STEC, INC.
Form 10-Q
August 03, 2010
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2010

or

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

For the transition period from ______ to ______

Commission File Number 000-31623

STEC, INC.

(Exact name of Registrant as specified in its charter)

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

(949) 476-1180

(Registrant s telephone number, including area code)

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

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

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

Large Accelerated Filer x	Accelerated Filer ¨
Non-Accelerated Filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company ¨

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

The number of shares outstanding of the registrant s common stock, par value $0.001, as of July 23, 2010 was 50,794,140.

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STEC, INC.

INDEX TO FORM 10-Q FOR THE

QUARTERLY PERIOD ENDED JUNE 30, 2010

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

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PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

STEC, INC.

UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except share and per share amounts)

	June 30, 2010	December 31, 2009
ASSETS:		
Current Assets:		
Cash and cash equivalents	$ 142,902	$ 135,658
Short-term investments	5,000	10,000
Accounts receivable, net of allowances of $2,944 at June 30, 2010 and $3,557 at December 31, 2009	40,666	78,373
Inventory	66,844	42,739
Other current assets	5,211	2,840
Total current assets	260,623	269,610
Leasehold interest in land	2,521	2,543
Property, plant and equipment, net	36,237	39,911
Intangible assets	179	292
Goodwill	1,682	1,682
Other long-term assets	4,881	5,076
Deferred income taxes	12,768	6,448
Total assets	$ 318,891	$ 325,562
LIABILITIES AND SHAREHOLDERS EQUITY:		
Current Liabilities:		
Accounts payable	$ 20,840	$ 29,911
Accrued and other liabilities	11,125	14,070
Total current liabilities	31,965	43,981
Long-term income taxes payable	3,084	2,986
Total liabilities	35,049	46,967
Commitments and contingencies (Note 9)		
Shareholders Equity:		
Preferred stock, $0.001 par value, 20,000,000 shares authorized, no shares issued and outstanding		
Common stock, $0.001 par value, 100,000,000 shares authorized, 50,765,640 shares issued and outstanding as of June 30, 2010 and 50,284,438 shares issued and outstanding as of December 31, 2009	51	50
Additional paid-in capital	161,899	154,087
Retained earnings	121,892	124,458

Total shareholders equity	283,842	278,595
Total liabilities and shareholders equity	$ 318,891	$ 325,562

See accompanying notes to unaudited condensed consolidated financial statements.

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STEC, INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share amounts)

	Three Months Ended June 30, 2010	Three Months Ended June 30, 2009	Six Months Ended June 30, 2010	Six Months Ended June 30, 2009
Net revenues	$ 61,348	$ 86,350	$ 100,157	$ 149,886
Cost of revenues	35,226	43,177	60,849	83,680
Gross profit	26,122	43,173	39,308	66,206
Sales and marketing	4,807	5,031	8,603	9,803
General and administrative	7,099	6,714	14,038	14,080
Research and development	10,366	5,423	20,020	10,943
Special charges (Note 7)	18	1,996	(48)	3,173
Total operating expenses	22,290	19,164	42,613	37,999
Operating income (loss)	3,832	24,009	(3,305)	28,207
Other income	523	614	389	602
Income (loss) from continuing operations before income taxes	4,355	24,623	(2,916)	28,809
(Provision) benefit for income taxes	(1,418)	(5,260)	500	(6,252)
Income (loss) from continuing operations	2,937	19,363	(2,416)	22,557
Discontinued operations (Note 8):				
Loss from operations of Consumer Division	(258)		(258)	(356)
Benefit for income taxes	108		108	141
Loss from discontinued operations	(150)		(150)	(215)
Net income (loss)	$ 2,787	$ 19,363	$ (2,566)	$ 22,342
Net income (loss) per share:				
Basic:				
Continuing operations	$ 0.06	$ 0.40	$ (0.05)	$ 0.46
Discontinued operations				
Total	$ 0.06	$ 0.40	$ (0.05)	$ 0.46
Diluted:				
Continuing operations	$ 0.06	$ 0.38	$ (0.05)	$ 0.45
Discontinued operations				
Total	$ 0.06	$ 0.38	$ (0.05)	$ 0.45
Shares used in per share computation:				
Basic	50,673	48,871	50,495	48,654

Diluted	51,463	50,702	50,495	49,883

See accompanying notes to unaudited condensed consolidated financial statements.

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STEC, INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	Six Months Ended June 30, 2010	Six Months Ended June 30, 2009
Cash flows from operating activities:		
Net (loss) income	$ (2,566)	$ 22,342
Loss from discontinued operations	150	215
Adjustments to reconcile net (loss) income to net cash provided by operating activities:		
Depreciation and amortization	6,231	5,992
Loss on sale of property, plant and equipment	22	40
Non-cash special charges	(104)	2,256
Accounts receivable (benefit) provision	(535)	1,526
Deferred income taxes	(5,881)	(1,427)
Stock-based compensation expense	4,032	1,698
Excess tax benefits from share-based payment arrangements	(1,516)	(3,459)
Change in operating assets and liabilities:		
Accounts receivable	38,242	(8,510)
Inventory	(24,105)	26,329
Leasehold interest in land	22	25
Other assets	(1,154)	(359)
Accounts payable	(9,640)	(3,171)
Income taxes	2,710	8,360
Accrued and other liabilities	(4,663)	2,721
Cash flows used in discontinued operations	(27)	
Net cash provided by operating activities	1,218	54,578
Cash flows from investing activities:		
Purchases of short-term investments	(4,998)	(5,200)
Sales of short-term investments	9,998	
Purchases of property, plant and equipment	(2,974)	(3,214)
Proceeds from sale of property, plant and equipment	219	134
Net cash provided by (used in) investing activities	2,245	(8,280)
Cash flows from financing activities:		
Proceeds from exercise of stock options	2,265	5,367
Excess tax benefits from share-based payment arrangements	1,516	3,459
Net cash provided by financing activities	3,781	8,826
Net increase in cash and cash equivalents	7,244	55,124
Cash and cash equivalents at beginning of period	135,658	33,379
Cash and cash equivalents at end of period	$ 142,902	$ 88,503
Supplemental schedule of noncash investing activities:		
Additions to property, plant and equipment acquired under accounts payable	$ 554	$ 219

See accompanying notes to unaudited condensed consolidated financial statements.

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STEC, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1 Basis of Presentation

The accompanying interim unaudited condensed consolidated financial statements of STEC, Inc., a California corporation, and its subsidiaries (the Company), have been prepared in accordance with generally accepted accounting principles in the United States of America (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. The unaudited condensed consolidated financial statements include the accounts of the Company and each of its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. In the opinion of management, all adjustments (consisting of normal and recurring adjustments and the special charges discussed in Note 7) considered necessary for a fair statement of the consolidated financial position of the Company at June 30, 2010, the consolidated results of operations for each of the three and six months ended June 30, 2010 and 2009, and the consolidated results of cash flows for each of the six months ended June 30, 2010 and 2009 have been included. These interim unaudited condensed consolidated financial statements do not include all of the information and footnotes required by GAAP for complete financial statements and, therefore, should be read in conjunction with the consolidated financial statements and related notes contained in the Company s most recent Annual Report on Form 10-K filed with the Securities and Exchange Commission (SEC). The December 31, 2009 balances reported herein are derived from the audited consolidated financial statements included in the Company s Annual Report on Form 10-K for the year ended December 31, 2009. The results for the interim periods are not necessarily indicative of results to be expected for the full year. Certain amounts previously reported have been reclassified to conform to the 2010 presentation.

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

Note 2 Sales Concentration

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

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2010	2009	2010	2009
	Revenues	Revenues	Revenues	Revenues
Customer A	38%	39%	23%	28%
Customer B	*	12%	*	13%
Customer C	13%	12%	14%	12%
Customer D	18%	10%	25%	*
Customer E	*	*	*	11%

* Less than 10%

International sales, which are derived from billings to foreign customers, as a percentage of total revenues were as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2010	2009	2010	2009
Malaysia	16%	*	21%	11%
Singapore	16%	*	19%	*
Czech Republic	11%	*	*	*
Taiwan	*	13%	*	14%
Other	13%	23%	22%	17%

Total	56%	36%	62%	42%

* Less than 10%

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STEC, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3 Financial Instruments

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

STEC, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

As of June 30, 2010, cash equivalents and short-term investments consisted of money market funds and FDIC-insured certificates of deposits. The Company determined the fair value of its cash equivalents and short-term investments based on Level 1 inputs, which consist of quoted prices in active markets for identical assets. Short-term investments have been classified as available-for-sale securities. As of June 30, 2010, the stated maturities of the Company s short-term investments are within one year.

Cash, cash equivalents and short-term investments consist of the following (in thousands):

	June 30, 2010	December 31, 2009
Cash and cash equivalents:		
Money market funds	$ 142,902	$ 135,658
Short-term investments:		
Certificates of deposit	5,000	10,000
Total cash, cash equivalents and short-term investments	$ 147,902	$ 145,658

Note 4 Income Taxes

The Company recorded a benefit for income taxes of $500,000 and a provision for income taxes of $6.3 million for the six months ended June 30, 2010 and June 30, 2009, respectively. The Company s effective tax rates were 17.1% and 21.7% for the six months ended June 30, 2010 and June 30, 2009, respectively. The difference between the Company s effective tax rate and the 35% federal statutory rate for the six months ended June 30, 2010 resulted primarily from foreign income taxed at rates lower than the federal statutory rate, partially offset by permanent differences between GAAP pre-tax income and taxable income. The difference between the Company s effective tax rate and the 35% federal statutory rate for the six months ended June 30, 2009 resulted primarily from foreign income taxed at rates lower than the federal statutory rate. The decrease in the effective tax rate for the six months ended June 30, 2010 from the same period in 2009 is due primarily to an increase in foreign sales and income by international subsidiaries in lower tax rate jurisdictions as a percentage of total Company sales and income during the six months ended June 30, 2010 compared to the same period in 2009.

The Company has been granted a fifteen-year tax holiday for its operations in Malaysia subject to meeting certain conditions. This tax holiday in Malaysia is effective through September 30, 2022. The impact of the Malaysia tax holiday decreased the provision for income taxes by $980,000 and $1.3 million in the three months ended June 30, 2010 and June 30, 2009, respectively. The impact of the Malaysia tax holiday increased the benefit for income taxes by $1.5 million in the six months ended June 30, 2010 and decreased the provision for income taxes by $1.7 million in the six months ended June 30, 2009. The benefit of the tax holiday on earnings per share was $0.02 and $0.03 for the three months ended June 30, 2010 and June 30, 2009, respectively, and $0.03 for the six months ended June 30, 2010 and June 30, 2009, respectively.

Note 5 Net Income Per Share

Basic earnings per share is computed by dividing net income by the weighted average number of shares outstanding. In computing diluted earnings per share, the weighted average number of shares outstanding is adjusted to reflect potentially dilutive securities. Options to purchase 4,515,459 and 4,375,497 shares of common stock were outstanding at June 30, 2010 and 2009, respectively. In addition, 645,632 and 377,740 restricted stock units payable in shares of common stock were outstanding at June 30, 2010 and 2009, respectively. For the three months ended June 30, 2010 and June 30, 2009, potentially dilutive securities consisted solely of options and restricted stock units and resulted in an upward adjustment to the weighted average number of shares outstanding of 789,993 and 1,830,568, respectively. Common stock equivalents of 2,572,869 and 1,655,000 shares for the three months ended June 30, 2010 and June 30, 2009, respectively, and 2,254,993 shares for the six months ended June 30, 2009, were outstanding but were not included in the computation of diluted earnings per share because the effect would have been anti-dilutive. For the six months ended June 30, 2009, potentially dilutive securities consisted solely of options and restricted stock units and resulted in an upward adjustment to the weighted average number of shares outstanding of 1,229,597. Because the Company incurred a net loss for the six months ended June 30, 2010, the potential dilutive effect of the Company s outstanding stock options and restricted stock units was not included in the computation of diluted loss per share because these securities were anti-dilutive.

Note 6 Supplemental Balance Sheet Information

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STEC, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Inventory consists of the following (in thousands):

	June 30, 2010	December 31, 2009
Raw materials	$ 53,471	$ 34,293
Work-in-progress	590	156
Finished goods	12,783	8,290
Total	$ 66,844	$ 42,739

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

	June 30, 2010	December 31, 2009
Payroll costs	$ 5,965	$ 7,510
Marketing	650	3,112
Other	4,510	3,448
Total	$ 11,125	$ 14,070

Note 7 Special Charges

Special charges consist of the following (in thousands):

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2010	2009	2010	2009
Employee severance and termination benefits	$ 30	$ 449	$ 69	$ 1,626
(Gain) loss on assets held for sale	(12)	1,547	(117)	1,547
Total special charges	$ 18	$ 1,996	$ (48)	$ 3,173

During the three months ended March 31, 2009, the Company commenced the first phase of a reduction in its workforce primarily at its Santa Ana, California headquarters as part of the transition of certain of its operations to its facility in Penang, Malaysia. The first phase, which mostly impacted its U.S.-based workforce, was completed by March 31, 2010. In connection with the first phase reduction in workforce, the Company recorded a charge of $449,000 during the three months ended June 30, 2009. During the three months ended June 30, 2010, the Company commenced the second phase of a reduction in its workforce, which also primarily impacted its Santa Ana, California headquarters and is expected to be substantially completed by the end of the fourth quarter of 2010. In connection with the second phase of the reduction in workforce, the Company recorded a charge for severance and related costs of approximately $30,000 during the three months ended June 30, 2010. In connection with both the first and second phases of its reduction in workforce, the Company recorded charges of $69,000 and $1.6 million during the six months ended June 30, 2010 and June 30, 2009, respectively. The Company recorded gains on the sale of impaired assets of approximately $12,000 and $117,000 during the three and six months ended June 30, 2010, respectively. The Company recorded asset impairments totaling $1.5 million during the three and six months ended June 30, 2009.

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

Activity and liability balances related to the 2009 restructuring plan during the six months ended June 30, 2010 are as follows (in thousands):

		Workforce Reductions
Restructuring balance, December 31, 2009	$	
Charged to costs and expenses		69
Cash payments		(55)
Restructuring balance, June 30, 2010	$	14

The remaining accrued restructuring balance is included in Accrued and Other Liabilities in the Unaudited Condensed Consolidated Balance Sheets and consists of obligations related to employee severance benefits. These obligations were paid in July 2010.

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STEC, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 8 Discontinued Operations

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

Operating results of the Consumer Division, which are accounted for as discontinued operations for the three and six months ended June 30, 2010 and June 30, 2009, are summarized as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Net revenues	$	$	$	$
Loss from discontinued operations	(258)		(258)	(356)
Benefit for income taxes	108		108	141
Loss from discontinued operations	$ (150)	$	$ (150)	$ (215)

Note 9 Commitments and Contingencies

Class Action Litigation

From November 6, 2009 through March 2, 2010, seven purported class action complaints were filed against the Company and several of its senior officers and directors in the United States District Court for the Central District of California. The Court consolidated these actions and appointed Lead Plaintiffs. A consolidated complaint was filed on April 9, 2010, and is purportedly brought on behalf of all persons and entities who acquired the Company s common stock during the period of June 16, 2009, to February 23, 2010. The consolidated complaint alleges claims against the Company and several of its senior officers and directors for violations of Section 10(b) of the Securities and Exchange Act of 1934 (the Exchange Act) and Rule 10b-5 thereunder, and claims against several of the Company s senior officers and directors for violations of Section 20(a) of the Exchange Act. The consolidated complaint seeks compensatory damages for all damages sustained as a result of the defendants alleged actions including reasonable costs and expenses, and other relief the Court may deem just and proper. On May 12, 2010, the defendants filed a motion to dismiss the consolidated complaint. On July 15, 2010, prior to hearing the defendants motion, the Court replaced the former Lead Plaintiffs with a new Lead Plaintiff. The Court has not yet ruled on the defendants motion to dismiss. The Company believes the lawsuit is without merit and intends to vigorously defend itself. No amounts have been recorded in the consolidated financial statements for this matter as management believes it is too early in the proceedings to determine an outcome.

Shareholder Derivative Litigation

From November 12, 2009, through December 3, 2009, four shareholder derivative actions were filed purportedly on the Company s behalf against several of its senior officers and directors in the Superior Court of Orange County, California. These cases were consolidated and have been stayed until further order of the Court. Two shareholder derivative actions were also filed purportedly on the Company s behalf against several of its senior officers and directors in the United States District Court for the Central District of California. These two lawsuits were consolidated on April 13, 2010 but stayed by order of

STEC, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

the Court on June 23, 2010. A consolidated complaint has been filed in the state derivative action and the federal derivative action. The operative complaints in both actions allege claims for breach of fiduciary duties for insider selling and misappropriation of information, abuse of control, gross mismanagement, waste of corporate assets, unjust enrichment and violation of California Corporations Code (with respect to the state court actions only) related to allegedly false and misleading statements regarding the Company s business and alleged illegal stock sales. The shareholder derivative actions generally seek compensatory damages for all alleged losses sustained as a result of the defendants alleged actions, including interest, reasonable costs and expenses, and other relief as the Court may deem just and proper. No amounts have been recorded in the consolidated financial statements for these matters as management believes it is too early in the proceedings to determine an outcome.

Shareholder Demand

From January 5, 2010 through January 29, 2010, the Company received three letters from counsel for purported shareholders demanding that the Company take action to remedy breaches of fiduciary duties by several of the Company s senior officers and directors. The allegations in these letters are similar to those found in the shareholder derivative complaints that have been filed in state and federal court, and demand that the Company take action to recover damages from its senior officers and directors and to correct deficiencies in its internal controls. The letters state that if, within a reasonable time, the Company s board of directors has not commenced the requested action, or if the board of directors refuses to commence the requested action, the named shareholders will commence derivative actions. The Company has responded in writing to counsel for the purported shareholders, stating that the board of directors is considering the demands and will respond in a reasonable time.

Other Legal Proceedings

The United States Securities and Exchange Commission (SEC) is conducting a formal investigation involving trading in the Company s securities. The Company, and certain officers and employees of the Company, including the Company s CEO and President, have received subpoenas in connection with the SEC s investigation. The Company is cooperating fully with the SEC in regards to this matter.

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

As is common in the industry, the Company currently has in effect a number of agreements in which it has agreed to defend, indemnify and hold harmless certain of its suppliers and customers from damages and costs which may arise from the infringement by the Company s products of third-party patents, trademarks or other proprietary rights. In addition, the Company has entered into indemnification agreements with its directors and certain of its officers that will require the Company, among other things, to indemnify them against certain liabilities that may arise by reason of their status or service as directors or officers. The Company maintains director and officer insurance, which may cover certain liabilities arising from its obligation to indemnify its directors and officers in certain circumstances. It is not possible to determine the maximum potential amount under these indemnification agreements due to the limited history of prior indemnification claims and the unique facts and circumstances involved in each particular agreement. Further, such indemnification agreements may not be subject to maximum loss clauses. The scope of such indemnity varies, but may, in some instances, include indemnification for damages and expenses, including attorneys fees. The term of these indemnification agreements is generally perpetual any time after execution of the agreement. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited. The Company has never incurred significant costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, and after consideration of the Company s current director and officer insurance coverage, the Company believes the estimated fair value of these agreements is minimal. Accordingly, the Company has no liabilities recorded for these agreements as of June 30, 2010.

Note 10 Credit Facility

On July 30, 2008, the Company entered into an agreement for a $35 million two-year senior unsecured revolving credit facility (the Credit Facility) with Wachovia Bank, National Association (Wachovia). The Credit Facility bore interest at a floating rate equivalent to, at the option of the Company, either (i) LIBOR plus 0.70% - 1.20% depending on the Company s leverage ratio at each quarter end or (ii) Wachovia s prime rate, announced from time to time, less 1.00% - 1.50% depending on the Company s leverage ratio at each quarter end. The Credit Facility was guaranteed by certain domestic subsidiaries of the Company. In addition, in the event the Company made a loan to any of its foreign subsidiaries, the Company had agreed to pledge to Wachovia the Company s intercompany note from such foreign subsidiary. The Credit Facility agreement contained customary affirmative and negative covenants, some of which required the maintenance of specified leverage and minimum liquidity ratios. The Company was subject to a maximum leverage ratio of 2.0 to 1.0 for the six months ended June 30, 2010 and a minimum liquidity ratio of 1.0 to 5.0 through June 30, 2010. As of June 30, 2010,

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

there were no borrowings outstanding under the Credit Facility with Wachovia, and the Company was in compliance with all required covenants. The Company s leverage and minimum liquidity ratios for the six months ended June 30, 2010 were 0.0 and 4.2, respectively. The Credit Facility expired on July 30, 2010 and was not renewed.

On November 23, 2009, the Company s subsidiary, STEC Malaysia, entered into an agreement for a short-term credit facility (the Short-term Facility) with Deutsche Bank (Malaysia) Berhad (Deutsche). The agreement allows STEC Malaysia to borrow an aggregate principal amount of $10 million in the form of letters of credit, trust receipts, bills acceptances/financing, banker s acceptances, and banker s and shipping guarantees, which are commonly used to conduct business in Asia. Credit under the Short-term Facility will be available until notice of termination by either party. Borrowings under the Short-term Facility will bear interest at various rates with repayments due between 30 days and 14 months, depending on the form of borrowing. The Short-term Facility is guaranteed by STEC, Inc. and contains customary affirmative and negative covenants. As of June 30, 2010, there were no borrowings outstanding under the Short-term Facility and STEC Malaysia was in compliance with all required covenants. The Short-term Facility will be used to facilitate general business transactions and fund working capital requirements for STEC Malaysia, on an as needed basis.

Note 11 Intangible Assets and Goodwill

The following table presents detail of the Company s intangible assets, related accumulated amortization and goodwill (in thousands):

	As of June 30, 2010			As of December 31, 2009		
	Gross	Accumulated Amortization	Net	Gross	Accumulated Amortization	Net
Developed technology (five years)	$ 1,070	$ 891	$ 179	$ 1,070	$ 824	$ 246
Customer relationships (five years)	792	792		792	746	46
Total intangible assets	$ 1,862	$ 1,683	$ 179	$ 1,862	$ 1,570	$ 292
Goodwill	$ 1,682	$	$ 1,682	$ 1,682	$	$ 1,682

Goodwill and other intangible assets with indeterminate lives are not subject to amortization but are tested for impairment annually or whenever events or changes in circumstances indicate that the asset might be impaired. Intangible assets with finite lives continue to be subject to amortization, and any impairment is determined in accordance with the authoritative guidance for intangible assets. The Company recorded amortization expense of $56,000 and $77,000 for the three months ended June 30, 2010 and June 30, 2009, respectively, and $113,000 and $154,000 for the six months ended June 30, 2010 and June 30, 2009. Estimated intangible asset amortization expense (based on existing intangible assets) for the remainder of the years ending December 31, 2010 and 2011 is $67,000 and $112,000, respectively. Amortization will be completed as of the end of 2011.

Note 12 Shareholders Equity

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

The 2010 Incentive Award Plan (the 2010 Plan) was adopted by the Company s board of directors on March 26, 2010, and was approved by its shareholders on May 27, 2010. The 2010 Plan provides for the direct issuance or sale of shares and the grant of options to purchase shares of the Company s common stock to officers and other employees, non-employee board members and consultants. Under the 2010 Plan, eligible individuals may be granted options to purchase shares of common stock at an exercise price not less than 100% of the fair market value of those shares on the grant date. Other types of equity awards that may be granted under the 2010 Plan include performance awards, dividend equivalents, deferred stock units, stock payments, restricted stock, restricted stock units, stock appreciation rights and other incentive awards. The Company s

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STEC, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

At June 30, 2010, the 2010 Plan provided for the issuance of up to 3,397,980 shares of common stock.

During the six months ended June 30, 2010, options for the purchase of 833,500 shares at a weighted-average option price of $12.09 per share, with annual vesting of 25%, were awarded pursuant to the 2000 Plan and 2010 Plan. The contractual lives of 2010 awards are consistent with those of prior years. The per share fair values of the options granted in the six months ended June 30, 2010 were estimated with the following weighted average assumptions:

Expected term (years)	5.8
Risk-free interest rate	2.4%
Volatility	67%
Dividend rate	0.0%

During the six months ended June 30, 2010, the Company issued 336,000 restricted stock units with a grant fair value per share determined by the closing price of the common stock on the issuance date. Each unit represents the right to receive one share of the Company s common stock as each restricted stock unit vests. The weighted average grant date fair value of restricted stock units granted in the first six months of 2010 was $12.06.

The following table sets forth the total stock-based compensation expense resulting from stock options and restricted stock units included in the Company s Unaudited Condensed Consolidated Statements of Operations (in thousands):

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2010	**2009**	**2010**	**2009**
Cost of revenues	$ 101	$ 72	$ 192	$ 108
Sales and marketing	396	185	769	315
General and administrative	764	396	1,455	608
Research and development	918	385	1,616	667
Total stock-based compensation expense	$ 2,179	$ 1,038	$ 4,032	$ 1,698

During the six months ended June 30, 2010, the Company received $2.3 million in cash proceeds for the exercise of 463,415 options and $1.5 million for excess tax benefits from share-based payment arrangements.

From time to time, the Company s board of directors has authorized various programs to repurchase shares of its common stock depending on market conditions and other factors. In November 2009, the board of directors authorized a share repurchase program effective November 10, 2009, enabling the Company to repurchase up to $75 million of its common stock over an 18-month period expiring on May 9, 2011. At June 30, 2010, $75 million was authorized for the repurchase of shares under these plans. The Company did not make any share repurchases in the six months ended June 30, 2010.

Note 13 New Accounting Pronouncements

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

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

Certain statements in this report are forward looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 21E of the Securities Exchange Act of 1934, as amended, and Section 27A of the Securities Act of 1933, as amended. These forward-looking statements often can be, but are not always, identified by the use of words such as anticipate, assume, believe, could, estimat
expect, goal, intend, may, might, plan, potential, predict, project, should, and similar expressions, or the negative of such expr
include, but are not limited to: statements regarding our revenue growth initiatives; continued growth in the sales of our Flash product line; changes in the average selling prices of our products; the loss of, or reduction in sales to, any of our key customers; our ability to deliver new and enhanced products on a timely basis; our sales, operating results and anticipated cash flows; our ability to forecast customer demand; the availability of certain components in our products that we obtain from a limited number of suppliers; competition from other companies in our industry; changes in political and economic conditions and local regulations, particularly outside of the United States; and our ability to protect our intellectual property rights. We base these forward-looking statements on our current expectations and projections about future events, our assumptions regarding these events and our knowledge of facts at the time the statements are made. These forward-looking statements are subject to various risks and uncertainties that may be outside our control and our actual results could differ materially from our projected results. Please see our most recent Annual Report on Form 10-K, our subsequent reports on Forms 10-Q and 8-K and our other SEC filings for a further discussion of these and other risks and uncertainties applicable to our business. We are not able to predict all of the factors that may affect future results. Forward-looking statements speak only as of the date of this Quarterly Report on Form 10-Q. Except as required by applicable laws or regulations, we do not undertake any obligation to update or revise any forward-looking statement, whether as a result of new information, future events or otherwise.

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

Overview

STEC, Inc. (including our subsidiaries, referred to collectively in this Report as STEC , we , our and us) is a leading global provider of enterprise-class Flash solid-state drives (SSDs) that are designed to increase the performance of enterprise-storage systems and servers that companies use to retain and access their critical data. Our products are designed specifically for storage systems and servers that run applications requiring a high level of input/output operations per second (IOPS) performance, capacity, reliability and low latency.

We design and develop our SSD controllers, enhance them with proprietary firmware and combine them with third-party Flash memory to form high-performance SSDs which provide a level of IOPS performance not currently possible with traditional hard disk drives (HDDs). We sell our SSDs to leading global storage and server original equipment manufacturers (OEMs), which integrate them into storage systems and servers used by enterprises in a variety of industries including financial services, government, transportation, defense and aerospace and transaction processing. We also manufacture small form factor Flash SSDs, cards and modules, as well as custom high density dynamic random access memory (DRAM) modules for networking, communications and industrial applications. We are headquartered in Santa Ana, California and have operations in Penang, Malaysia. We also have sales and engineering offices located in Europe and Asia.

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

We are focusing on certain revenue growth initiatives, including:

Continuing to develop and qualify customized Flash-based SSDs, including our Zeus^{IOPS} and MACH-class of products; and

Exploring new market opportunities that leverage our core SSD expertise.

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Over the past several years, we have expanded our custom design capabilities of Flash products for OEM applications. We have invested significantly in the design and development of customized Flash controllers, firmware and hardware and made strategic acquisitions that have expanded our Flash controller design capabilities and enhanced our capabilities to use third-party controllers. We expect to continue to make investments in Flash custom design capabilities and controller development. Flash product revenue decreased 37% from $76.6 million in the second quarter of 2009 to $48.6 million in the second quarter of 2010. Sales of Flash products represented 79% and 89% of our total revenues in the three months ended June 30, 2010 and June 30, 2009, respectively. An inventory carryover related to sales made to our largest customer during the second half of 2009 negatively impacted our Flash revenues in the first six months of 2010.

A major area of our Flash-based product investment has been applied to SSD technology. We believe the advantages of SSD technology are currently being defined in several distinct market segments including: a) enterprise-storage applications, b) enterprise-server applications, and c) government, defense and industrial applications. We see opportunities to leverage our SSD expertise across each of these markets where we believe our technology can outperform existing HDD solutions. In the long term, we expect Flash component pricing to decline, which will serve to improve the comparative economics of Flash-based SSDs versus HDDs in both new and existing storage applications.

With respect to the SSD government, defense and industrial segment, we signed an OEM Agreement (Agreement) in May 2009 to supply a defense systems contractor (Defense Contractor) with approximately $28 million of our MACH family product through a distributor over a 14-month period ending on July 31, 2010. As of July 31, 2010, the Defense Contractor had purchased approximately $14 million of its $28 million order commitment. Since the Defense Contractor has not met its contractual obligations, we are currently in settlement discussions with the Defense Contractor.

Although the enterprise Flash-based SSD market is relatively new, evolving and difficult to predict, we are encouraged by the variety of applications that our SSDs are able to support. As more of our customers and end-users experience the benefits of SSD technology, we believe that adoption will continue to expand. Accordingly, on a selective basis, we have introduced certain marketing programs and sales initiatives with our customers, in order to help accelerate the adoption of our SSD products. The increased use of data-tiering software used by storage OEMs may also be a factor in increasing SSD adoption in enterprise systems.

We also offer both monolithic DRAM modules and DRAM modules based on our proprietary stacking technology. DRAM product revenue increased 35% from $9.4 million in the second quarter of 2009 to $12.7 million in the second quarter of 2010. Sales of DRAM products represented 21% and 11% of our total revenues in the three months ended June 30, 2010 and June 30, 2009, respectively. The increase in sales of DRAM products in absolute dollars and as a percentage of our total revenues was due primarily to an increase in product sales to a single customer.

Historically, a limited number of customers have accounted for a significant percentage of our revenues. Our ten largest customers accounted for an aggregate of 83.0% of our revenues during the first six months of 2010, compared to 82.3% of our revenues during the first six months of 2009, and 87.7% of our revenues during the second quarter of 2010, compared to 86.8% of our revenues during the second quarter of 2009. We had three customers account for more than 10% of our revenues, at 24.6%, 23.2% and 13.7%, for the six months ended June 30, 2010, compared to four customers, which accounted for more than 10% of our revenues, at 27.5%, 12.5%, 12.0%, and 10.5%, for the same period in 2009. We had three customers account for more than 10% of our revenues, at 37.6%, 18.2% and 12.8% in the second quarter of 2010, compared to four customers, which accounted for more than 10% of our revenues, at 38.9%, 11.8%, 11.8%, and 10.0%, for the same period in 2009. With certain exceptions, sales of our products are generally made through individual purchase orders and, in certain cases, are made under master agreements governing the terms and conditions of the relationships.

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

International sales, which are derived from billings to foreign customers, as a percentage of total revenues were as follows:

	For the Three Months Ended June 30, 2010	2009	For the Six Months Ended June 30, 2010	2009
Malaysia	16%	*	21%	11%
Singapore	16%	*	19%	*
Czech Republic	11%	*	*	*
Taiwan	*	13%	*	14%
Other	13%	23%	22%	17%
Total	56%	36%	62%	42%

* Less than 10%

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

Results of Operations

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

	Three Months Ended June 30, 2010	2009	Six Months Ended June 30, 2010	2009
Net revenues	100.0%	100.0%	100.0%	100.0%
Cost of revenues	57.4	50.0	60.8	55.8
Gross profit	42.6	50.0	39.2	44.2
Operating expenses:				
Sales and marketing	7.9	5.8	8.6	6.6
General and administrative	11.6	7.8	14.0	9.4
Research and development	16.9	6.3	20.0	7.3
Special charges	0.0	2.3	(0.1)	2.1
Total operating expenses	36.4	22.2	42.5	25.4
Operating income (loss)	6.2	27.8	(3.3)	18.8
Other income	0.9	0.7	0.4	0.4
Income (loss) from continuing operations before income taxes	7.1%	28.5%	(2.9)%	19.2%

Comparison of Three Months Ended June 30, 2010 to Three Months Ended June 30, 2009

Net Revenues. Our revenues were $61.3 million in the second quarter of 2010, compared to $86.4 million in the same period in 2009. Revenues decreased 29% in the second quarter of 2010 due primarily to a 25% decrease in unit shipments of Flash products. The decrease in revenues was due primarily to a 37% decrease in Flash memory sales, partially offset by a 35% increase in sales of DRAM products. Within Flash memory sales, shipments of our Zeus ^{IOPS} SSDs into the enterprise-storage market decreased 40% from $57.7 million in the second quarter of 2009 to $34.7 million in the second quarter of 2010. An inventory carryover related to sales made to our largest customer during the second half of 2009 negatively impacted our Flash revenues in the second quarter of 2010. Based on new orders received from this customer, we believe the inventory situation at this customer has now been resolved. In addition, during the second quarter of 2010, this customer elected to discontinue the sales incentive program that we implemented at the beginning of the fourth quarter of 2009. As a result, we reversed the related sales incentive program liability and recognized additional revenue in the amount of $1.3 million in the second quarter of 2010.

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

Gross Profit. Our gross profit was $26.1 million in the second quarter of 2010, compared to $43.2 million in the same period in 2009. Gross profit as a percentage of revenues was 42.6% in the second quarter of 2010, compared to 50.0% in the second quarter of 2009. The decrease in gross profit in absolute dollars was due primarily to decreased revenues for Flash products.

Gross profit as a percentage of revenue in the second quarter of 2010 decreased due primarily to a shift in product mix toward lower gross profit margin non-Zeus^{IOPS} Flash products and DRAM products, partially offset by a $1.5 million decrease in write-downs of our inventory related to obsolescence, excess quantities and declines in market value below our costs.

Sales and Marketing. Sales and marketing expenses are comprised primarily of payroll and payroll-related expenses for our domestic and international sales and marketing employees and expenses for trade shows. Sales and marketing expenses were $4.8 million in the second quarter of 2010, compared to $5.0 million in the second quarter of 2009. Sales and marketing expenses as a percentage of revenue were 7.9% in the second quarter of 2010, compared to 5.8% in the second quarter of 2009. The decrease in sales and marketing expenses in absolute dollars was due to a $1.1 million decrease in commissions as the result of a lower revenues for the second quarter of 2010, partially offset by a $580,000 increase in payroll and payroll-related costs due to an increase in employee headcount and higher stock-based compensation and a $250,000 increase in trade show expenses. The increase in sales and marketing expenses as a percentage of revenues was due primarily to the fixed nature of some of these expenses.

General and Administrative. General and administrative expenses are primarily comprised of personnel costs for our executive and administrative employees, professional fees and facilities overhead. General and administrative expenses were $7.1 million in the second quarter of 2010, compared to $6.7 million in the second quarter of 2009. General and administrative expenses as a percentage of revenues were 11.6% and 7.8% in the second quarters of 2010 and 2009, respectively. The increase in general and administrative expenses in absolute dollars was due primarily to a $370,000 increase in stock-based compensation and a $180,000 increase in professional fees, partially offset by a $320,000 decrease in the loss on impairment of fixed assets.

Research and Development. Research and development expenses are comprised primarily of personnel costs for our engineering staff and material costs related to new product designs. Research and development expenses were $10.4 million in the second quarter of 2010, compared to $5.4 million in the second quarter of 2009. Research and development expenses as a percentage of revenues were 16.9% in the second quarter of 2010 compared to 6.3% in the second quarter of 2009. Research and development expenses increased due primarily to a $3.4 million increase in payroll and payroll-related costs from our expanding global research and development efforts and a $760,000 increase in new product development expenses that were predominantly related to our Flash product line, which includes the advancement of high-performance SSDs.

Special Charges. Special charges consist of approximately $30,000 in employee severance and termination benefits and approximately $12,000 related to a gain on the sale of previously impaired assets in the second quarter of 2010. For the second quarter of 2009, special charges consisted of approximately $449,000 in employee severance and termination benefits and $1.5 million of asset impairment charges.

During the first quarter of 2010, we completed the first phase of a reduction of our workforce and during the second quarter of 2010, we commenced the second phase of a reduction of our workforce primarily at our Santa Ana, California headquarters as part of the transition of certain of our operations to our facility in Penang, Malaysia as described above. The first phase of the reduction in our workforce was completed on March 31, 2010. In connection with these reductions in our workforce, we recorded a charge of approximately $30,000 and $449,000 for severance and related costs during the three months ended June 30, 2010 and June 30, 2009, respectively. We expect to incur approximately $1.2 million to $1.5 million of additional costs related to the second phase of the reduction in our workforce, which is expected to be substantially completed by the end of the fourth quarter of 2010. We expect substantially all of the expenses associated with the reduction in our workforce to result in cash expenditures. Actual amounts and the exact timing of the reduction in our workforce could differ from these estimates. Future cash payments related to the second phase of the reduction in our workforce are not expected to significantly impact our liquidity.

We expect that the second phase of a reduction of our workforce will reduce annual operating expenses by approximately $3.5 million, including approximately $1.0 million in cost of revenues, approximately $100,000 in sales and marketing expenses, and approximately $2.4 million in certain research and development expenses that previously supported our Santa Ana, California production operations. We began to realize cost savings in the second quarter of 2010. We expect the cost savings from the second phase of our reduction of our workforce to be partially offset by approximately $1.0 million in incremental cost increases at our foreign subsidiaries, related primarily to headcount increases for our Malaysia facility.

Other Income. Other income was $523,000 in the second quarter of 2010 and $614,000 in the second quarter of 2009. Other income is comprised of government grant income received from the Malaysian government authority for qualified research and development expenses, interest earned on our cash, cash equivalents, and short-term investments, partially offset by losses on foreign currency transactions.

Provision (Benefit) for Income Taxes. We recorded a provision for income taxes of $1.4 million and $5.3 million in the second quarters of 2010 and 2009, respectively. The effective tax rate increased from 21.4% in the second quarter of 2009 to 32.6% in the second quarter of 2010 due primarily to a reduction in the tax benefit recorded on the loss from continuing operations before taxes for the first six months of 2010. We operate under a tax holiday in Malaysia, which is effective through September 30, 2022 subject to meeting certain conditions. The impact of the Malaysia tax holiday decreased our provision for income taxes by $980,000 and $1.3 million in the three months ended June 30, 2010 and June 30, 2009, respectively. The benefit of the tax holiday on earnings per share was $0.02 and $0.03 for the three months ended June 30, 2010 and June 30, 2009, respectively.

Income (Loss) from Continuing Operations. Income from continuing operations was $2.9 million and $19.4 million in the second quarters of 2010 and 2009, respectively. The decrease in income from continuing operations was due primarily to a $17.1 million decrease in gross profit and a $3.1 million increase in operating expenses, partially offset by a $3.8 million decrease in the provision for income taxes. The increase in operating expenses was due primarily to increased investments in research and development for new Flash products, partially offset by a decrease in special charges.

Loss from Discontinued Operations. As the result of the sale of the assets of our Consumer Division on February 9, 2007, the Consumer Division is reflected as discontinued operations. Loss from discontinued operations was $150,000 and $0 in the second quarters of 2010 and 2009, respectively. Loss from discontinued operations was due primarily to a legal settlement related to the resolution of disputes with the acquiring company of our Consumer Division over the final purchase price.

Comparison of Six Months Ended June 30, 2010 to Six Months Ended June 30, 2009

Net Revenues. Our revenues were $100.2 million in the first six months of 2010, compared to $149.9 million in the same period in 2009. Revenues decreased 33% in the first six months of 2010 due primarily to a 32% decrease in unit shipments of Flash products. The decrease in revenues was due primarily to a 45% decrease in Flash memory sales, partially offset by a 72% increase in sales of DRAM products. Within Flash memory sales, shipments of our Zeus ^{IOPS} SSDs into the enterprise-storage market decreased 46% from $83.3 million in the first six months of 2009 to $45.0 million in the first six months of 2010. An inventory carryover related to sales made to our largest customer during the second half of 2009 negatively impacted our Flash revenues in the first six months of 2010. Based on new orders received from this customer, we believe that the inventory situation at this customer has now been resolved.

Gross Profit. Our gross profit was $39.3 million in the first six months of 2010, compared to $66.2 million in the same period in 2009. Gross profit as a percentage of revenues was 39.2% in the first six months of 2010, compared to 44.2% in the first six months of 2009. The decrease in gross profit in absolute dollars was due primarily to decreased revenues for Flash products. Gross profit as a percentage of revenue in the first six months of 2010 decreased due primarily to a shift in product mix toward lower gross profit margin non-Zeus^{IOPS} Flash products and DRAM products, partially offset by a $2.3 million decrease in write-downs of our inventory related to obsolescence, excess quantities and declines in market value below our costs.

Sales and Marketing. Sales and marketing expenses are comprised primarily of payroll and payroll-related expenses for our domestic and international sales and marketing employees and expenses for trade shows. Sales and marketing expenses were $8.6 million in the first six months of 2010, compared to $9.8 million in the first six months of 2009. Sales and marketing expenses as a percentage of revenue were 8.6% in the first six months of 2010, compared to 6.6% in the first six months of 2009. The decrease in sales and marketing expenses in absolute dollars was due to a $2.2 million decrease in commissions as the result of lower revenues for the first six months of 2010 and the termination of certain outside manufacturing representative firm commission agreements in the first quarter of 2009, partially offset by a $900,000 increase in payroll and payroll-related costs due to an increase in employee headcount and higher stock-based compensation and a $250,000 increase in trade show expenses. The increase in sales and marketing expenses as a percentage of revenues was due primarily to the fixed nature of some of these expenses.

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General and Administrative. General and administrative expenses are primarily comprised of personnel costs for our executive and administrative employees, professional fees and facilities overhead. General and administrative expenses were $14.0 million in the first six months of 2010, compared to $14.1 million in the first six months of 2009. General and administrative expenses as a percentage of revenues were 14.0% and 9.4% in the first six months of 2010 and 2009, respectively. The decrease in general and administrative expenses in absolute dollars was due primarily to a $720,000 decrease in legal fees and a $310,000 decrease in the loss on impairment of fixed assets in the second quarter of 2009, partially offset by an $850,000 increase in stock-based compensation. Legal fees decreased as result of an intellectual property litigation matter which began in the second quarter of 2008 and was settled in the first quarter of 2009.

Research and Development. Research and development expenses are comprised primarily of personnel costs for our engineering staff and material costs related to new product designs. Research and development expenses were $20.0 million in the first six months of 2010, compared to $10.9 million in the first six months of 2009. Research and development expenses as a percentage of revenues were 20.0% in the first six months of 2010 compared to 7.3% in the first six months of 2009. Research and development expenses increased due primarily to a $6.4 million increase in payroll and payroll-related costs from our expanding global research and development efforts and a $1.4 million increase in new product development expenses that were predominantly related to our Flash product line, which includes the advancement of high-performance SSDs.

Special Charges. Special charges, in connection with the first and second phases of the reduction in our workforce, consist of approximately $69,000 in employee severance and termination benefits and approximately $117,000 related to a gain on the sale of previously impaired assets in the first six months of 2010. For the first six months of 2009, special charges consisted of approximately $1.6 million in employee severance and termination benefits and $1.5 million of asset impairment charges.

Other Income. Other income was $389,000 and $602,000 in the six months of 2010 and 2009, respectively. Other income is comprised of government grant income received from the Malaysian government authority for qualified research and development expenses and interest earned on our cash, cash equivalents, and short-term investments, partially offset by losses on foreign currency transactions. The decrease in other income resulted primarily from an increase in losses on foreign currency transactions.

Provision (Benefit) for Income Taxes. We recorded a benefit for income taxes of $500,000 and a provision for income taxes of $6.3 million in the first six months of 2010 and 2009, respectively. The effective tax rate decreased from 21.7% in the first six months of 2009 to 17.1% in the first six months of 2010 due primarily to an increase in our foreign sales and income by international subsidiaries in lower tax rate jurisdictions as a percentage of total Company sales and income during the six months ended June 30, 2010 compared to the same period in 2009. We operate under a tax holiday in Malaysia, which is effective through September 30, 2022 subject to meeting certain conditions. The impact of the Malaysia tax holiday decreased our provision for income taxes by $1.5 million and $1.7 million in the six months ended June 30, 2010 and June 30, 2009, respectively. The benefit of the tax holiday on earnings per share was $0.03 for the six months ended June 30, 2010 and June 30, 2009.

Income (Loss) from Continuing Operations. Loss from continuing operations was $2.4 million and income from continuing operations was $22.6 million in the first six months of 2010 and 2009, respectively. The decrease in income from continuing operations was due primarily to a $26.9 million decrease in gross profit and a $4.6 million increase in operating expenses, partially offset by a $6.8 million decrease in the provision for income taxes. The increase in operating expenses was due primarily to increased investments in research and development for new Flash products and an increase in payroll and payroll-related expenses, partially offset by a decrease in special charges, commissions, legal fees and loss on impairment.

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

Consumer Division over the final purchase price. Loss from discontinued operations was $215,000 in the first six months of 2009 due primarily to the write-off of uncollectible receivables from the acquiring company of the Consumer Division arising from the sale and from services performed after the sale.

Liquidity and Capital Resources

Working Capital, Cash, Cash Equivalents and Short-term Investments

As of June 30, 2010, we had working capital of $228.7 million, including $147.9 million of cash, cash equivalents, and short-term investments compared to working capital of $225.6 million, including $145.7 million of cash, cash equivalents, and short-term investments as of December 31, 2009 and working capital of $163.7 million, including $93.7 million of cash, cash equivalents, and short-term investments as of June 30, 2009. Current assets were 8.2 times current liabilities at June 30, 2010, compared to 6.1 times current liabilities at December 31, 2009, and 7.8 times current liabilities at June 30, 2009.

Operating Activities

Net cash provided by operating activities was $1.2 million for the six months ended June 30, 2010 and resulted primarily from a $37.7 million decrease in accounts receivable, net of reserves, non-cash depreciation and amortization expense of $6.2 million, and $4.0 million of stock-based compensation expense, partially offset by a $24.1 million increase in inventory, a $9.6 million decrease in accounts payable, a $4.7 million decrease in accrued and other liabilities, a $5.9 million benefit from non-cash deferred income taxes, and net loss of $2.6 million. Accounts receivable, net of reserves, decreased due primarily to a decrease in sales in the second quarter of 2010, compared to the fourth quarter of 2009. Inventory increased due primarily to an increase in purchases of raw materials under non-cancelable inventory purchase commitments and a decrease in our inventory turns in the second quarter of 2010, compared to the fourth quarter of 2009. Accounts payable decreased as a result of lower inventory purchases in the second quarter of 2010, compared to the fourth quarter of 2009. Accrued and other liabilities decreased due to a decrease in commissions and sales incentives as a result of lower sales in the second quarter of 2010, compared to the fourth quarter of 2009, and the expiration of certain marketing programs in the second quarter of 2010. During the first six months of 2010, we incurred approximately $2.3 million of legal fees in excess of our insurance deductible under our director and officer insurance coverage. Accordingly, we have recognized a liability, with a corresponding receivable that offsets legal expense, until our claims are paid by our insurance carriers.

Investing Activities

Net cash provided by investing activities was $2.2 million for the six months ended June 30, 2010 resulting primarily from a $5.0 million net decrease in short-term investments, partially offset by $3.0 million in purchases of property, plant and equipment.

As of June 30, 2010, we have made capital expenditures of approximately $39 million for our Malaysia facility primarily related to building construction costs, acquisition of land and purchases of production equipment. We estimate that total investments in land, facilities and capital equipment will be approximately $14 million over the next five years ending June 30, 2015. We expect that the substantial majority of these estimated investments will relate to our Malaysia facility.

Financing Activities

Net cash provided by financing activities was $3.8 million for the six months ended June 30, 2010 and resulted from $2.3 million of proceeds realized from the exercise of stock options and a $1.5 million tax benefit from excess tax benefits from share-based payment arrangements.

From time to time, our board of directors has authorized various programs to repurchase shares of our common stock depending on market conditions and other factors. In November 2009, our board of directors authorized a share repurchase program effective November 10, 2009, enabling us to repurchase up to $75 million of our common stock over an 18-month period expiring on May 9, 2011. At June 30, 2010, $75 million was still authorized for the repurchase of shares under these plans. We did not make any share repurchases under this plan in the six months ended June 30, 2010.

On July 30, 2008, we entered into an agreement for a $35 million two-year senior unsecured revolving credit facility (the Credit Facility) with Wachovia Bank, National Association (Wachovia). The Credit Facility bore interest at a floating rate equivalent to, at our option, either (i) LIBOR plus 0.70% - 1.20% depending on our leverage ratio at each quarter end or (ii) Wachovia s prime rate, announced from time to time, less 1.00% - 1.50% depending on our leverage ratio at each quarter end. The Credit Facility was guaranteed by certain of our domestic subsidiaries. In addition, in the event we made a loan to any of our foreign subsidiaries, we had agreed to pledge to Wachovia our intercompany note from such foreign subsidiary. The Credit Facility agreement contained customary affirmative and negative covenants, some of which required the maintenance of specified leverage and minimum liquidity ratios. We were subject to a maximum leverage ratio of 2.0 to 1.0 for the three months ended June 30, 2010, and a minimum liquidity ratio of 1.0 to 5.0 through June 30, 2010. The Credit Facility expired on July 30, 2010 and was not renewed. As of June 30, 2010, there were no borrowings outstanding under our Credit Facility with Wachovia and we were in compliance with all required covenants. Our leverage and minimum liquidity ratios for the three months ended June 30, 2010 were 0.0 and 4.2, respectively. The Credit Facility was used to maintain liquidity and fund working capital requirements on an as needed basis. We do not have any immediate plans to enter into a new borrowing arrangement to replace this Credit Facility as we believe we have adequate liquidity to meet our capital requirements for the next twelve months. However, if business conditions or other circumstances change, we may elect to pursue additional financing at any point in the future.

On November 23, 2009, our subsidiary, STEC Technology Sdn. Bhd. (STEC Malaysia) entered into a short-term credit facility (the Short-term Facility) with Deutsche Bank (Malaysia) Berhad (Deutsche). The agreement allows STEC Malaysia to borrow an aggregate principal amount of $10 million in the form of letters of credit, trust receipts, bills acceptances/financing, banker s acceptances, and banker s and shipping guarantees, which are commonly used to conduct business in Asia. Credit under the Short-term Facility will be available until notice of termination by either party. Borrowings under the Short-term Facility will bear interest at various rates with repayments due between 30 days and 14 months, depending on the form of borrowing. The Short-term Facility is guaranteed by STEC, Inc. and contains customary affirmative and negative covenants. As of June 30, 2010, there were no borrowings outstanding under the Short-term Facility and STEC Malaysia was in compliance with all required covenants. The Short-term Facility will be used to facilitate general business transactions and fund working capital requirements for STEC Malaysia on an as needed basis.

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

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

- General economic and political conditions and specific conditions in the markets we address, including the continuing volatility in the technology sector and semiconductor industry, and fluctuation in the global economy;
- The inability of certain of our customers who depend on credit to have access to their traditional sources of credit to finance the purchase of products from us, which may lead them to reduce their level of purchases or to seek credit or other accommodations from us;
- Whether our revenues increase substantially;
- Our relationships with suppliers and customers;
- The market acceptance of our products;
- Expansion of our international business, including the opening of offices and facilities in foreign countries;

Price discounts on our products to our customers;

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

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

The levels of inventory and accounts receivable that we maintain;

Our entrance into new markets;

Capital improvements to new and existing facilities;

Technological advances; and

Competitors responses to our products.

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Contractual Obligations and Off-Balance Sheet Arrangements

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

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

Set forth in the table below is our estimate of our significant contractual obligations at June 30, 2010 (in thousands):

	Payment due by period				
Contractual Obligation	**Total**	**Less than 1 year**	**1-3 years**	**3-5 years**	**More than 5 years**
Non-cancelable inventory purchase commitments	$ 109,113	$ 109,113	$	$	$
Operating lease obligations	5,191	909	1,575	1,326	1,381
Other non-cancelable purchase commitments	986	986			
Non-cancelable capital equipment purchase commitments	1,274	1,274			
Total	$ 116,564	$ 112,282	$ 1,575	$ 1,326	$ 1,381

Inflation

Inflation was not a material factor in either revenue or operating expenses during each of the first six months ended June 30, 2010 and 2009.

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations are based upon our unaudited condensed consolidated financial statements, which have been prepared in accordance with generally accepted accounting principles in the United States of America (GAAP). The preparation of these financial statements requires us to make estimates and judgments that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses for each period. Information with respect to our critical accounting policies which we believe could have the most significant effect on our reported results and require subjective or complex judgments is contained in the notes to the consolidated financial statements in the Annual Report on Form 10-K for the fiscal year ended December 31, 2009. There have been no significant changes in our critical accounting policies and estimates during the six months ended June 30, 2010 as compared to what was previously disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2009.

New Accounting Pronouncements

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

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest Rate Risk

At June 30, 2010, our cash, cash equivalents and short-term investments were $148 million invested in money market funds and certificates of deposits. Our main investment objectives are the preservation of investment capital and the maximization of after-tax returns on our investment portfolio. Consequently, we invest in securities that meet high credit quality standards and we limit the amount of our credit exposure to any one issuer. We do not use derivative instruments for speculative or investment purposes.

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

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

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

The carrying amount, principal maturity and estimated fair value of our cash, cash equivalents and short-term investments as of June 30, 2010 were as follows (in thousands, except percentages):

	Expected Maturity Date			
	Before 7/1/2011	Thereafter	Total	Fair Value 6/30/2010
Cash and cash equivalents:				
Money market funds	$ 142,902	$	$ 142,902	$ 142,902
Short-term investments:				
Certificates of deposit	5,000		5,000	5,000
Total cash, cash equivalents and short-term investments	$ 147,902	$	$ 147,902	$ 147,902
Weighted average interest rate	0.10%		0.10%	0.10%

We are also exposed to interest rate risks due to the possibility of changing interest rates under our $35 million two-year senior unsecured revolving credit facility with Wachovia Bank (the Credit Facility) and our $10 million short-term credit facility with Deutsche Bank (Malaysia) Berhdad (the Short-term Facility). Borrowings under the Credit Facility will bear interest at a floating rate equivalent to, at our option, either (i) LIBOR plus 0.70% - 1.20% depending on our leverage ratio at each quarter end or (ii) Wachovia s prime rate, announced from time to time, less 1.00% - 1.50% depending on our leverage ratio at each quarter end. The Credit Facility expired on July 30, 2010. Loan draws under the Short-term Facility will bear interest at various rates depending on the type of borrowing. As of June 30, 2010, there were no borrowings outstanding under our credit facilities.

Foreign Currency Exchange Rate Risk

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

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ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

An evaluation as of the end of the period covered by this report was carried out under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, of the effectiveness of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) and Rule 15d-15(e) promulgated under the Securities Exchange Act of 1934, as amended (the Exchange Act). Based on this evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures were effective as of the end of the period.

Changes in Internal Control Over Financial Reporting

During the three months ended June 30, 2010, there have not been any changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Class Action Litigation

From November 6, 2009 through March 2, 2010, seven purported class action complaints were filed against us and several of our senior officers and directors in the United States District Court for the Central District of California. The Court consolidated these actions and appointed Lead Plaintiffs. A consolidated complaint was filed on April 9, 2010 and is purportedly brought on behalf of all persons and entities who acquired our common stock during the period of June 16, 2009, to February 23, 2010. The consolidated complaint alleges claims against us and several of our senior officers and directors for violations of Section 10(b) of the Securities and Exchange Act of 1934 (the Exchange Act) and Rule 10b-5 thereunder, and claims against several of our senior officers and directors for violations of Section 20(a) of the Exchange Act. The consolidated complaint seeks compensatory damages for all damages sustained as a result of the defendants alleged actions including reasonable costs and expenses, and other relief the Court may deem just and proper. On May 12, 2010, the defendants filed a motion to dismiss the consolidated complaint. On July 15, 2010, prior to hearing the defendants motion, the Court replaced the former Lead Plaintiffs with a new Lead Plantiff. The Court has not yet ruled on the defendants motion to dismiss. We believe the lawsuit is without merit and intend to vigorously defend ourselves. No amounts have been recorded in the consolidated financial statements for this matter as we believe it is too early in the proceedings to determine an outcome.

Shareholder Derivative Litigation

From November 12, 2009, through December 3, 2009, four shareholder derivative actions were filed purportedly on our behalf against several of our senior officers and directors in the Superior Court of Orange County, California. These cases were consolidated and have been stayed until further order of the Court. Two shareholder derivative actions were also filed purportedly on our behalf against several of our senior officers and directors in the United States District Court for the Central District of California. These two lawsuits were consolidated on April 13, 2010 but stayed by order of the Court on June 23, 2010. A consolidated complaint has been filed in the state derivative action and the federal derivative action. The operative complaints in both actions allege claims for breach of fiduciary duties for insider selling and misappropriation of information, abuse of control, gross mismanagement, waste of corporate assets, unjust enrichment and violation of California Corporations Code (with respect to the state court actions only) related to allegedly false and misleading statements regarding our business and alleged illegal stock sales. The shareholder derivative actions generally seek compensatory damages for all alleged losses sustained as a result of the defendants alleged actions, including interest, reasonable costs and expenses, and other relief as the Court may deem just and proper. No amounts have been recorded in the consolidated financial statements for these matters as we believe it is too early in the proceedings to determine an outcome.

Shareholder Demand

From January 5, 2010 through January 29, 2010, we received three letters from counsel for purported shareholders demanding that we take action to remedy breaches of fiduciary duties by several of our senior officers and directors. The allegations in these letters are similar to those found in the shareholder derivative complaints that have been filed in state and federal court and demand that we take action to recover damages from our senior officers and directors and to correct deficiencies in our internal controls. The letters state that if, within a reasonable time, our board of directors has not commenced the requested action, or if our board of directors refuses to commence the requested action, the named shareholders will commence derivative actions. We have responded in writing to counsel for the purported shareholders, stating that our board of directors is considering the demands and will respond in a reasonable time.

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Fabrik Petition

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

Other Legal Proceedings

The United States Securities and Exchange Commission (SEC) is conducting a formal investigation involving trading in our securities. Certain of our officers and employees, including our CEO and President, have received subpoenas in connection with the SEC s investigation. We are fully cooperating with the SEC in regards to this matter.

We are involved in other suits and claims in the ordinary course of business, and we may from time to time become a party to other legal proceedings arising in the ordinary course of business.

As is common in the industry, we currently have in effect a number of agreements in which we have agreed to defend, indemnify and hold harmless certain of our suppliers and customers from damages and costs which may arise from the infringement by our products of third-party patents, trademarks or other proprietary rights. The scope of such indemnity varies, but may, in some instances, include indemnification for damages and expenses, including attorneys fees. The term of these indemnification agreements is generally perpetual any time after execution of the agreement. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited. We have never incurred significant costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, we believe the estimated fair value of these agreements is minimal. Accordingly, no liabilities for these agreements have been recorded as of June 30, 2010.

ITEM 1A. RISK FACTORS

Our business, operating results and cash flows can be impacted by a number of factors, any one of which could cause our actual results to vary materially from recent results or from our anticipated future results. The descriptions below include any material changes to and supersede the description of the risk factors affecting our business previously disclosed in Part I, Item 1A. Risk Factors of our Annual Report on Form 10-K for the fiscal year ended December 31, 2009. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also impair our business operations.

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

Historically, sales to a relatively limited number of customers have accounted for a significant percentage of our revenues. In the six months ended June 30, 2010 and June 30, 2009, sales to our ten largest customers accounted for an aggregate of 83.0% and 82.3%, respectively, of our total revenues. In 2009, our largest customer was EMC Corporation, which accounted for 45.1% of our total revenues.

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

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

The enterprise Flash-based SSD market is new and rapidly evolving. As a result, we may encounter risks and uncertainties related to our business and future prospects. It is difficult to predict, with any precision, end user adoption rates, customer demand for our products or the future growth rate and size of this market. The rapidly evolving nature of the markets in which we sell our products and services, as well as other factors that are beyond our control, reduce our ability to accurately evaluate our future outlook and forecast quarterly or annual performance. Furthermore, our ability to predict future sales is limited because our SSDs are currently offered as options in our customers systems. Therefore, the demand for SSDs is unpredictable and fully dependent on end user requirements. Unless and until our SSDs are offered as a standard feature in our customers systems, this product runs the risk of serving a niche market and may never reach mass adoption.

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

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

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

Our dependence on a small number of suppliers for components, including IC devices, and our inability to obtain a sufficient supply of these components on a timely basis could harm our ability to fulfill orders.

Typically IC devices represent more than 80% of the component costs of our products. We are dependent on a small number of suppliers that supply key components used in the manufacture of our products. Since we have no long-term supply contracts, there is no assurance that our suppliers will agree to supply the quantities of components we may need to meet our production goals. In the first six months of 2010, Samsung and Toshiba supplied substantially all of the IC devices used in our Flash memory products while Micron and Samsung supplied substantially all of the DRAM IC devices used in our DRAM products.

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

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

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

- The inability to obtain an adequate supply of components;
- Price increases, late deliveries and poor component quality;
- An unwillingness of a supplier to supply such components to us;
- A key supplier s or sub-supplier s inability to access credit necessary to operate its business;
- Failure of a key supplier to remain in business or adjust to market conditions;
- Consolidation among suppliers, resulting in some suppliers exiting the industry or discontinuing the manufacture of components; or
- Failure of a supplier to meet our quality, yield or production requirements.

A disruption in or termination of our supply relationship with any of our significant suppliers or our inability to develop relationships with new suppliers, if required, would cause delays, disruptions or reductions in product shipments or require product redesigns which could damage relationships with our customers, increase our costs or the prices of our products and adversely affect our revenues and business.

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

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

We have experienced, and may experience in the future, delays in the development and introduction of new products. These delays would provide a competitor a first-to-market opportunity and allow a competitor to achieve greater market share. Once a customer designs a competitor s product into its product offering, it becomes significantly more difficult for us to sell our products to that customer because changing suppliers involves significant cost, time, effort and risk for the customer. Our product development is inherently risky because it is difficult to foresee developments in technology, anticipate the adoption of new standards, coordinate our technical personnel, and identify and eliminate design flaws. Defects or errors found in our products after commencement of commercial shipments could result in delays in market acceptance of these products. New products, even if first introduced by us, may not gain market acceptance or result in future profitability. Lack of market acceptance for our new products will jeopardize our ability to recoup research and development expenditures, hurt our reputation and harm our business, financial condition and results of operations. In addition, after we have developed a new product, our customers will usually test and evaluate our products. Our customers may need three or more months to test, evaluate and adopt our products and an additional three or more months to begin volume production of equipment that incorporates our products. Even if a customer selects our product to incorporate into its equipment, we have no assurance that the customer will ultimately bring its product to market or that such effort by our customer will be successful.

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We may also seek to develop products with new standards for our industry; however, it will take time for these new standards and products to be adopted, for customers to accept and transition to these new products and for significant sales to be generated from them, if this happens at all. Moreover, broad acceptance of new standards or products by customers may reduce demand for our older products. If this decreased demand is not offset by increased demand for our new products, our results of operations could be harmed. There can be no assurances that any new products or standards we develop will be commercially successful.

Disruption of operations at our manufacturing facilities in Penang, Malaysia would substantially harm our business.

Substantially all of our manufacturing operations are located in Penang, Malaysia. Due to this geographic concentration, a disruption of our manufacturing operations, whether as a result of sustained process abnormalities, human error, government intervention or natural disasters, including earthquakes, power failures, fires or floods, or otherwise, could cause us to cease or limit our manufacturing operations which would harm our business, financial condition and results of operations.

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

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

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

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

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

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

- Problems or delays in successfully closing the acquisition;
- Problems or delays assimilating and integrating the purchased operations, personnel, technologies, products and information systems;
- Unanticipated costs and expenditures associated with the acquisition, including any need to infuse significant capital into the acquired operations;

- Adverse effects on existing business relationships with suppliers, customers and strategic partners;
- Risks associated with entering markets and foreign countries in which we have limited or no prior experience;
- Contractual, intellectual property or employment issues;
- Potential loss of key employees of purchased organizations; and
- Potential litigation arising from the acquired company s operations before the acquisition.

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

We are unable to predict whether or when any prospective acquisition candidate will become available or the likelihood that any acquisition will be completed. Even if we do find suitable acquisition opportunities, we may not be able to consummate the acquisitions on commercially acceptable terms or realize the anticipated benefits of any acquisitions we do undertake.

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

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

- Impact of changing and recently volatile U.S. and global economic conditions;
- Our suppliers production levels for the components used in our products;
- Our ability to procure required components;
- Market acceptance of new and enhanced versions of our products;
- Expansion of our international business, including the opening of offices and facilities in foreign countries;
- The timing of the introduction of new products or components and enhancements to existing products or components by us, our competitors or our suppliers;
- Fluctuations in the cost of components and changes in the average sales prices of our products;
- Fluctuating market demand for our products;
- Changes in our customer or product revenue mix;
- The loss of one or more of our customers;
- Our ability to successfully integrate any acquired businesses or assets;
- Expenses associated with the start up of new operations or divisions;
- Order cancellations, product returns, inventory buildups by customers and inventory write-downs;
- Manufacturing inefficiencies associated with the start-up of new manufacturing operations, new products and volume production;

- Expenses associated with strategic transactions, including acquisitions, joint ventures and capital investments;
- Our ability to adequately support potential future rapid growth;
- Our ability to absorb manufacturing overhead if revenues decline;
- The effects of litigation; and
- Increases in our sales and marketing and research and development expenses in connection with decisions to pursue new product initiatives.

Due to such factors, quarterly revenues and results of operations are difficult to forecast, and period-to-period comparisons of our operating results may not be predictive of future performance. In one or more future quarters, our results of operations may fall below the expectations of securities analysts and investors. In that event, the market price of our common stock would likely decline. In addition, the market price of our common stock may fluctuate or decline regardless of our

operating performance.

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

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

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

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

If we are unable to properly monitor, control and manage our inventory and maintain an appropriate level and mix of products to support our customers needs, we may incur increased and unexpected costs associated with our inventory. If we manufacture products in anticipation of future demand that does not materialize, or if a customer cancels outstanding orders, we could experience an unanticipated increase in our inventory that we may be unable to sell in a timely manner, if at all. For example, during 2009, we significantly increased our non-cancelable inventory purchase commitments as a result of the actual and anticipated growth in orders for our Zeus^{IOPS} products. If demand does not meet our expectations, we could incur increased expenses associated with writing off excess or obsolete inventory. We also maintain inventory, or hubbing, arrangements with certain of our customers. Pursuant to these arrangements, we deliver products to a customer or a designated third party warehouse based upon the customer s projected needs but do not recognize product revenue unless and until the customer has removed our product from the warehouse to incorporate into its end products. If a customer does not take our products under a hubbing arrangement in accordance with the schedule it originally provided us, our predicted future revenue stream could vary substantially from our forecasts and our results of operations could be materially and adversely affected. Additionally, since we own inventory that is physically located in a third party s warehouse, our ability to effectively manage inventory levels may be impaired, causing our total inventory turns to decrease, which could increase expenses associated with excess and obsolete inventory and negatively impact our cash flow. In addition, while we may not be contractually obligated to accept returned products, we may determine that it is in our best interest to accept returns in order to maintain good relationships with our customers. Product returns would increase our inventory and reduce our revenues. Alternatively, we could end up with too little inventory and we may not be able to satisfy demand, which could have a material adverse effect on our customer relationships. Our risks related to inventory management are exacerbated by our strategy of closely matching inventory levels with product demand, leaving limited margin for error. We have had to write-down inventory in the past for reasons such as obsolescence, excess quantities and declines in market value below our costs. These inventory write-downs were $1.3 million and $3.6 million in the first six months of 2010 and 2009, respectively.

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

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

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

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

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

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In addition, from time to time, our industry experiences shortages in IC devices and foundry services which have resulted in placing customers for such products and services, including us, on component allocation. This means that while we may have customer orders, we may not be able to obtain the materials that we need to fill those orders in a timely manner or at competitive prices. As a result, our reputation could be harmed, we may lose business from our customers, our revenues may decline, and we may lose market share to our competitors who are not similarly affected.

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

As described in detail in Item 1. Legal Proceedings of Part II of this Quarterly Report on Form 10-Q, purported class action complaints were filed in the U.S. District Court for the Central District of California from November 6, 2009 through March 2, 2010, alleging, among other things, that our company and certain of our officers and directors violated the federal securities laws by issuing materially false and misleading statements. In addition, purported shareholder derivative complaints were filed in Orange County Superior Court from November 12, 2009 through December 3, 2009 against certain of our officers and directors based on allegations substantially similar to those set forth in the purported class action complaints. The two derivative lawsuits were consolidated on April 13, 2010. Regardless of the merits, the expense of defending such litigation may have a substantial impact if our insurance carriers fail to cover the cost of the litigation, and the time required to defend the actions could divert management s attention from the day-to-day operations of our business, which could adversely affect our business, results of operations and cash flows. In addition, an unfavorable outcome in such litigation could have a material adverse effect on our business, results of operations and cash flows.

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

The manufacture of our Flash controllers, Flash memory products and stacked DRAM products is a complex process, and it is often difficult for companies such as ours to achieve acceptable product yields. Reduced yields could decrease available supply and increase costs. Flash controller yields depend on both our product design and the manufacturing process technology unique to our semiconductor foundry partners. Because low yields may result from either design defects or process difficulties, we may not identify yield problems until well into the production cycle, when an actual product defect exists and can be analyzed and tested. In addition, many of these yield problems are difficult to diagnose and time consuming or expensive to remedy.

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

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

Our efforts to expand our business internationally may not be successful and may expose us to additional risks that may not exist in the United States, which in turn could cause our business and operating results to suffer.

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

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

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

- Difficulties and costs of staffing and managing operations in certain foreign countries;
- Foreign laws and regulations, which may vary country by country, and may impact how we conduct our business;
- Higher costs of doing business in certain foreign countries, including different employment laws;
- Difficulty protecting our intellectual property rights from misappropriation or infringement;
- Political or economic instability;
- Changes in import/export duties;
- Necessity of obtaining government approvals;
- Trade restrictions;
- Work stoppages or other changes in labor conditions;
- Difficulties in collecting accounts receivables on a timely basis or at all;
- Taxes;
- Longer payment cycles and foreign currency fluctuations; and

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

In addition, changes in policies and/or laws of the U.S. or foreign governments resulting in, among other things, higher taxation, currency conversion limitations, restrictions on fund transfers or the expropriation of private enterprises, could reduce the anticipated benefits of our international expansion. Moreover, as a result of our international operations, we are subject to tax in multiple jurisdictions. If any taxing authority (in the U.S. or otherwise) were to successfully challenge our interpretation of the applicable tax laws or our determination of the income and expenses attributable to operations in a specific jurisdiction, we could be required to pay additional taxes, interest and penalties. Furthermore, any actions by countries in which we conduct business to reverse policies that encourage foreign trade or investment could adversely affect our business. If we fail to realize the anticipated revenue growth of our future international operations, our business and operating results could suffer.

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

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

The volatility of general economic conditions and fluctuations in currency exchange rates affect the prices of our products and the prices of the components used in our products. International sales, which are derived from billings to foreign customers, accounted for 62% and 42%, of our total revenues for the six months ended June 30, 2010 and June 30, 2009, respectively. During the six months ended June 30, 2010, 21% and 19% of our revenues were derived from billings to customers in the Malaysia and Singapore, respectively. During the six months ended June 30, 2009, 14% and 11% of our revenues were derived from billings to customers in Taiwan and Malaysia, respectively. For the first six months of 2010 and the first six months of 2009 more than 95% of our international sales were denominated in U.S. dollars, and if the U.S. dollar experiences significant appreciation relative to the currency of a specific country, the prices of our products will rise in such country and our products may be less competitive. In addition, we cannot be sure that our international customers will continue to be willing to place orders denominated in U.S. dollars. If they do not, our revenues and results of operations will be subject to foreign exchange fluctuations, which could harm our business. We do not hedge against foreign currency exchange rate risks.

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

Our international sales are subject to other risks, including regulatory risks, tariffs and other trade barriers, timing and availability of export licenses, political and economic instability, difficulties in accounts receivable collections, difficulties in managing distributors, lack of a significant local sales presence, difficulties in obtaining governmental approvals, compliance with a wide variety of complex foreign laws and treaties and potentially adverse tax consequences. In addition, the U.S. or foreign countries may implement quotas, duties, taxes or other charges or restrictions upon the importation or exportation of our products, leading to a reduction in sales and profitability in that country.

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

Our intellectual property is critical to our success. As of June 30, 2010, we owned 22 patents and 54 additional patent applications were pending. We protect our intellectual property rights through patents, trademarks, copyrights and trade secret laws, confidentiality procedures and employee disclosure and invention assignment agreements. It is possible that our efforts to protect our intellectual property rights may not:

- Prevent the challenge, invalidation or circumvention of our existing patents;
- Result in patents that lead to commercially viable products or provide competitive advantages for our products;
- Prevent our competitors from independently developing similar products, duplicating our products or designing around the patents owned by us;
- Prevent third-party patents from having an adverse effect on our ability to do business;
- Provide adequate protection for our intellectual property rights;
- Prevent disputes with third parties regarding ownership of our intellectual property rights;
- Prevent disclosure of our trade secrets and know-how to third parties or into the public domain; and

Result in patents from any of our pending applications.

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

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

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

The semiconductor industry is characterized by vigorous protection and pursuit of intellectual property rights. We believe that it may be necessary, from time to time, to initiate litigation against third parties to preserve our intellectual property rights. Some of our suppliers and licensors have generally agreed to provide us with various levels of intellectual property indemnification for products and technology we purchase or license from them. A third party could claim that our products infringe or contribute to the infringement of a patent or other proprietary right. In addition, from time to time, we have received, and may continue to receive in the future, notices that claim we have infringed upon, misappropriated or misused other parties proprietary rights. Any of the foregoing events or claims could result in litigation. Such litigation, whether as plaintiff or defendant, would likely result in significant expense to us and divert the efforts of our technical and management personnel, whether or not such litigation is ultimately determined in our favor. In the event of an adverse result in such litigation, we could be required to pay substantial damages, cease the manufacture, use and sale of certain products, expend significant resources to develop, license or acquire non-infringing technology, discontinue the use of certain processes or obtain licenses to use the infringed technology. In addition, our suppliers and licensors obligation to indemnify us for intellectual property infringement may be insufficient or inapplicable to any such litigation or other claims of intellectual property infringement. A license may not be available on commercially reasonable terms, if at all. Our failure to obtain a license on commercially reasonable terms, or at all, could cause us to incur substantial costs and suspend manufacturing products using the infringed technology. If we obtain a license, we would likely be required to pay license fees or make royalty payments for sales under the license. Such payments would increase our costs of revenues and reduce our gross margins and gross profit. If we are unable to obtain a license from a third party for technology, we could incur substantial liabilities or be required to expend substantial resources redesigning our products to eliminate the infringement. There can be no assurance that we would be successful in redesigning our products or that we could obtain licenses on commercially reasonable terms, if at all. Product development or license negotiating would likely result in significant expense to us and divert the efforts of our technical and management personnel.

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

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

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

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

Incurring indebtedness could adversely affect our cash flow and prevent us from fulfilling our financial obligations.

On July 30, 2008, we entered into a credit agreement for a $35 million revolving credit facility, and on November 23, 2009, we entered into a credit agreement for a $10 million short-term credit facility. As of the date of the end of the period covered by this report, we do not have outstanding borrowings under these credit facilities; however, we may incur debt in the future which could have important consequences, such as:

Requiring us to dedicate a portion of our cash flow from operations and other capital resources to debt service, thereby reducing our ability to fund working capital, capital expenditures, and other cash requirements;

Increasing our vulnerability to adverse economic and industry conditions;

- Limiting our flexibility in planning for, or reacting to, changes and opportunities in, our business and industry, which may place us at a competitive disadvantage; and

- Limiting our ability to incur additional debt on acceptable terms, if at all.

If we were to default under our credit agreements and were unable to obtain a waiver for such a default, interest on the obligations would accrue at an increased rate and the lenders could accelerate our obligations under the credit agreements. Acceleration will be automatic in the case of bankruptcy and insolvency events of default.

Additionally, to the extent we have made intercompany loans to our subsidiaries that have required us to pledge such loans to the lenders under the credit agreements, our subsidiaries would be required to pay the amount of the intercompany loans to the lenders in the event we are in default under the credit agreements. Any actions taken by the lenders against us in the event we are in default under the credit agreements could harm our financial condition. Finally, the credit facilities contains certain restrictive covenants, including provisions restricting our ability to incur additional indebtedness, guarantee certain obligations, create or assume liens and pay dividends.

Failure to maintain effective internal control over financial reporting could result in a negative market reaction.

Section 404 of the Sarbanes-Oxley Act of 2002 requires that we thoroughly examine, document and test our internal control systems and procedures for financial reporting. Section 404 also requires us to evaluate the effectiveness of our internal control over financial reporting as of the end of each year, and to include a management report assessing the effectiveness of our internal control over financial reporting in our annual reports. In addition, Section 404 requires our independent registered public accounting firm to annually attest to, and report on, the effectiveness of our internal control over financial reporting.

Although our management has determined, and our independent registered public accounting firm has attested, that our internal control over financial reporting was effective as of December 31, 2009, we cannot assure you that we or our independent registered public accounting firm will not identify a material weakness in our internal control over financial reporting in the future. If our internal control over financial reporting is not considered adequate, we may experience a loss of public confidence, which could have an adverse effect on our business and our stock price.

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

Our business is subject to regulation by various U.S. federal, state, local and foreign governmental agencies. Such regulation includes employment and labor laws, workplace safety, product safety, environmental laws, consumer protection laws, import/export controls, federal securities laws and tax. In certain jurisdictions, such regulatory requirements may be more stringent than in the U.S. Noncompliance with applicable regulations or requirements could subject us to investigations, sanctions, mandatory product recalls, enforcement actions, disgorgement of profits, fines, damages, civil and criminal penalties, or injunctions. These enforcement actions could harm our business, financial condition, results of operations and cash flows. If any governmental sanctions are imposed, or if we do not prevail in any possible civil or criminal litigation, our business, financial condition, results of operations and cash flows could be materially adversely affected. In addition, responding to any action will likely result in a significant diversion of management s attention and resources and an increase in professional fees.

As described in Item 1. Legal Proceedings of Part II of this Quarterly Report on Form 10-Q, the United States Securities and Exchange Commission (SEC) is conducting a formal investigation involving trading in our securities. Certain of our officers and employees, including our CEO and President, have received subpoenas in connection with this investigation. We are fully cooperating with the SEC in regards to this matter.

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

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

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

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

We operate in different countries throughout the world and are subject to taxation in a variety of jurisdictions. As a result, our future effective tax rates could be impacted by changes in the applicable tax laws of such jurisdictions or the interpretation of such tax laws. For example, in February 2010, the U.S. Treasury Department released its annual proposed changes to the tax rules including changes for U.S. corporations doing business outside the U.S. The proposed changes include provisions to tax excess returns associated with the transfer of intangible assets offshore, limit the ability of U.S. corporations to deduct interest expense attributable to foreign earnings deferred abroad, and modify the foreign tax credit rules. Many of these changes have been proposed to be effective for tax years beginning January 1, 2011. We cannot determine whether these proposals will be enacted into law or what changes, if any, may be made to such proposals prior to their being enacted into law. Depending on their content, such proposals (if enacted) or other changes in the applicable tax laws could increase our effective tax rate and adversely affect our future after-tax profits.

Risks related to our common stock

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

Manouch Moshayedi and Mark Moshayedi are brothers who (along with a third brother Mike Moshayedi) founded our company. They have owned a substantial amount of shares since our inception and prior to our initial public offering in 2000. As of June 30, 2010, Manouch and Mark Moshayedi beneficially owned approximately 15% of our outstanding common stock (assuming the inclusion of shares of common stock subject to options that are exercisable within 60 days). As shareholders, Manouch and Mark Moshayedi may have interests that diverge from those of other holders of our common stock. In addition, Manouch and Mark Moshayedi are executive officers and directors. As a result, they have the potential ability to control or influence all matters requiring approval by our shareholders, including approval of significant corporate transactions and the decision of whether a change in control will occur. This potential control could affect the price that certain investors may be willing to pay in the future for shares of our common stock.

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

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

These provisions include:

- Limitations on who may call special meetings of shareholders;
- Advance notice requirements for nominations for election to the board of directors or for proposing matters that can be acted upon by shareholders at shareholder meetings;
- Elimination of cumulative voting in the election of directors;
- The right of a majority of directors in office to fill vacancies on the board of directors; and
- The ability of our board of directors to issue, without shareholder approval, blank check preferred stock to increase the number of outstanding shares and thwart a takeover attempt.

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

Our stock price is likely to be volatile, which could cause the value of your investment to decline.

Our common stock has been publicly traded since September 2000. The market price of our common stock has been subject to significant fluctuations since the date of our initial public offering. The stock market has from time to time experienced significant price and volume fluctuations that have affected the market prices of securities, particularly securities of technology companies. As a result, the market price of our common stock may materially decline, regardless of our operating performance. Following periods of volatility in the market price of a particular company s securities, securities class action litigation has often been brought against that company and such litigation has in fact been brought against us. Litigation of this type is often expensive, diverts management s attention and resources and may have a material adverse effect on our business and operating results.

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ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Issuer Purchases of Equity Securities

The following is a summary of our common stock repurchased and average price paid per share for the three months ended June 30, 2010:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Programs	Maximum Dollar Value that May Yet be Purchased Under the Programs
As of March 31, 2010	1,335,541	$ 3.74	1,335,541	
April 1 through April 30, 2010				
May 1 through May 31, 2010				
June 1 through June 30, 2010				
Total	1,335,541	$ 3.74	1,335,541	$ 75,000,000(1)

(1) In November 2009, our board of directors authorized another share repurchase program effective November 10, 2009, enabling us to repurchase up to $75 million of our common stock over an 18-month period expiring on May 9, 2011. Repurchases under our share repurchase programs were and will be made in open market or privately negotiated transactions in compliance with Rule 10b-18 promulgated under the Securities Exchange Act of 1934, as amended. There is no guarantee as to the exact number of shares that will be repurchased by us, and we may discontinue repurchases at any time that management determines that additional repurchases are not warranted. Repurchased shares were returned to the status of authorized but unissued shares of common stock and may be issued by us in the future. All shares were repurchased pursuant to our existing share repurchase programs.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. (REMOVED AND RESERVED)

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

Exhibit Number	Description
10.1	STEC, Inc. 2010 Incentive Award Plan (filed as Appendix A to the Proxy Statement for the 2010 Annual Meeting of Shareholders on April 16, 2010 and incorporated herein by reference).
10.2	Form of Employee Stock Option Grant Notice and Stock Option Agreement (filed as Exhibit 99.2 to the Registration Statement on Form S-8 (File No. 333-167171) on May 28, 2010 and incorporated herein by reference).

10.3	Form of Restricted Stock Unit Award Grant Notice and Restricted Stock Unit Award Agreement (filed as Exhibit 99.3 to the Registration Statement on Form S-8 (File No. 333-167171) on May 28, 2010 and incorporated herein by reference).
10.4	Form of Non-Employee Director Stock Option Grant Notice and Stock Option Agreement (filed as Exhibit 99.4 to the Registration Statement on Form S-8 (File No. 333-167171) on May 28, 2010 and incorporated herein by reference).
31.1	Section 302 Certification of Chief Executive Officer
31.2	Section 302 Certification of Chief Financial Officer
32.1*	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2*	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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Exhibit Number	Description
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

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

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

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SIGNATURES

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

STEC, INC.,

a California corporation

Date: August 3, 2010

/s/ RAYMOND COOK

Raymond Cook
Chief Financial Officer
(Principal Financial Officer and Duly Authorized Signatory)

STEC, INC.

Index to Exhibits

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