Per Share Amount	Net Income	Shares	Per Share Amount
Basic	\$ 489	15,355	\$ 0.03	\$ 720	16,334	\$ 0.04
Effect of stock options and unvested restricted stock		1,055			1,056	
Diluted	\$ 489	16,410	\$ 0.03	\$ 720	17,390	\$ 0.04

Options to purchase 2,305,919 shares of common stock with an exercise price and net proceeds in excess of \$4.69 per share outstanding during the three months ended July 27, 2008 were not included in the computation of diluted income per share because they were anti-dilutive.

Options to purchase 2,398,937 shares of common stock with an exercise price and net proceeds in excess of \$4.23 per share outstanding during the three months ended July 29, 2007 were not included in the computation of diluted income per share because they were anti-dilutive.

**Note 5 Balance Sheet Components**

	July 27, 2008	April 27, 2008
	(in thousands)	
Accounts receivable:		
Accounts receivable	\$ 11,422	\$ 10,539
Less: Allowance for doubtful accounts	(23)	(68)
	\$ 11,399	\$ 10,471

The Company's bad debts written off to the allowance for doubtful accounts were not material in the three months ended July 27, 2008 and July 29, 2007, respectively.

	July 27, 2008	April 27, 2008
	(in thousands)	
Inventories:		
Work-in-process	\$ 11,880	\$ 9,493
Finished goods	3,409	3,681
	\$ 15,289	\$ 13,174

**Table of Contents**

	July 27, 2008	April 27, 2008
	(in thousands)	
Property, plant and equipment, net:		
Land	\$ 2,525	\$ 2,525
Buildings and improvements	5,481	5,481
Engineering and test equipment	11,843	11,824
Computer software	1,861	1,836
Computer hardware	846	816
Leasehold improvements	97	100
Furniture and office equipment	824	824
Vehicles	144	144
	23,621	23,550
Less: accumulated depreciation and amortization	(12,432)	(11,955)
	\$ 11,189	\$ 11,595
Accrued expenses:		
Accrued employee compensation	\$ 1,090	\$ 1,973
Accrued taxes	241	117
Other	672	590
	\$ 2,003	\$ 2,680

**Note 6 Income Taxes**

The provision for income taxes was \$223,000, or 31.3% of income before taxes, for the three months ended July 27, 2008. The provision for income taxes was \$451,000, or 38.5% of income before taxes, for the three months ended July 29, 2007. The lower effective income tax rate for the three months ended July 27, 2008 was due to higher non-taxable income associated with the Company's internal test operations in Thailand, which operate under a tax holiday that expires in October 2014.

The Company adopted the provisions of FIN 48 effective April 30, 2007. FIN 48 clarifies the accounting for uncertainty in tax positions. The interpretation prescribes a recognition threshold and measurement criteria for financial statement recognition of a tax position taken or expected to be taken in a tax return. FIN 48 requires the Company to recognize in the financial statements, the impact of a tax position, if that position is more likely than not of being sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. The interpretation also provides guidance on derecognition, classification, interest and penalties, accounting interim periods, disclosure and transition.

As of April 27, 2008, the Company had gross unrecognized tax benefits of approximately \$977,000. Unrecognized tax benefits were \$1.0 million as of July 27, 2008. If such amounts ultimately prove to be unnecessary, the resulting reversal of such reserves would generate tax benefits to be recorded in the period the reserves are no longer deemed necessary. If such amounts ultimately prove to be less than the final assessment, a future charge to expense would be recorded in the period in which the assessment is determined. Although timing of the resolution and/or closure on audits is highly uncertain, the Company does not believe it is reasonably possible that the unrecognized tax benefits would materially change in the next 12 months.

The Company recognizes interest and penalties related to unrecognized tax benefits within its income tax provision.

The Company conducts business globally and, as a result, the Company and its subsidiaries file income tax returns in the U.S. federal jurisdiction and various state and foreign jurisdictions. In the normal course of business the Company is subject to examination by taxing authorities throughout the world. The Company is subject to examination for carryforwards of research and development tax credits and net operating losses for years beginning in 1995 to the present time. The Company is not currently under federal or state income tax examination.

**Table of Contents****Note 7 Segment Reporting**

The Company operates in one business segment, the semiconductor manufacturing segment. Sales transactions are denominated in U.S. dollars.

Net revenues by product group were as follows (in thousands):

	Three Months Ended	
	July 27, 2008	July 29, 2007
EEPROM	\$ 15,130	\$ 16,418
Flash	747	780
Analog/mixed-signal	2,744	2,658
Total net revenues	\$ 18,621	\$ 19,856

Net revenues by geography were as follows (in thousands):

	Three Months Ended	
	July 27, 2008	July 29, 2007
United States	\$ 1,477	\$ 1,622
Hong Kong/China	5,975	4,495
Japan	1,223	1,737
Europe	1,827	1,807
South Korea	1,280	3,662
Taiwan	3,660	2,789
Singapore	2,531	3,047
Other Far East	506	528
Other Americas	142	169
Total net revenues	\$ 18,621	\$ 19,856

For the three months ended July 27, 2008, the Yosun Group represented 12.3% of the Company's net revenues. For the three months ended July 29, 2007, Hynix Semiconductor and Avnet represented 11.4% and 10.6% of the Company's net revenues, respectively.

Property, plant and equipment, net, geographical breakdown was as follows (in thousands):

	July 27, 2008	April 27, 2008
United States	\$ 7,349	\$ 7,513
Thailand	1,407	1,454
Romania	2,087	2,128
Japan	280	367
Other	66	133
Total net property, plant and equipment	\$ 11,189	\$ 11,595

**Note 8 Commitments and Contingencies****Purchase Commitments**

## Edgar Filing: CATALYST SEMICONDUCTOR INC - Form 10-Q

Purchase commitments for open purchase orders at July 27, 2008 and April 27, 2008 for which goods and services had not been received were approximately \$7.3 million and \$9.4 million, respectively.

### *Litigation and Other Claims*

In the normal course of business, the Company periodically receives notification of threats of legal action in relation to claims of patent infringement by the Company. Currently there are no such active actions.

**Table of Contents*****Guarantees***

In November 2002, the FASB issued FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (FIN 45). The Company applies the disclosure provisions of FIN 45 to its agreements that contain guarantee or indemnification clauses. FIN 45 requires that a liability be recorded in the guarantor's balance sheet upon issuance of a guarantee. In addition, FIN 45 requires disclosures about the guarantees that an entity has issued, including a reconciliation of changes in the entity's product warranty liabilities. These disclosure provisions expand those required by SFAS No. 5, *Accounting for Contingencies* by requiring that guarantors disclose certain types of guarantees, even if the likelihood of requiring the guarantor's performance is remote. The following is a description of significant arrangements through which the Company is a guarantor:

***Indemnification Obligations***

The Company is a party to a variety of agreements pursuant to which it may be obligated to indemnify the other party with respect to certain matters. Typically, these obligations arise in the context of contracts entered into by the Company, under which the Company customarily agrees to hold the other party harmless against losses arising from a breach of representations and covenants related to such matters as title to assets sold and certain intellectual property rights. Generally, payment by the Company is conditioned on the other party making a claim pursuant to the procedures specified in the particular contract, which procedures typically allow the Company to challenge the other party's claims. Further, the Company's obligations under these agreements may be limited in terms of time and/or amount, and in some instances, the Company may have recourse against third parties for certain payments made by it under these agreements.

It is not possible to predict the maximum potential amount of future payments under these or similar agreements due to the conditional nature of the Company's obligations and the unique facts and circumstances involved in each particular agreement. Historically, payments made by the Company under these agreements have not had a material effect on its business, financial condition, cash flows or results of operations. The Company believes that if it were to incur a loss in any of these matters, such loss should not have a material effect on its business, financial condition, cash flows or results of operations.

***Product Warranties***

The Company estimates its product warranty costs based on historical warranty claim experience and applies this estimate to the revenue stream for products under warranty. Included in the Company's sales returns reserves are estimated return exposures associated with product warranties. Estimated future costs for warranties applicable to revenues recognized in the current period are charged to the Company's cost of revenues. The warranty accrual is reviewed quarterly to verify that it properly reflects the remaining obligations based on the anticipated expenditures over the balance of the obligation period. Adjustments are made when actual claim experience differs from estimates. Warranty cost was not material for the three months ended July 27, 2008 and July 29, 2007.

**Note 9 Related Party Transactions*****Elex N.V. and Xtrion N.V.***

The Company purchases wafers fabricated by X-FAB, a majority-owned subsidiary of Xtrion, a Belgium holding company. X-FAB was formerly owned by Elex, a Belgium holding company. Elex's ownership in X-FAB was transferred to Xtrion. Roland Duchâtelet, the chairman and chief executive officer of Elex, serves as a member of the Company's board of directors and is a major shareholder in both Elex and Xtrion. The wafers provided by X-FAB include most of the Company's analog/mixed-signal products and supplement some of the same EEPROM designs fabricated at various other foundries the Company utilizes. Other than purchase orders currently open with X-FAB, there is no purchasing agreement in place with X-FAB. In March 2008, the Company entered into a development contract with X-FAB for \$220,000. A prepayment of \$120,000 was made at signing, with the balance due upon delivery of the first silicon. The Company has recognized \$32,000 in expenses towards this contract to date, of which \$8,000 was incurred in the quarter ended July 27, 2008.

During the three months ended July 27, 2008 and July 29, 2007, the Company purchased \$391,000 and \$344,000 of wafers, respectively, from X-FAB. As of July 27, 2008 and April 27, 2008, the total amount due X-FAB was \$195,000 and \$250,000, respectively.



**Table of Contents**

Elex held approximately 4.7% of the Company's outstanding shares of common stock as of July 27, 2008.

**Note 10 Other Comprehensive Income (Loss)**

The components of other comprehensive income (loss), net of tax, are presented in the following table (in thousands):

	Three Months Ended	
	July 27, 2008	July 29, 2007
Reported net income	\$ 489	\$ 720
Other comprehensive income:		
Unrealized gain (loss) on available-for-sale investments, net of related tax	(12)	3
Total comprehensive income	\$ 477	\$ 723

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

*This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, (the Securities Act) and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act), which involve risks and uncertainties. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors that include, but are not limited to, the risks discussed in Part II, Item 1A Risk Factors and elsewhere in this Quarterly Report on Form 10-Q and similar discussions in our other filings with the Securities and Exchange Commission (SEC) including our Annual Report on Form 10-K for the year ended April 27, 2008. These forward-looking statements include, but are not limited to: the statements relating to demand for and supply of our Company's products; the statements relating to downward pricing trends and average selling prices; the statements relating to reduction of expenses related to our Thailand subsidiary; the statements relating to the increasing portion of our net revenues from analog/mixed-signal products; the statements relating to the sufficiency of our cash resources and cash flows to fund our operating and capital requirements and the risks associated with seeking additional financing, uncertainty around the pending merger with ON, and statements relating to our compliance with existing environmental regulations. These forward-looking statements are based on current expectations and entail various risks and uncertainties that could cause actual results to differ materially from those projected in the forward-looking statements. In addition, historical information should not be considered an indicator of future performance. We undertake no obligation to update publicly any forward-looking statements for any reason, even if new information becomes available or other events occur, except as required by law.*

**Pending Merger With ON Semiconductor Corporation**

On July 16, 2008, we entered into an Agreement and Plan of Merger and Reorganization (the Merger Agreement) with ON Semiconductor Corporation, a Delaware Corporation (ON), and Centaur Acquisition Corporation, a Delaware corporation and a wholly-owned subsidiary of ON, pursuant to which ON has agreed to acquire us subject to the terms and conditions set forth in the Merger Agreement (the Merger) in an all-stock transaction with an equity value of approximately \$115 million. Based on the July 16, 2008 closing stock price of ON, this represents a value to our stockholders of approximately \$6.24 per share. The Merger Agreement was unanimously approved by the Board of Directors of both ON and Catalyst.

Subject to the terms and conditions of the Merger Agreement, each share of the Catalyst common stock that is outstanding at the effective time of the Merger shall be converted into the right to receive 0.706 of a share of ON's common stock. The Merger is intended to be a tax-free reorganization for federal income tax purposes, and it therefore is expected that no gain or loss will be recognized by the holders of Catalyst common stock with respect to the shares of ON common stock they receive in exchange for their shares of Catalyst common stock. The transaction is subject to the approval of our stockholders as well as customary closing conditions and regulatory approvals. The companies expect the transaction to close in the fourth calendar quarter of 2008.

**Overview**

We design, develop and market a broad line of reprogrammable non-volatile memory products and analog/mixed-signal semiconductor products. Our products are used by manufacturers of electronic products in a wide range of consumer, computing, communications, industrial and automotive applications. We generally target high-volume markets for our cost-effective, high quality products.

The market for our non-volatile memory is highly competitive and market participants have relatively weak pricing power. Average selling prices (ASPs) of our non-volatile memory products have declined over time and prices are sensitive to conditions in our OEM customers' target markets. In general, we expect the average selling price for a given memory product to decline over time, primarily due to market competition, product availability and manufacturing capacity. In response to that trend, we continue to work with our foundries and other vendors to increase the manufacturing efficiency of our products. Through periods of tight manufacturing capacity and cyclical downturns, we have demonstrated consistent long-term commitment to the memory products market.

We have leveraged our extensive experience in high-volume, reprogrammable memory products to develop complementary analog/mixed-signal products. We have strengthened and expanded the expertise of our research and development team by establishing our own development center in Bucharest, Romania. We continue to make substantial investments in research and development to grow our line of analog/mixed-signal products, while also advancing our non-volatile memory products. Our subsidiary in Thailand, incorporated in 2007, is expected to provide a majority of the inventory management and manufacturing test functions that were previously subcontracted to a third party, as well as reduce our manufacturing and tax expense and improve our control over the personnel and assets located in Thailand.



## **Table of Contents**

Our business is less capital intensive than traditional semiconductor companies because we outsource the wafer fabrication, assembly and approximately 50% of the final testing of our products to third parties. We strive to maintain long-term relationships with our suppliers to ensure stability in our supply of products at a competitive cost. In addition, we maintain a supply of wafers in a die bank for selected products in an effort to alleviate any potential wafer capacity constraints.

We market and sell our products directly through our sales force and sales representatives to OEMs and indirectly through distributors and resellers who sell to their end customers. Indirect sales represented 58.3% and 55.1% of net revenues in the three months ended July 27, 2008 and July 29, 2007, respectively. Our total customer base, including OEMs and end-customers of our distributors and resellers, is relatively diverse and consists of more than 3,200 end customers. We have approximately 46 distributors and resellers.

Distributors and resellers have accounted for a significant portion of our net revenues. For the three months ended July 27, 2008, the Yosun Group represented 12.3% of our net revenues. For the three months ended July 29, 2007, Avnet represented 10.6% of our net revenues.

Our sales are initiated by purchase orders received from our customers and are typically shipped within a few weeks of receiving the order. Cancellations of customer orders and distributor price protection, both of which are standard semiconductor industry practices, could result in the loss of future net revenues without allowing us sufficient time to reduce our inventory and operating expenses.

Sales to customers outside the United States comprised approximately 92.1% and 91.8% of our net revenues for the three months ended July 27, 2008 and July 29, 2007, respectively. All sales of our products are denominated in U.S. dollars.

## **Description of Operating Accounts**

*Net Revenues.* Net revenues consist of product sales, net of returns and allowances and any recoveries from sales of previously written down inventories.

*Cost of Revenues.* Cost of revenues consists primarily of costs of manufacturing, assembly and testing of our products, compensation (including stock-based compensation) and associated costs related to manufacturing support, inbound freight shipments and quality assurance personnel, as well as provision for excess and obsolete inventories. It also can include, on occasion, adjustments to inventory valuations based on demand and average selling prices expected in future periods.

*Gross Profit.* Gross profit is net revenues less cost of revenues and is affected by a number of factors, including competitive pricing, product mix, foundry pricing, the cost of test and assembly services, manufacturing yields and provision for excess and obsolete inventories.

*Research and Development.* Research and development expense consists primarily of compensation (including stock-based compensation) and associated costs for engineering, technical and support personnel, contract engineering services, depreciation of equipment and cost of wafers and mask sets used to evaluate new products and new versions of current products.

*Selling, General and Administrative.* Selling, general and administrative expense consists primarily of compensation (including stock-based compensation) and associated costs for sales, marketing and administrative personnel, commissions, promotional activities, bad debt expense, outbound freight shipments, professional fees including audit and costs associated with Sarbanes-Oxley compliance, and director and officer insurance.

## **Critical Accounting Policies and Estimates**

The preparation of our condensed consolidated financial statements and related disclosures in conformity with accounting principles generally accepted in the United States requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue, cost of revenues, expenses and related disclosure of contingencies. On an on-going basis, we evaluate our estimates, including those related to revenue recognition, inventory valuation, accounts receivable and allowance for doubtful accounts, stock-based compensation and income taxes. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, and apply them on a consistent basis. We believe that such consistent application results in condensed consolidated financial statements and accompanying notes that fairly state our financial condition, operating results and cash flows for all periods presented.

## **Table of Contents**

However, any factual errors or errors in these estimates and judgments may have a material impact on our financial conditions, operating results and cash flows. There have been no significant changes to our critical accounting policies and estimates since April 27, 2008.

### ***Recognition of Revenues***

We generally recognize revenues as products are shipped if all of the following criteria are met:

we have evidence that a sales arrangement exists;

our customer has taken title to the products;

we have performed the services, if any;

the sales price is fixed or determinable;

we believe that collection of the resulting receivable is reasonably assured; and

we can reasonably estimate product returns.

We sell our products directly through our sales force and sales representatives to OEMs and indirectly through distributors and resellers who sell to their end customers. We recognize revenues upon delivery to OEM customers and resellers who have no, or limited, product return rights and no price protection rights. We deem that delivery occurs when legal title and the risk of loss transfers to the customer. Delivery is generally defined by the customers' shipping terms, as stated in the related purchase order. If the customers' purchase orders do not define the shipping terms, the shipping terms will be Ex-Works as defined in our invoice. We record an estimated allowance for returns from OEM customers and resellers, based on a percentage of our revenues. This estimate is based on historical averages and management's estimate of future trends.

We sell products to certain distributors under agreements that provide for product return and price protection rights. These agreements generally permit the distributor to return up to 10% by value of the total products that the distributor has purchased from us every six months, in exchange for credit on a replacement order of the same value. We defer recognition of revenues until the time the distributor resells the product to an end-customer, at which time the sales price becomes fixed. On a monthly basis, we receive point of sales and ending inventory information from each distributor. Using this information, we determine the amount of revenues to recognize. For distributors who have product return rights, we also record an inventory reserve to address the cost of products we anticipate that we will not be able to resell after their return by the distributors. For distributors who have price protection rights, distributors may take the associated credits immediately and in general, we process the credits one or two months after the credit is earned by the distributor. We record a reserve to cover the estimated liability of those unprocessed credits.

In assessing the timing of revenue recognition from sales to distributors and resellers, we consider both direct and indirect risks of returns and price protection associated in our business dealings with them. We recognize that we may accept returns or grant price protection to certain resellers, even though the sales contracts do not explicitly provide for such rights. Accordingly, we account for sales to such resellers on a sell through basis.

We re-evaluate our revenue recognition policies on an ongoing basis.

### ***Inventory Valuation***

We value our inventory at the lower of standard cost or net realizable value. Standard cost approximates actual cost on a first-in, first-out basis. We routinely evaluate the value and quantities of our inventory in light of the current market conditions and market trends and we record reserves for quantities in excess of demand, cost in excess of market value and product age. Our analysis may take into consideration historical

## Edgar Filing: CATALYST SEMICONDUCTOR INC - Form 10-Q

usage, expected demand over the next 12 months, anticipated sales price, new product development schedules, the effect new products might have on the sales of existing products, product age, customer design activity, customer concentration and other factors. Our forecasts for our inventory may differ from actual inventory use.

We reduce the value of our inventory by analyzing on-hand quantities and open purchase orders which are in excess of demand equal to the cost of inventory that exceeds expected demand for the next 12 months. We make judgments in establishing these provisions and do not establish provisions if we believe we can sell the excess inventory. If market conditions are less favorable than those we estimate, we may be required to write down inventory. If we overestimate the

## **Table of Contents**

future selling prices, we will incur additional losses when the inventory is sold for a lower price or when we establish additional write downs to cover the even lower estimated sales price. Once written down, we do not reverse inventory provisions until the associated inventory has been sold or physically scrapped.

### ***Allowance for Doubtful Accounts***

We estimate the collectibility of our accounts receivable at the end of each reporting period. We analyze the aging of accounts receivable and bad debt history, payment history, customer concentration, customer credit worthiness and current economic trends when evaluating the adequacy of the allowance for doubtful accounts. We maintain an allowance for doubtful accounts, which is created by charges to selling, general and administrative expenses. Our accounts receivable balance was \$11.4 million, net of allowance for doubtful accounts of \$23,000 as of July 27, 2008.

### ***Stock-Based Compensation***

Effective May 1, 2006, we adopted the provisions of SFAS No. 123(R). We estimate the fair value of stock options using the Black-Scholes option pricing model ( Black-Scholes model ), consistent with the provisions of SFAS No. 123(R) and SEC Staff Accounting Bulletin No. 107, Share-Based Payment. Option-pricing models require the input of highly subjective assumptions, including the price volatility of the underlying stock. The expected term assumption used in calculating the estimated fair value of our stock-based compensation awards using the Black-Scholes model is based primarily on detailed historical data about employees' exercise behavior and vesting schedules. In addition, we are required to estimate the expected forfeiture rate and only recognize expense for those shares expected to vest. We estimate the forfeiture rate based on historical experience of our stock-based awards that have been granted and forfeited prior to vesting. Stock-based compensation is amortized on a straight-line basis and allocated to cost of revenues, research and development and selling, general and administrative expenses in the accompanying condensed consolidated statements of operations based on the related employee's function.

### ***Income Taxes***

As part of the process of preparing our consolidated financial statements, we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves estimating our current tax exposure and assessing temporary differences resulting from differing treatment of items, such as deferred revenues, for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included on our balance sheet on a net basis. We then assess the likelihood that our deferred tax assets will be recovered from future taxable income and to the extent we establish a valuation allowance or increase this allowance in a period, we will include an additional tax provision in the statement of operations.

The calculation of tax liabilities involves dealing with uncertainties in the application of complex global tax regulations. We recognize potential liabilities for anticipated tax audit issues in the U.S. and other tax jurisdictions based on its estimate of whether, and the extent to which, additional taxes will be due. If payment of these amounts ultimately proves to be unnecessary, the reversal of the liabilities that would result in tax benefits being recognized in the period when we determine that liabilities are no longer necessary. If the estimate of tax liabilities proves to be less than the ultimate assessment, a further charge to expense would result.

We make significant judgments in determining our provision for income taxes, our deferred tax assets and any valuation allowance recorded against our net deferred tax asset. Our net deferred tax assets, consisting primarily of net operating loss carryforwards, tax credit carryforwards and currently nondeductible reserves and accruals, were valued at \$6.1 million as of July 27, 2008 and April 27, 2008. Our valuation allowance was zero as we have concluded that it is more likely than not that all of our deferred tax assets will be realizable, based on available objective evidence and our history of taxable income.

**Table of Contents****Results of Operations**

The following table sets forth the results of our operations as a percentage of net revenues for the periods indicated:

	Three Months Ended	
	July 27, 2008	July 29, 2007
Net revenues	100.0%	100.0%
Cost of revenues	61.6	63.8
Gross profit	38.4	36.2
Operating expenses:		
Research and development	11.6	10.6
Selling, general and administrative	23.6	21.8
Income from operations	3.2	3.8
Interest income and other, net	0.6	2.2
Income before income taxes	3.8	6.0
Income tax provision	1.2	2.4
Net income	2.6%	3.6%

The following table sets forth net revenues (in thousands) and percentage of net revenues by product group:

	Three Months Ended			
	July 27, 2008		July 29, 2007	
EEPROM	\$ 15,130	81.3%	\$ 16,418	82.7%
Flash	747	4.0	780	3.9
Analog/mixed-signal	2,744	14.7	2,658	13.4
Net revenues	\$ 18,621	100.0%	\$ 19,856	100.0%

**Comparison of the Three Months Ended July 27, 2008 and July 29, 2007**

*Net Revenues.* Our net revenues decreased approximately \$1.2 million, or 6.2%, to \$18.6 million for the three months ended July 27, 2008 from \$19.9 million for the three months ended July 29, 2007. Total unit volume increased by 9% for the three months ended July 27, 2008.

Net revenues for our EEPROM products decreased by approximately \$1.3 million, or 7.8%, to \$15.1 million and represented 81.3% of our total net revenues for the three months ended July 27, 2008. The decline was driven by the difference in EEPROM product mix sold during the period, as well as lower ASPs due to competitive market conditions. Unit volume increased by 7%.

Our analog/mixed-signal products, which have higher gross margins, increased by approximately \$86,000 or 3.2% to \$2.7 million, and represented 14.7% of our total net revenues for the three months ended July 27, 2008. The growth was mainly due to increased demand for our supervisor products. Unit volume increased by 27%.

Net revenues for our line of flash memory products, which are a legacy business with declining industry utilization, decreased by \$33,000, or 4.2%, to \$747,000 and represented 4.0% of our total net revenues for the three months ended July 27, 2008. Unit volume decreased by 8%.

Our customers and end-users overseas activities continue to be our major source of revenues. Sales to customers outside the United States represented approximately 92.1% of net revenues for the three months ended July 27, 2008 as compared to 91.8% of net revenues for the three months ended July 29, 2007.



## Edgar Filing: CATALYST SEMICONDUCTOR INC - Form 10-Q

*Gross Profit.* Gross profit decreased approximately \$27,000, or 0.4%, to approximately \$7.2 million for the three months ended July 27, 2008 from \$7.2 million for the three months ended July 29, 2007. On a percentage basis, gross margin increased from 36.2% for the three months ended July 29, 2007 to 38.4% for the three months ended July 27, 2008.

The increase in gross profit percentage was mainly due to the reduction in our back-end manufacturing costs and lower inventory write downs of excess and old date code material compared to the same period in the prior year.

**Table of Contents**

*Research and Development.* Research and development expense increased approximately \$54,000, or 2.6%, to \$2.2 million for the three months ended July 27, 2008 from \$2.1 million for the three months ended July 29, 2007. As a percentage of net revenues, research and development expense was 11.6% and 10.6% for the three months ended July 27, 2008 and July 29, 2007, respectively. The increase for the three month period ended July 27, 2008 was primarily attributable to a higher stock-based compensation expense of \$191,000, which was partially offset by a \$160,000 reduction in bonus expense.

*Selling, General and Administrative.* Selling, general and administrative expense increased \$65,000, or 1.5%, to \$4.4 million for the three months ended July 27, 2008 from \$4.3 million for the three months ended July 29, 2007. As a percentage of net revenues, selling, general and administrative expense was 23.6% and 21.8% for the three months ended July 27, 2008 and July 29, 2007, respectively. The increase was attributable to higher compensation costs of \$206,000 for new employees in the sales and marketing organization. In addition, stock-based compensation expense was higher by \$123,000. The increase in these expenses was offset by reductions of \$188,000 in commissions for outside sales representatives and \$48,000 in bonus expense.

*Interest Income and Other, net.* We earned interest and other income, net, of \$117,000 for the three months ended July 27, 2008 as compared to interest and other income, net, of \$429,000 for the three months ended July 29, 2007. The decrease primarily resulted from a lower rate of return of approximately 2.1% for the three months ended July 27, 2008 compared to approximately 5.0% for the three months ended July 29, 2007.

*Income Tax Provision.* The provision for income taxes was \$223,000, or 31.3% of income before taxes, for the three months ended July 27, 2008. The provision for income taxes was \$451,000, or 38.5% of income before taxes, for the three months ended July 29, 2007. The lower effective income tax rate for the three months ended July 27, 2008 was due to higher non-taxable income associated with our new internal test operations in Thailand, which operate under a tax holiday that expires in October 2014.

**Liquidity and Capital Resources**

At July 27, 2008, we had cash, cash equivalents and short-term investments of \$27.4 million as compared to \$29.6 million at April 27, 2008. We invest our excess cash in short-term financial instruments to generate interest income. These instruments are U.S. government and U.S. government agency debt securities, the majority of which have maturities that are less than one year. They are highly liquid and can be converted to cash at any time.

Historically, our primary source of cash has been provided through operations and the issuance of our common stock. Our historical uses of cash have primarily been for operating activities as well as capital expenditures. Supplemental information pertaining to our historical sources and uses of cash is presented as follows and should be read in conjunction with our unaudited condensed consolidated statements of cash flows and notes thereto (in thousands):

	Three months ended	
	July 27, 2008	July 29, 2007
Net cash provided by (used in) operating activities	\$ (2,181)	\$ 1,492
Net cash proceeds from sales and purchases of short-term investments	5,478	4,557
Acquisition of property, plant and equipment	(71)	(358)
Employee exercises of stock options	93	204
Treasury stock repurchases	\$	\$ (98)

**Net Cash from Operating Activities**

In the three months ended July 27, 2008, cash used by operating activities was \$2.2 million, which is due to a \$3.9 million change in working capital items mainly from increases in accounts receivable and inventory, as well as decreases in accrued liabilities and deferred gross profit on shipments to distributors. Net income contributed \$489,000, adjusted for non-cash depreciation and amortization on property, equipment and leasehold improvements of \$477,000 and stock-based compensation expense of \$767,000.

**Table of Contents**

In the three months ended July 29, 2007, we generated cash from operating activities of \$1.5 million, which was primarily due to net income of \$720,000, adjusted for non-cash items such as depreciation and amortization of \$514,000, stock-based compensation of \$451,000 and a net increase in inventory reserves of \$183,000. Additionally, our net working capital during the period decreased by \$949,000, primarily due to the increase in accounts receivable resulting from a higher level of net revenues.

**Net Cash from Investing Activities**

In the three months ended July 27, 2008, cash provided by investing activities was \$5.4 million, which principally consisted of net proceeds from the sales and purchases of short-term investments of \$5.5 million, offset by capital expenditures of \$71,000 related to the purchase of computer equipment.

In the three months ended July 29, 2007, investing activities provided \$4.2 million, primarily related to proceeds from the sales and maturities of our short-term investments of \$6.7 million, which were offset in part by purchases of short-term investments of \$2.2 million. We had capital expenditures of \$358,000, related to the purchase of computer hardware, masks and engineering test equipment.

**Net Cash from Financing Activities**

In the three months ended July 27, 2008, cash provided by financing activities was \$93,000, which consisted of proceeds from the sale of common stock through the exercise of stock options.

In the three months ended July 29, 2007, cash provided by financing activities was \$106,000, consisting of \$204,000 in proceeds from the sale of common stock through the exercise of stock options, offset in part by approximately \$98,000 for repurchases of an aggregate of 22,800 shares of our common stock on the open market as part of our stock repurchase program.

**Common Stock Repurchase Plan**

For information with respect to activity under our common stock repurchase plan and the impact of these transactions on our consolidated financial statements, see Note 3 of Notes to Unaudited Condensed Consolidated Financial Statements.

**Contractual Obligations and Commercial Commitments**

The following table summarizes our contractual obligations as of July 27, 2008 and the effects these obligations and commitments are expected to have on our liquidity and cash flows in future periods (in thousands):

	Total	Payments Due by Period			More Than 5 Years
		Less Than 1 Year	1-3 Years	4-5 Years	
<i>Contractual cash obligations</i>					
Operating leases	\$ 596	\$ 232	\$ 364	\$	\$
Wafer purchases	6,837	6,837			
Other purchase commitments	503	503			
<b>Total contractual cash obligations</b>	<b>\$ 7,936</b>	<b>\$ 7,572</b>	<b>\$ 364</b>	<b>\$</b>	<b>\$</b>

Our long-term income tax payable has been excluded from the table above because the timing of any future cash outflows is uncertain. As discussed in Note 6 Income Taxes, we adopted the provisions of FIN 48 on April 30, 2007. At July 27, 2008, we had approximately \$1.0 million of gross unrecognized tax benefits that may be subject to examination by applicable tax authorities. Although timing of the resolution and/or closure on audits is highly uncertain, we do not believe it is reasonably possible that the unrecognized tax benefits would materially change in the next 12 months.

**Off-Balance Sheet Arrangements**

As of July 27, 2008, we did not have any off-balance sheet arrangements.

*Future Liquidity*

We believe that our current cash, cash equivalents and available-for-sale securities will be sufficient to meet our anticipated operating and capital requirements for at least the next 12 months. We have no current plans, nor are we currently negotiating, to obtain additional financing. Our long-term plan is to finance our core business operations with cash we generate from operations. However, from time to time we may raise additional capital through a variety of sources, including

## **Table of Contents**

the public equity market, private financings, collaborative arrangements and debt. The additional capital we raise could be used for working capital purposes, to fund our research and development activities or our capital expenditures or to acquire complementary businesses or technologies. If we raise additional capital through the issuance of equity or securities convertible into equity, our stockholders may experience dilution. Those securities may have rights, preferences or privileges senior to those of the holders of the common stock. Additional financing may not be available to us on favorable terms, if at all. If we are unable to obtain financing, or to obtain it on acceptable terms, we may be unable to successfully support our business requirements.

### **Effects of Transactions with Related Parties**

For information with respect to related party transactions and the impact of these transactions on our consolidated financial statements, see Note 9 of Notes to Unaudited Condensed Consolidated Financial Statements.

### **New Accounting Pronouncements**

For information with respect to recent accounting pronouncements and the impact of these pronouncements on our consolidated financial statements, see Note 2 of Notes to Unaudited Condensed Consolidated Financial Statements.

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

*Interest Rate Risk.* We do not use derivative financial instruments in our investment portfolio. Our investment portfolio is generally comprised of U.S. government and U.S. government agency debt securities. Our policy is to place these investments in instruments that meet high credit quality standards and have maturities of less than two years with an overall average maturity of less than one year. These securities are subject to interest rate risk and could decline in value if interest rates fluctuate. Due to the short duration of the securities in which we invest and the conservative nature of our investment portfolio, a 10% change in interest rates would have an immaterial effect on our financial position, results of operations and cash flows through April 2009.

*Foreign Currency Exchange Rate Risk.* All of our sales and a substantial majority of our manufacturing costs, research and development and marketing expenses are transacted in U.S. dollars. Gains and losses from fluctuations in exchange rates, primarily related to our operations in Romania and Thailand, have not been material to date.

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

Based on their evaluation as of July 27, 2008, our management, including our principal executive officer and principal financial officer, have concluded that our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act) are effective to provide reasonable assurance that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms and is accumulated and communicated to management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

### ***Changes in Internal Control Over Financial Reporting***

There were no changes in our internal control over financial reporting during our last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

### ***Inherent Limitations on Effectiveness of Controls***

Our management, including our principal executive officer and principal financial officer, does not expect that our disclosure controls and procedures or our internal controls, will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within our company have been detected.



---

**Table of Contents**

**PART II**

**OTHER INFORMATION**

**Item 1. Legal Proceedings**

We are not a party to any material legal proceedings as of the date of this report.

**Item 1A. Risk Factors**

*We are subject to a number of risks. Some of these risks are endemic to the high-technology and semiconductor industry and are the same or similar to those disclosed in our previous SEC filings. This section should be read in conjunction with the unaudited condensed consolidated financial statements and the accompanying notes thereto, and Management's Discussion and Analysis of Financial Condition and Results of Operations included in this Quarterly Report on Form 10-Q. The risks and uncertainties set out below are not the only risks and uncertainties we face. Our business could be harmed by any of these risks. The trading price of our common stock could decline due to any of these risks and investors may lose all or part of their investment. The information included in this Quarterly Report on Form 10-Q is provided as of the filing date with the SEC and future events or circumstances could differ significantly from the forward-looking statements included herein.*

***Risks Related to the Pending Merger***

***Uncertainty about the pending merger with ON could harm our business, whether or not the merger is completed.***

In response to the announcement of the pending merger with ON, existing or prospective customers may delay or defer their purchasing or other decisions, or they may seek to change their existing business relationships. In addition, as a result of the merger, current and prospective employees could experience uncertainty about their future with us, and we could lose key employees as a result. In addition to retention, these uncertainties may also impair our ability to recruit or motivate key personnel. Completion of the merger will also require a significant amount of time and attention from management and may detract from our ability to grow revenues and achieve our corporate objectives. The distraction could also adversely affect ongoing operations and business relationships. In addition, we may be unable to respond effectively to competitive pressures, industry developments and future opportunities.

***Failure to complete the merger with ON could adversely affect our stock price and future business and financial results.***

Completion of the merger is conditioned upon, among other things, the receipt of regulatory approvals and the approval of our stockholders. There is no assurance that we will receive the necessary approvals or satisfy the other conditions to the completion of the merger. Failure to complete the proposed merger would prevent ON and Catalyst from realizing the anticipated benefits of the merger. We would also remain liable for significant transaction costs, including legal, accounting and financial advisory fees. In addition, the market price of our common stock may reflect various market assumptions as to whether the merger will occur. Consequently, the completion of, or failure to complete, the merger could result in a significant change in the market price of our common stock.

***The ability to complete the merger is subject to the receipt of consents and approvals from government entities, which may impose conditions that could have an adverse effect on ON or Catalyst or could cause either party to abandon the merger.***

In deciding whether to grant antitrust and competition approvals, the relevant governmental entities will consider the effect of the merger on competition within their relevant jurisdictions. The terms and conditions of the approvals that are granted, if accepted, may impose requirements, limitations, or costs or place restrictions on the conduct of ON's business following the merger.

Neither ON nor Catalyst can provide any assurance that either company will obtain the necessary approvals or that any other conditions, terms, obligations, or restrictions sought to be imposed, and if accepted, would not have a material adverse effect on ON following the merger. In addition, we can provide no assurance that these conditions, terms, obligations, or restrictions will not result in the delay or abandonment of the merger.





## **Table of Contents**

*The merger agreement contains provisions that could discourage a potential alternative acquirer that might be willing to pay more to acquire us.*

The merger agreement contains no shop provisions that restrict our ability to solicit or facilitate proposals regarding a merger or similar transaction with another party. Further, there are only limited exceptions to our agreement that our board of directors will not withdraw or adversely qualify its recommendation regarding the merger agreement. Although our board of directors is permitted to terminate the merger agreement in response to an unsolicited third party proposal to acquire Catalyst, which our board of directors determines to be more favorable than the merger with ON, if our board of directors determines that a failure to do so would result in a breach of its fiduciary duties, its doing so would entitle ON to collect a \$3.27 million termination fee from us. In addition, ON is entitled to be paid the termination fee by Catalyst if (i) either ON or Catalyst terminates the merger agreement because we do not obtain the required stockholder vote, (ii) at the time of the merger termination, a third party has publicly announced an acquisition proposal for Catalyst that was not absolutely and unconditionally withdrawn and abandoned more than ten business days prior to the stockholders meeting, and (iii) within twelve months of the date of the merger termination, we consummate an acquisition transaction or enters into an acquisition agreement relating to an acquisition proposal.

These provisions could discourage a potential third party acquirer from considering or proposing an alternative acquisition, even if it was prepared to pay consideration with a higher value than that proposed to be paid in the merger, or might result in a potential third party acquirer proposing to pay a lower per share price than it might otherwise have proposed to pay because of the added expense of the termination fee.

### ***Risks Related to our Business***

The following risk factors assume that we remain a standalone company except unless otherwise noted.

***Our quarterly operating results may fluctuate due to many factors and are difficult to forecast, which may cause the trading price of our common stock to decline substantially.***

Our operating results have historically been and in the future may be adversely affected or otherwise fluctuate due to factors such as:

fluctuations in customer demand for the electronic devices into which our products are incorporated;

volatility in demand affecting semiconductor prices generally, such as an increase in the supply of competitive products and a significant decline in average selling prices;

volatility in supply affecting our ability to meet customer demand;

establishment of additional inventory reserves if sales of our inventory fall below our expected sales, or the anticipated selling prices of our products fall below the amounts paid to produce and sell certain parts;

changes in our product mix including product category, density, package type, lead content or voltage;

inadequate visibility of future demand for our products;

timing of new product introductions and orders for our products;

## Edgar Filing: CATALYST SEMICONDUCTOR INC - Form 10-Q

increases in expenses associated with new product introductions and promotions, process changes and/or expansion of our sales channels;

timing of audit fees and increases in expenses to comply with new accounting regulations;

increases in wafer prices due to increased market demand and other factors;

increases in prices charged by our suppliers due to increased costs, decreased competition and other factors;

fluctuations in manufacturing yields;

gains or losses of significant OEM customers or indirect channel sellers, such as distributors or resellers;

increases in costs associated with evaluating strategic alternatives or merger or acquisitions;

## Table of Contents

changes in our accounting principles as a consequence of our adoption of SFAS No. 123(R) and FIN 48; and

general economic conditions.

Our net revenues and operating results are difficult to forecast. We base our expense levels, in significant part, on our expectations of future net revenues and our expenses are therefore relatively fixed in the short term. If our net revenues fall below our forecasts, our operating results are likely to be disproportionately adversely affected because our costs are difficult to reduce significantly in the short term.

***We may never realize a material portion of our net revenues from our analog/mixed-signal products, despite our expenditure of a disproportionate amount of our research and development and marketing resources on these products.***

Analog/mixed-signal products accounted for 14.7% and 13.4% of net revenues for the three months ended July 27, 2008 and July 29, 2007, respectively. We believe that the growth in our analog/mixed-signal product revenues has been limited due to the extended product design cycles and production lead times and a sales force that is still gaining experience selling these products. We continue to invest in and devote research and development and marketing resources to analog/mixed-signal products with the expectation that our analog/mixed-signal products will be accepted by many of our current customers and additional new customers. Competition is intense and our ability to compete is impacted by our relatively limited range of products while our more established competitors are offering a much broader array of analog/mixed-signal products. Many customers favor a vendor that offers a broad range of products. If we are unable to realize more revenues from these products, our net revenues may not grow. In addition, if we devote a disproportionate amount of our research and development resources to analog/mixed-signal products, our development of new non-volatile memory products may suffer and operating results may be harmed.

***We have in the past been unable and in the future we may be unable to obtain sufficient quantities of wafers from our current foundry suppliers to fulfill customer demand.***

We currently purchase a majority of our production wafers from two foundries, OKI Semiconductor and X-FAB. In June 2008, we signed a wafer supply agreement with OKI Semiconductor for a five year period. However, OKI Semiconductor recently announced the spin-off of its semiconductor unit and transfer of 95% of the new company's shares to Rohm Co. Ltd. Although we do not expect this to materially affect our relationship with OKI Semiconductor, our business could be adversely affected by this development. In addition, we do not presently have a wafer supply agreement with X-FAB and instead purchase wafers on a purchase order and acceptance basis. To address our wafer supply concerns, we plan to continue expanding our foundry capability by qualifying our products in multiple fabrication plants owned by our current and other suppliers. As the need arises, from time to time, we may pursue additional wafer sources. However, we cannot be certain that these efforts will provide us with access to adequate capacity in the future at costs which will enable us to remain profitable. Even if such capacity is available from another manufacturer, the qualification process and time required to make the foundry fully operational for us could take many months or longer and be subject to other factors described below and the prices could be materially higher. Our business, financial condition and results of operations could be materially adversely affected by:

inadequate wafer supplies to meet our production needs;

the loss of any of our current foundries as a supplier;

increased prices charged by these independent foundries;

reduced control over delivery schedules, manufacturing yields and costs;

our inability to qualify our current foundry suppliers for additional products; and

any other problems foundries may have that cause a significant interruption in our supply of semiconductor wafers.

*We may forecast incorrectly and produce excess or insufficient inventories of particular products, which may adversely affect our results of operations.*

Since we must order products and build inventory substantially in advance of product shipments, we may forecast incorrectly and produce excess or insufficient inventories of particular products. The ability of our customers to reschedule

**Table of Contents**

or cancel orders without significant penalty could adversely affect our liquidity, as we may be unable to adjust our purchases from our wafer suppliers to match any customer changes and cancellations. As part of our business strategy, we maintain a substantial inventory of sorted wafers in a die bank but limit our investment in finished goods. We may have adequate wafer inventory to meet customer needs but may be unable to finish the manufacturing process prior to the delivery date specified by the customer. Demand for our products is volatile and customers often place orders with short lead times. Our inventory may not be reduced by the fulfillment of customer orders and in the future we may produce excess quantities of our products.

It is our policy to fully write down all inventories that we do not expect to sell in a reasonable period of time. During recent fiscal years, as a result of reductions in estimated demand for our various products, we have taken charges for write down of inventories for certain products, primarily our EEPROM products. For example, we recorded inventory write down charges of \$186,000 and \$279,000 for the three months ended July 27, 2008 and July 29, 2007, respectively, which were partially offset by benefits of \$163,000, and \$96,000, respectively, relating to products that were written off in prior periods and sold during these periods. We may suffer reductions in values of our inventories in the future and we may be unable to liquidate our inventory at acceptable prices. To the extent we have excess inventories of particular products, our operating results could be adversely affected by charges to cost of revenues that we would be required to recognize due to significant reductions in demand for our products or rapid declines in the market value of inventory, resulting in inventory write downs or other related factors.

***We may be unable to fulfill all our customers' orders according to the schedule originally requested due to the constraints in our wafer supply and processing time from die bank to finished goods, which could result in reduced revenues or higher expenses.***

Due to the lead time constraints in our wafer supply, foundry activities and other manufacturing processes, from time to time we have been unable to fulfill all our customers' orders on the schedule originally requested. Although we attempt to anticipate pending orders and maintain an adequate supply of wafers and communicate to our customers delivery dates that we believe we can reasonably expect to meet, our customers may not accept the alternative delivery date or may cancel their outstanding orders. Reductions in orders received or cancellation of outstanding orders would result in lower net revenues and reduced operating results, excess inventories and increased inventory reserves. We may also be required to pay substantially higher per wafer prices to replenish our die bank, which could harm our gross margins. If we were requested to pay rush charges to our manufacturing or foundry suppliers to meet a customer's requested delivery date, our expenses would increase and possibly harm our operating results.

***We rely on distributors and resellers for a substantial portion of our net revenues and if our relationships with one or more of those distributors or resellers were to terminate, our operating results may be harmed.***

We market and distribute our products primarily through independent distributors and resellers, which typically offer competing products. These distribution channels have been characterized by rapid change, including consolidations and financial difficulties. During the three months ended July 27, 2008 and July 29, 2007, distributors and resellers accounted for approximately 58.3% and 55.1% of our net revenues, respectively. For the three months ended July 27, 2008, the Yosun Group represented 12.3% of our net revenues. For the three months ended July 29, 2007, Avnet represented 10.6% of our net revenues.

Our business depends on these third parties to sell our products. As a result, our operating results and financial condition could be materially adversely affected by the loss of one or more of our current distributors or resellers, additional volume pricing arrangements, order cancellations, delay in shipment by one of our distributors or resellers, or the failure of our distributors or sellers to successfully sell our products.

In addition, we have experienced and may continue to experience lower margins on sales to certain customers as a result of volume pricing arrangements. We also do not typically enter into long-term arrangements with our customers and we cannot be certain as to future order levels from our customers. When we do enter into long-term arrangements, the contracts are generally terminable at the convenience of either party and it may be difficult to replace that source of revenues in the short-term upon cancellation.

***We face risks from failures in our manufacturing processes and the processes of our foundries and vendors.***

The fabrication of semiconductors, particularly EEPROM products, is a highly complex and precise process. Most of our products are currently manufactured by two outside foundries and a number of other vendors participate in assembling, testing and other processing of our products. During manufacturing, each wafer is processed to provide numerous EEPROM, flash or analog/mixed-signal devices. We may reject or be unable to sell a substantial percentage of wafers or the components on a given wafer because of:

minute impurities;



## **Table of Contents**

difficulties in the fabrication process, such as failure of special equipment, operator error or power outages;

defects in the masks used to imprint circuits on a wafer;

nonconforming electrical and/or optical performance;

breakage of wafers; or

other factors.

We refer to the proportion of final components that have been processed, assembled and tested relative to the gross number of components that could be constructed from the raw materials as our manufacturing yield. Occasionally in the past we have experienced lower than expected manufacturing yields, which have delayed product shipments and negatively impacted our results of operations. We may experience difficulty achieving or maintaining acceptable manufacturing yields in the future. In addition, the maintenance of our outsourced fabrication, manufacturing and assembly model is subject to risks, including:

the demands of managing and coordinating workflow between geographically separate production facilities;

disruption of production in one facility as a result of a slowdown or shutdown in another facility; and

higher operating costs from managing geographically separate manufacturing facilities.

We depend on certain vendors for foundry services, materials and test and assembly services. We maintain stringent policies regarding qualification of these vendors. However, if these vendors' processes vary in reliability or quality, they could negatively affect our products and our results of operations.

***We rely on third party subcontractors to assemble, test and ship our products to customers, which reduces our control over quality, delivery schedules and capacity.***

We outsource assembly and approximately 50% of our final test operations to subcontractors who are primarily located in Thailand and the Philippines. We do not have long-term contractual arrangements with these subcontractors. Our reliance on third parties subjects us to risks such as reduced control over delivery schedules and quality, a potential lack of adequate capacity during periods when demand is high and potential increases in product costs due to factors outside our control such as capacity shortages and pricing changes. Our outsourcing model could lead to delays in product deliveries, lost sales and increased costs which could harm our relationships with OEM customers and indirect sales channels and result in lower operating results. Because we utilize the services of a group of assembly and test providers, this makes our operation highly complex, requiring a high degree of diligence in managing the costs of production and overall logistics of our manufacturing operations.

***We could experience disruption of our business as we decrease our dependence on third party subcontractors to conduct our final test operations.***

As we transition from third party subcontractors to utilizing our own subsidiary, Catalyst Semiconductor Thailand Company Limited near Bangkok, Thailand, to support our on-going cost management efforts and to provide approximately 50% of our final test operations, we may encounter an interruption in our supply chain or an unanticipated increase in costs, which could delay or decrease our revenue or harm our business.

***International sales comprise a significant portion of our product sales, which exposes us to foreign political and economic risks.***

## Edgar Filing: CATALYST SEMICONDUCTOR INC - Form 10-Q

For the three months ended July 27, 2008 and July 29, 2007, sales outside the United States accounted for approximately 92.1% and 91.8% of our net revenues, respectively. We expect that sales outside of the United States will continue to represent a significant portion of our net revenues in the future. However, our international operations may be adversely affected by the following factors:

greater fluctuations in demand for our products due to the increased sensitivity to pricing changes in certain markets, particularly Asia;

longer payment cycles;

fluctuations in exchange rates, particularly any strengthening of the U.S. dollar versus other currencies;



**Table of Contents**

general economic conditions;

imposition of government controls;

difficulties in staffing international operations;

political, socioeconomic and financial instability, such as the military actions in Afghanistan and Iraq;

trade restrictions;

the effects of natural catastrophes, such as earthquakes and weather-related occurrences;

the impact of communicable diseases, such as severe acute respiratory syndrome and avian bird flu; and

changes in regulatory requirements.

Our business is also subject to other risks because of our engineering design center in Romania, our operations in Thailand, and our relationships with foreign manufacturing, assembly and test subcontractors in Thailand and the Philippines. These risks include, but are not limited to, foreign government regulations and political and financial unrest which may cause disruptions or delays in shipments to our customers or access to our inventories. Catalyst Semiconductor Thailand Company Limited near Bangkok, Thailand, a subsidiary formed in 2007, supports our on-going cost management efforts and is expected to provide approximately 50% of our final test operations.

***We are exposed to fluctuations in currency exchange rates that could negatively impact our financial results and cash flows.***

Because a significant portion of our business is conducted outside the United States, we face exposure to adverse movements in the value of the U.S. dollar. When we incur a cost denominated in a foreign currency we may pay more dollars than initially anticipated if that local currency strengthens against the dollar before we pay costs. Consequently, in addition to reducing our revenues or increasing our costs, this risk can negatively affect our operating results. We do not currently hedge against any foreign currency exchange rate risks.

***Our corporate tax rate may increase, which could adversely impact our cash flow, financial condition and results of operations.***

We have significant operations in various tax jurisdictions throughout the world and a substantial portion of our taxable income historically has been generated in these jurisdictions. Currently, some of our operations are taxed at rates substantially lower than U.S. tax rates. If our income in these lower tax jurisdictions were no longer to qualify for these lower tax rates, if the applicable tax laws were rescinded or changed, or if the mix of our earnings shifts from lower rate jurisdictions to higher rate jurisdictions, our operating results could be materially adversely affected. While we are looking at opportunities to reduce our tax rate, there is no assurance that our tax planning strategies will be successful. In addition, many of these strategies will require a period of time to implement. Moreover, if U.S. or other foreign tax authorities were to change applicable foreign tax laws or successfully challenge the manner in which our profits are currently recognized, our overall taxes could increase, and our business, cash flow, financial condition and results of operations could be materially adversely affected. We adopted the provisions of FIN 48 effective April 30, 2007. FIN 48 requires that we recognize in our financial statements the impact of a tax position if that position is more likely than not of being sustained on audit, based on the technical merits of the position. The cumulative effect of the change in accounting principle, which was immaterial, was recorded as an adjustment to beginning retained earnings.

***Environmental regulations such as WEEE, RoHS and REACH directives may require us to redesign our products and to develop compliance administration systems.***

Various countries have begun to require companies selling a broad range of electrical equipment to conform to regulations such as the WEEE, RoHS and REACH directives and we expect additional countries and locations to adopt similar regulations in the future. New environmental

## Edgar Filing: CATALYST SEMICONDUCTOR INC - Form 10-Q

standards such as these could require us to redesign our products in order to comply with the standards, and require the development of compliance administration systems. We have already invested significant resources into developing compliance tracking systems, and further investments may be required. Additionally, we may incur significant costs to redesign our products and to develop compliance administration systems; however, alternative designs may have an adverse effect on our gross profit margin. If we cannot develop compliant products timely or properly administer our compliance programs, our revenues may decline due to lower sales, which would adversely affect our operating results. Compliance in these regulations may also impose impact cash flow through the need for additional capital equipment or other requirements.

## **Table of Contents**

***While we believe that we currently have adequate internal control over financial reporting, we are exposed to risks from legislation requiring companies to evaluate internal control over financial reporting and cannot be certain that our internal control over financial reporting will be effective or sufficient in the future.***

Section 404 of the Sarbanes-Oxley Act of 2002 requires our management to report on the effectiveness of our internal control over financial reporting. We have an ongoing program to perform the system and process evaluation and testing necessary to comply with these requirements.

As a result, we expect to continue to incur related expenses and to devote additional resources to Section 404 compliance. In addition, it is difficult for us to predict how long it will take to complete the assessment of the effectiveness of our internal control over financial reporting each year and we may not be able to complete the process on a timely basis. Our ability to manage our operations and growth will require us to improve our operations, financial and management controls, as well as our internal control over financial reporting. In the event that our principal executive officer, principal financial officer or independent registered public accounting firm determine that our internal control over financial reporting is not effective as defined under Section 404, we cannot predict how regulators will react or how the market prices of our shares will be affected.

***Our ability to operate successfully depends upon the continued service of certain key employees and the continued ability to attract and retain additional highly qualified personnel.***

Our ability to operate successfully will depend, to a large extent, upon the continued service of certain key employees and the continued ability to attract and retain additional highly qualified personnel. In February 2008, our Vice President of Worldwide Sales resigned; we are currently searching for a replacement. Competition for personnel, particularly for highly skilled design, process and test engineers, is intense and we may not be able to retain or attract other highly qualified personnel. In addition, there has been increased competition in Romania, making it more difficult to hire and retain qualified engineers at our design center. We have historically used stock options and other forms of stock-based compensation as a means to hire, motivate and retain our employees, and to align employees' interests with those of our stockholders. Our business, financial condition and results of operations could be materially adversely affected by the loss of or failure to attract and retain highly qualified personnel.

***Our low-density flash memory products may become obsolete.***

A portion of our net revenues have been and continue to be derived from sales of low density flash memory products. Flash memory products represented 4.0% and 3.9% of our net revenues for the three months ended July 27, 2008 and July 29, 2007, respectively. In general, the market for flash memory products has been characterized by competing technologies, migration of demand to larger memory sizes and intense overall competition. Other flash memory vendors continue to design, develop and sell flash memory devices with larger memory in reaction to changes in market demand. This transition to larger flash memory sizes is resulting in a limited and shrinking market for the low density flash memory products that we currently offer. We have decided not to develop any of the higher density flash memory devices due to the extreme competition in the medium and high density flash memory market and the considerable costs of development associated with it. Due to these and other factors, we may experience declining net revenues from our low-density flash memory products, which could harm our operating results.

***We are not protected by long-term contracts with our customers.***

We do not typically enter into long-term contracts with our distributors and resellers, and we cannot be certain as to future order levels from them. In the event one of our major distributors fails to place their usual orders in a quarter, it is unlikely that we will be able to rapidly replace that revenue source, which would be harmful to our financial results.

### ***Risks Related to Our Industry and Competition***

***Competition in our markets may lead to reduced average selling prices of our products, reduced sales of our products or gross margins.***

The non-volatile memory market is competitive and has been characterized by rapid price erosion, manufacturing capacity constraints and limited product availability. Average selling prices in the non-volatile memory market generally, and for our products in particular, have fluctuated significantly over the life of each product and, over the long term, the average selling price of each product has tended to decline. Declines in average selling prices for our products, if not offset

## **Table of Contents**

by reductions in the cost of producing those products or by sales of new products with higher gross margins, would decrease our overall gross margins, could cause a negative adjustment to the value of our inventories and could materially and adversely affect our operating results.

We compete with major domestic and international semiconductor companies, many of which have substantially greater financial, technical, marketing, distribution and other resources. We may not be able to compete successfully in the future. Our more mature products, such as serial and parallel EEPROM devices, compete on the basis of price, product availability and customer service. Principal competitors for our EEPROM products currently include Atmel Corporation, STMicroelectronics N.V. and Microchip Technology Incorporated. Principal competitors for our analog/mixed-signal products include Fairchild Semiconductor International, Inc., Intersil Corporation, Linear Technology Corporation, Maxim Integrated Products, National Semiconductor and Texas Instruments Incorporated.

***The semiconductor industry is highly cyclical in nature, which may cause our operating results to fluctuate.***

We operate in a highly cyclical industry that has been subject to significant economic downturns often in connection with, or in anticipation of, maturing product cycles and declines in general economic conditions. During such downturns, we experience reduced product demand and production overcapacity, which result in competitive pricing pressures leading to accelerated erosion of average selling prices and reduced gross margins. These downturns may occur for extended periods. Accordingly, we may experience substantial period-to-period fluctuations in operating results.

Our continued success depends in large part on the continued growth of various electronics industries that use semiconductors. We attempt to identify changes in market conditions as soon as possible; however, market dynamics make our prediction of and timely reaction to such events difficult. Our business could be harmed in the future by additional cyclical downturns in the semiconductor industry or by slower growth by any of the markets served by our end customers' products.

***If our products fail to keep pace with the rapid changes in the semiconductor industry, we could lose customers and revenues.***

The markets for our products are characterized by rapidly changing customer demand, over or under utilization of manufacturing capacity and price fluctuations. To compete successfully, we must introduce new products in a timely manner at competitive price, quality and performance levels. In particular, our future success will depend on our ability to develop and implement new design and process technologies which enable us to reduce product costs. Our business, financial condition and results of operations could be materially adversely affected by delays in developing new products, achievement of volume production and market acceptance of new products, successful completion of technology transitions of our existing products to new process geometries or foundries with acceptable yields and reliability.

### ***Risks Related to Our Intellectual Property***

***Our business may be harmed if we fail to protect our proprietary technology.***

We rely on a combination of patents, trademarks, copyrights, trade secret laws, confidentiality procedures and licensing arrangements to protect our intellectual property rights. As of July 27, 2008, we had 28 patents granted, 17 applications pending in the United States and 18 patent applications pending in other countries. Subsequent to July 27, 2008, one of our patents expired. The expiration dates of our patents range from October 2010 to December 2026. We intend to seek further United States and international patents on our technology. However, we cannot be certain that patents will be issued from any of our pending applications, that patents will be issued in all countries where our products can be sold or that any issued patents will be of sufficient scope or strength to provide meaningful protection or any commercial advantage. Our competitors may also be able to design around our patents. The laws of some countries in which our products are or may be developed, manufactured or sold may not protect our products or intellectual property rights to the same extent as do the laws of the United States, increasing the possibility of piracy of our technology and products. Although we intend to vigorously defend our intellectual property rights, we may not be able to prevent misappropriation of our technology. Our competitors may also independently develop technologies that are substantially equivalent or superior to our technology.

***Our ability to produce our products may suffer if someone claims we infringe on their intellectual property.***

The semiconductor industry is characterized by vigorous protection and pursuit of intellectual property rights or positions, which have resulted in significant and often protracted and expensive litigation. In addition, it is typical for companies in the industry to receive notices from time to time that allege infringement of patents or other intellectual property rights. We may receive other notices or become a party to other proceedings alleging our infringement of patents or intellectual property rights in the future. If it is necessary or desirable, we may seek licenses under such patents or other



## **Table of Contents**

intellectual property rights. However, we cannot be certain that licenses will be offered or that we would find the terms of licenses that are offered acceptable or commercially reasonable. Our failure to obtain a license from a third party for technology used by us could cause us to incur substantial liabilities and to suspend the manufacture of the affected products. Furthermore, we may initiate claims or litigation against third parties for infringement of our proprietary rights or to establish the validity of our proprietary rights. Litigation by or against us could result in significant expense and divert the efforts of our technical personnel and management, whether or not the litigation results in a favorable resolution. In the event of an adverse result in any litigation, we could be required to:

pay substantial damages as well as legal fees;

pay amounts to indemnify our customers;

stop the manufacture and sale of the infringing products;

expend significant resources to develop non-infringing technology;

discontinue the use of certain processes; or

obtain licenses to the technology.

We may be unsuccessful in developing non-infringing products or negotiating licenses with reasonable terms, or at all. These problems might not be resolved in time to avoid harming our results of operations. If any third party makes a successful claim against our customers or us and a license is not made available to us on commercially reasonable terms, our business could be harmed.

***We may be subject to damages resulting from claims that we have wrongfully used the alleged trade secrets of our employees' former employers.***

Many of our employees were previously employed at other companies, including our competitors or potential competitors. Although we have no current or pending claims against us, we may be subject to claims that we have relied on information that these employees have inadvertently, or otherwise, disclosed trade secrets or other proprietary information of their former employers. Litigation may be necessary to defend against these claims. If we fail in defending such claims, in addition to paying monetary damages and incurring legal fees, we may lose valuable intellectual property rights or personnel. A loss of key research personnel or their work product could hamper or prevent our ability to develop new products, which could severely harm our business. Even if we are successful, litigation could result in substantial costs and be a distraction to management.

***We may not be able to expand our proprietary technology if we do not acquire rights to use key technologies, consummate potential acquisitions or investments or successfully integrate them with our business.***

To expand our proprietary technologies, we may acquire or make investments in complementary businesses, technologies or products if appropriate opportunities arise. We may be unable to identify suitable acquisition or investment candidates at reasonable prices or on reasonable terms or consummate transactions with such candidates, the failure of which could slow our growth. We may also have difficulty in acquiring licenses to use proprietary technologies of third parties to expand our product lines. We may have difficulty integrating the acquired products, personnel or technologies of any acquisition we might make. These difficulties could disrupt our ongoing business, limit our future growth, distract our management and employees and increase our expenses.

### ***Risks Related to Our Stock***

***Our stock is subject to substantial price and volume fluctuations due to a number of factors, many of which are beyond our control, and those fluctuations may prevent our stockholders from reselling our common stock at a profit.***

## Edgar Filing: CATALYST SEMICONDUCTOR INC - Form 10-Q

The trading price of our common stock has in the past been and could in the future be subject to significant fluctuations in response to:

variations in our results of operations;

announcements of technological innovations or new products by us, our customers or competitors;

our failure to achieve the operating results anticipated by analysts or investors;

**Table of Contents**

sales or the perception in the market of possible sales of a large number of shares of our common stock by our directors, officers, employees or principal stockholders;

general economic conditions;

international political, socioeconomic and financial instability, including instability associated with military action in Afghanistan, Iraq or other conflicts;

releases or reports by or changes in security analysts' recommendations; and

developments or disputes concerning patents or proprietary rights or other events.

If our net revenues and results of operations are below the expectations of investors, significant fluctuations in the market price of our common stock could occur. Furthermore, because our stock generally trades at relatively low volumes, any sudden increases in trading volumes can cause significant volatility in the stock price. In addition, the securities markets have, from time to time, experienced significant price and volume fluctuations, which have particularly affected the market prices for high technology companies and often are unrelated and disproportionate to the operating performance of particular companies. These broad market fluctuations, as well as general economic, political and market conditions, may negatively affect the market price of our common stock.

***Our charter documents, Delaware law and our stockholder rights plan contain provisions that may inhibit potential acquisition bids, which may adversely affect the market price of our common stock, discourage merger offers or prevent changes in our management.***

Our board of directors has the authority to issue up to 2,000,000 shares of preferred stock and to determine the rights, preferences, privileges and restrictions, including voting rights, of the shares without any further vote or action by our stockholders. If we issue any of these shares of preferred stock in the future, the rights of shareholders of our common stock may be negatively affected. If we issue preferred stock, a change of control of our company could be delayed, deferred or prevented. We have no current plans to issue shares of preferred stock. Section 203 of the Delaware General Corporation Law restricts certain business combinations with any interested stockholder as defined by that statute. In addition, our certificate of incorporation and bylaws contain certain other provisions that may have the effect of delaying, deferring or preventing a change of control. These provisions include:

the classification of our board so that only a portion of our directors are elected each year and each director serves a three year term;

the elimination of actions by written consent of stockholders;

the condition that our directors may only be removed for cause; and

the establishment of an advance notice procedure and a minimum holding requirement for stockholder proposals and director nominations to be acted upon at annual meetings of the stockholders.

In December 2006, our board of directors adopted a stockholder rights plan with a term of ten years which will expire in December 2016. Under this plan, we issued a dividend of one right for each share of our common stock. Each right initially entitles stockholders to purchase one one-thousandth of a share of our preferred stock for \$18.00. However, the rights are not immediately exercisable. If a person or group acquires, or announces a tender or exchange offer that would result in the acquisition of 15% of our common stock, unless the rights are redeemed by us for \$0.01 per right, the rights will become exercisable by all rights holders, except the acquiring person or group, for shares of our common stock or the stock of the third party acquirer having a value of twice the rights' then-current exercise price.



## Edgar Filing: CATALYST SEMICONDUCTOR INC - Form 10-Q

These provisions are designed to encourage potential acquirers to negotiate with our board of directors and give our board of directors an opportunity to consider various alternatives to increase stockholder value. These provisions are also intended to discourage certain tactics that may be used in proxy contests. However, the potential issuance of preferred stock, our charter and bylaw provisions, the restrictions in Section 203 of the Delaware General Corporation Law and our stockholder rights plan could discourage potential acquisition proposals and could delay or prevent a change in control, which may adversely affect the market price of our stock. These provisions and plans may also have the effect of preventing changes in our management or board of directors.

**Table of Contents**

On July 16, 2008, our board of directors amended the stockholder rights plan to provide that the proposed merger with ON and the transactions contemplated by the merger agreement with ON will not cause the rights to separate or otherwise become exercisable, and to provide that these rights and the stockholder rights plan will terminate upon completion of the merger.

*We may be the subject of securities class action litigation due to future stock price volatility.*

In the past, when the market price of a stock has been volatile, holders of that stock have often initiated securities class action litigation against the company that issued the stock. We maintain directors and officers insurance to mitigate the impact of potential claims. However, if any of our stockholders brought a lawsuit against us, we could incur substantial costs defending the lawsuit. The lawsuit could also divert the time and attention of our management.

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

None.

**Item 3. *Defaults Upon Senior Securities***

Not applicable.

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

None.

**Item 5. *Other Information***

None.

**Item 6. *Exhibits***

**Exhibit**

<b>Number</b>	<b>Description</b>
2.1(1)	Agreement and Plan of Merger and Reorganization, dated July 16, 2008, by and among ON Semiconductor Corporation ( Parent ), a Delaware corporation; Centaur Acquisition Corporation, a Delaware corporation and a wholly owned subsidiary of Parent; and Catalyst Semiconductor, Inc., a Delaware corporation.
4.1(1)	Amendment No. 1 to Rights Agreement dated July 16, 2008, between Catalyst Semiconductor, Inc. and Computershare Trust Company, N.A.
31.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

Edgar Filing: CATALYST SEMICONDUCTOR INC - Form 10-Q

- (1) Incorporated by reference to Registrant's Current Report on Form 8-K filed with the SEC on July 17, 2008.

**Table of Contents**

**SIGNATURES**

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

Date: September 10, 2008

By: /s/ GELU VOICU  
Gelu Voicu  
*President, Chief Executive Officer and Director*

Date: September 10, 2008

By: /s/ DAVID EICHLER  
David Eichler  
*Vice President of Finance and Administration*  
  
*and Chief Financial Officer*

**Table of Contents**

**INDEX TO EXHIBITS**

**Exhibit**

<b>Number</b>	<b>Description</b>
2.1(1)	Agreement and Plan of Merger and Reorganization, dated July 16, 2008, by and among ON Semiconductor Corporation ( Parent ), a Delaware corporation; Centaur Acquisition Corporation, a Delaware corporation and a wholly owned subsidiary of Parent; and Catalyst Semiconductor, Inc., a Delaware corporation.
4.1(1)	Amendment No. 1 to Rights Agreement dated July 16, 2008, between Catalyst Semiconductor, Inc. and Computershare Trust Company, N.A.
31.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(1) Incorporated by reference to Registrant's Current Report on Form 8 K filed with the SEC on July 17, 2008.